UNIVERSITY OF KWAZULU NATAL

THE CONTRIBUTION OF PRIVATE EQUITY CAPITAL TO ENTERPRISE DEVELOPMENT IN SOUTH AFRICA

By

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Abstract

Employment, economic growth and self-reliance are the appetites of every country. Small enterprise development is seen as an effective solution towards this goal depending on the availability of resources. Private equity finance is one of the key resources to enterprise development in a country. International case studies have shown that private equity finance can lead to enterprise development in a country.

The aim of the study is to determine the contribution of private equity finance to enterprise development in South Africa. In order to get views from other role players in the private equity finance market, questionnaires were distributed to 200 private equity finance players and the response rate was 39%. The sample size comprised 61.5% males and 38.5% females. The majority of the participants were in the age group 25–34 and constituted 53% of the respondents, whilst those aged 35–49 years constituted 35.9%. A smaller number of respondents were in the age group 18–24 and 50 and above, which both comprised 11.5% as an aggregate.

The results revealed that there is a positive correlation between enterprise development and private equity capital with 83% of the respondents agreeing and strongly agreeing that the business skills and expertise brought by private equity investors increase business performance. Of the respondents, 74.4% strongly agree and agree with the notion that most Small and Medium Enterprises do need the intervention of private equity investors.

It is recommended that the government, through relevant legislation, needs to promote and encourage private equity investment. Some form of private equity investment such as angel investment needs to be formalized, as is available in other countries such as the United States of America and some countries in Europe.

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List of Acronyms

(AC) Angel Capital

(BEE) Black Economic Empowerment

(BVCA) British Venture Capital Association

(CSI) Corporate Social Investment

(CSR) Corporate Social Responsibility

(DTI) Department of Trade and Industry

(DFI) Development Funding Institution

(DCF) Discounted Cash Flow

(EVCA) European Venture Capital Association

(GEPF) Government Employees Pension Fund

(GIRR) Gross Internal Rate of Return

(HDI) Historically Disadvantaged Individuals

(IDC) Industrial Development Corporation

(IPO) Initial Public Offering

(IRR) Internal Rate of Return

(IFC) International Finance Corporation

(JSE) Johannesburg Securities Exchange

(LBO) Leverage Buy-Out

(MBIs) Management buy-ins

(MBOs) Management buy-outs

(MIRR) Marginal Internal Rate of Return

(NEF) National Empowerment Fund

(NSBAA) National Small Business Amendment Act

(NPV) Net Present Value

(OECD) Organisation for Economic Cooperation and Development

(PIC) Public Investment Corporation

(SME) Small and Medium Enterprises

(SMMEs) Small Medium and Micro Enterprises

(SBICs) Small Business Investment Companies

(SAVCA) South African Venture Capitalists Association

(AIM) The Alternative Investment Market

(ALTX) The Alternative Stock Exchange

(SAEDF) The South African Enterprise Development Fund

(USM) The Unlisted Security Market

(VC) Venture Capital

(WACC) Weighted Average Cost of Capital

CHAPTER 1: INTRODUCTION AND BACKGROUND TO THE STUDY

1.1 Introduction

There is an increasing public awareness and interest all over the world of the roles and functions of private equity and entrepreneurship in contributing to economic growth through the development of successful businesses. The global evidence has demonstrated that private sector development is the key to economic growth and development in any country. Ladzani and van Vuuren (2002:2) argue that the development of small, medium and micro-enterprises (SMMEs) contributes significantly to job creation, social stability and economic welfare across the globe. Scarborough and Zimmerer (1996:10) as quoted by Mutezo (2005:1), assert that in the United State of America (USA), for example, SMMEs have introduced innovative products and services, created new jobs, opened foreign markets, and in the process ignited the USA's economy into regaining its competitive edge in the global economy. Mutezo (2005:1) contends that for the private sector to grow, it needs to have access to finance, accompanied by a strong mentoring and management support system. The type of finance required in this scenario can be found in the private equity capital finance arrangement.

The concept of private equity capital financing is very crucial in relation to Small, Medium and Micro Enterprises (SMMEs) in South Africa due to the exploding population growth level with its skyrocketing unemployment level. This sector of the economy (SMMEs) often finds it very difficult to source finance as most of its players are not considered financially viable by traditional sources of business financing. It is for this reason that the question of private equity capital funding emerges as the panacea of the above mentioned problem. For the purpose of this research the study will concentrate on the Small and Medium Enterprises (SMEs).

The KPMG report (2001:8) defines private equity capital essentially as money that is invested in a company in exchange for an ownership interest in the business. The same report further explains that investors do not intend to be permanent in the business but exit the business within five to seven years by selling the shares they own. The British Venture Capital Association (BVCA) guide to private equity (2007:4) states that in the UK, Continental Europe and much of the rest of the world, ‘private equity’ means the equity financing of unquoted companies at many stages in the life of a company, from start-up to expansion, together with management buy-outs and buy-ins, often by established companies.

Hayes, Missankov, van Biljon, van Dyk and van der Veen (2006:9) argue that private equity investing may be defined as investment in securities through a negotiated process. The majority of private equity investments are in unquoted companies. Hayes et al. (2006:9) further assert that private equity investment is typically a transformed, value added and an active investment strategy. It calls for a specialised set of skills which is a key due diligence area for investors’ assessment of a business. The process of buy-out and venture investing calls for different applications of these skills as they focus on different stages of the life of a company (Hayes et al., 2006: 6).

Jones (2003:1) expresses the view that the terms ‘venture capital’ and ‘private equity’ are often used interchangeably and their respective definitions vary from country to country. This creates an issue of comparability of studies conducted in different jurisdictions with different definitions. This must therefore be kept in mind when making comparisons across borders. The South African Venture Capital Association (SAVCA) and the South African Private Equity Association have classified private equity into three sub-classes: venture capital, development capital and buy-out funding. This distinction is further supported in the KPMG Report (2006:8) which states that private equity entails the provision of equity to enterprises that are generally not listed on a public stock exchange. It can be used to develop new products and technologies, to expand working capital, to make new acquisitions or to strengthen a business’ balance sheet. It can also facilitate 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.

Private equity capital, unlike debt, is not intended to be repaid according to a specific arrangement and is not secured (or guaranteed) by the company's assets. Instead, an equity investor (i.e. the individual or entity that supplies the company with the money) expects that, within a certain time frame, the ownership percentage held will be worth more than the original amount invested (Venture Financing and Equity Investment, 2007).

There are different forms of equity capital funding. This funding can either take the form of Venture Capital (VC) or Angel Equity investor. Venture capitalists invest funds in early stages of businesses and more risk-oriented business endeavours. A VC funding arrangement will typically entail relinquishing fifty percent or more ownership and control of the business. Venture Capitalists typically expect a twenty six per cent annual return on their loan investment at the time of investment in a private company. They also invest in high growth companies with the potential to generate revenues of $20 million in single investment, with a typical investment ranging between $500,000 and $5 million (Venture Financing and Equity Investment, 2007).

To offset the high risk, investors envisage a high return on investment. The investment is usually in the form of stocks or convertible debentures. As the business matures, an initial public offering may take place, the business may merge, be sold or other sources of capital may be found. Any of these would occur with the intention of buying-out the venture capitalists. Management experience is a major consideration in evaluating financing prospects for any investment (Venture Financing and Equity Investment, 2007).

Other than the venture capitalist, the company may obtain funding from angel equity investors or business angels. Business angels are wealthy individuals, generally with substantial business and entrepreneurial experience who usually invest substantial amounts primarily in start-up, early stage or expanding firms. The majority of investments are in the form of equity finance but they do purchase debt instruments and preference shares. They usually do not purchase a controlling interest, and they are willing to invest at an earlier stage than most formal venture capitalists (Business Angel Finance, 2007).

Set against the above backdrop, this study attempts to investigate the contribution of private equity capital finance to the growth and development of enterprises in South Africa.

1.2 Motivation for the Study

Access to finance in South Africa is a very serious issue in particular with regard to the alienated sector of SMEs, which are considered to be very risky by most commercial banks. For this reason it is difficult for this sector to obtain business loans for start-ups. This view is supported by

Foxcroft, Wood, Kew, Herrington and Segal (2002:39), by stating that the availability of and access to finance for entrepreneurs in small enterprises is considered to be a problem in many countries.

Medium enterprises are also affected if it is taken into account that some are not qualified to raise equity capital on the stock market because of the size of the capital required. This has on many occasions resulted in good ideas being set aside or lost forever, simply due to lack of access to finance, as most of the players within the SMEs sector cannot provide all the securities required by most financiers (Foxcroft et al., 2002: 42).

The study focuses on business ventures that are victims of the capital market, the commercial banks and private financiers, who realise that there is an equity gap in the country and lastly, the government which could introduce some form of policy intervention to alleviate the equity gap problems.

Ebony Consulting International (2001:2) asserts that in South Africa most SMEs are under-capitalised and over-leveraged. Moreover, as has been shown above, many township entrepreneurs have a lack of collateral acceptable by the banks. Falkena, Abedian, von Blottnitz, and Magudulela (2001:206) further assert that this is due to the fact that before 1994, black entrepreneurs were legally hindered from accumulating assets and, therefore do not have access to collaterals. Falkena et al. (2001: 2006) state that private equity finance would be more suitable than debt finance and is one of the only options for entrepreneurs without collateral. However, currently the low-value equity market is under-serviced and the need for financing under R5m exists globally and internationally. This need is referred to as the 'equity gap' (Falkena et al., 2001: 2006).

1.3 The research problem

The researcher is of the opinion that to access equity capital finance in South Africa a company needs to be registered with the Johannesburg Securities Exchange (JSE) or the Alternative Stock Exchange (ALTX). This poses a problem for new and growing businesses in the country which cannot meet the requirements of either the JSE or the ALTX. In many instances such businesses which cannot meet the requirements of the above-mentioned institutions fall within the domain of SMEs. In most cases, such businesses resort to expensive debt capital, which impedes profits and growth potential. Lack of access to finance also hinders enterprise development in the country and wastes innovative ideas which may have had the potential to take the country to the next level of business trade.

The researcher is also suggest that an alternative way of making capital finance available is through private equity capital because it is less expensive and often the financiers contribute their managerial and technical expertise to participate actively in the day-to-day operations of the business.

The research problem raises the following questions:

- Does venture capital play a vital role in the development of enterprises in the country?
- Does private equity capital contribute significantly to the development of enterprises in South Africa?
- Does government play a meaningful role in the development of the private equity capital market in South Africa?

All the above questions explore the contribution of private equity finance to enterprise development in South Africa.

The purpose of this study is firstly to examine the extent to which private equity capital can enhance enterprise development in South Africa, particularly in the SMEs sector and, secondly, to make a comparison with other foreign countries.

1.4 Research objectives

The aim of the study is to explore the contribution of equity capital to enterprise development in South Africa and to make a comparison with other countries in the world.

The objectives of the study are:

- To explore the contribution of private equity capital finance to SMEs in South Africa;

- To explore the availability of private equity capital finance to SMEs in South Africa;
- To explore interventions by the government into the private equity capital finance market in South Africa;
- To explore the financial models used by the private equity capital investors.

1.5 Significance of the study

The South African cemeteries are full of corpses with papers of brilliant business ideas as their obituaries. This poses a serious problem to growth of business development in the country. The study intends to unveil the contributions of private equity capital to the development and growth of businesses in the country. Private equity capital finance is not only about capital injections into respective businesses, but it also involves the dilution of weak and inexperienced management, through investment and mentorship, into a solid management composition with proper vision and business expertise. Private equity capital financiers usually stay in the funded company for a minimum of five years, providing mentorship to inexperienced management in the company and business expertise to the company as a whole.

The Private equity capital market tries to alleviate the problem of companies with limited access to finance and other resources such as skills and management expertise. As mentioned earlier, SMEs normally do not have sufficient collateral or track record of profits to support bank borrowings or debt raisings. In cases where debt capital is available, it may be relatively expensive; hence, the issue of private equity capital emerges as an alternative.

Kadhikwa et al. (2005: 4-5) express the opinion that private equity finance can provide a crucial combination of capital, business mentoring and financial discipline to help and encourage enterprises to realise their growth potential. This financing and business development process supports wider economic growth by enabling structural change and redeploying capital rapidly to new businesses in new sectors. This industry plays an important role in mending the financial gap which cannot be addressed by other forms of financing, such as loans from commercial banks and other redeemable securities. Kadhikwa et al. (2005: 5) are also of the opinion that banks all over the world are perceived to be averse to the risk of long-term finance-unsecured projects. The study is significant in the sense that it unveils alternative opportunities of financing the alienated SMEs.

1.6 Literature survey

1.6.1 Defining the topic

The literature review provides the basis for defining the topic and focus of the study. 'The concept of equity capital explains what the owner of a business has contributed excluding the liabilities and debt capital. Equity finance is provided by the sale of ordinary shares to investors. This may be a sale of shares to new owners, perhaps through the stock market as part of a company seeking a quotation, or it may be a sale of shares to existing shareholders, for example by means of a rights issue. This sometimes poses problems to young and growing enterprises which cannot meet the requirements of both the ALTX and the JSE. Enterprises which cannot raise capital from these open markets are left with an equity gap' (Equity Gap Financing, 2007).

"To finance the gap the unquoted firms usually rely on retained earnings, capital injections from the founder and bank borrowings, but in most cases, these are not enough to finance growth aspirations. Thus, between large firms with access to the stock market and small firms financed by internally generated funds, personal and bank loans there is a financing gap. The finance equity gap confronts intermediate businesses which find themselves too large or too fast growing to ask the individual shareholders for more funds or to obtain sufficient bank finance, and they are not ready to launch on the stock market" (Equity Gap Finance, 2007).

The growth of private equity capital is the result of the equity gap left by the open capital market. Some of the new and growing enterprises, in particular SMEs, cannot be listed as a result of certain requirements. There are several ways in which the SMEs can raise capital to close this equity gab. These are business angels, venture capital and other options which provide equity capital (New Business Angels, 2007).

(a) Business angels

Business angels are wealthy individuals, generally with substantial business and entrepreneurial experience who usually invest substantial amounts primarily in start-up, early stage or expanding firms. The majority of investments are in the form of equity finance but they do purchase debt instruments and preference shares. They usually do not purchase a controlling interest, and they are willing to invest at an earlier stage than most formal venture capitalists (sometimes they call themselves 'informal venture capitalists' instead of business angels). They are generally looking for entrepreneurial companies which have high aspirations and potential for growth. Business angels are generally patient investors willing to hold their investment for at least a five-year period. The main way in which firms and angels find each other is through friends and business associates, although sometimes informal networks may be of help (New Business Angels, 2007).

Venture capital involves selling a stake in one's business to a financial investor in return for a capital injection. It is a longer-term investment than a loan and is generally only appropriate for businesses with reasonable growth potential. By taking a stake in one's business, the investor will expect to have some say in the way the business is run and to share in the profits and future value of the business. The investor seeks to make a profit on his/her investment by selling his/her stake in the business after 5 or 7 years. Venture capital can be provided by a firm of venture capitalists or by an individual business angel (New Business Angels, 2007).

(b) Venture capital

Venture capital funds provide finance for high-growth-potential unquoted firms. Venture capital is a medium- to long-term investment and may consist of a package of debt and equity finance. Venture capitalists take high risks by investing in the equity of young companies, often with a limited (or no) track record. Many of their investments are little more than a management team with a good idea which may not have started selling a product or even developed a prototype (Venture Capital Financing, 2007).

Jones (2003:1) explains that "venture capital is a source of equity capital provided on unlisted enterprises". It can be a means of providing capital for organic and acquisitive growth or to resolve ownership and management-related issues. The aim of venture capitalists is to generate returns on capital invested in a private business, and after a period of supporting the investment, to realise these returns on exit. The venture capital exits are traditionally through a listing on a stock exchange as an Initial Public Offering (IPO)) or through a trade sale (Jones S., 2003:1).

Kadhikwa, Uanguta and Zaaruka (2005:1) assert that venture capital specialises in providing finance to companies for use in product development and initial marketing. At this stage companies have not yet sold their products commercially. The venture capitalists may also continue to provide finance to companies that have completed product development and which require funds to start commercial sales.

The questions which arise from the above-mentioned private equity capital finance conundrum are its contribution to enterprise development in South Africa. Because of the historical background of the country most enterprises may possibly only be successful if private equity finance is accessible.

1.7 The Research design and methodology

A qualitative method of research in the form of snowballing was followed. In this case it was going to be difficult to identify members of the desired population. One case of the desired population helped to identify other further cases, and new cases also helped to identify further cases and so on. The process then stops when no new cases are given or when the sample size is large enough to justify reliable results (Saunders et al., 2003:176). It is for this reason that snowball sampling is considered most appropriate for the study.

1.7.1 Desk research

Desk research was used to understand the private equity industry in South Africa and to identify the key funds available for SME investment. Searches were also conducted to identify similar case studies in other countries, particularly in emerging markets. Primary interviews were held with Khula and Business Partners, as these organisations were believed to be the primary development-focused equity financiers in the industry. Interviews were conducted with some of the larger private equity financiers and DFIs to get their perspectives on development-focused and SME private equity.

1.7.2 Hypothesis generation

This pioneering research – with its broad objective of understanding the SME equity landscape and the techniques used for sustainable investment – was not suited to a hypothesis-driven approach. Desk research and high-level interviews were, however, used to focus the research in a few key areas.

1.7.3 Research questions

The following key questions will be posed to a number of people in this field of profession and study:

- Does venture capital play a vital role to the development of enterprises in the country?
- Does private equity capital contribute significantly to the development of enterprises in South Africa?
- Does government intervention play a meaningful role in the development of enterprises in South Africa?

The above-mentioned questions were refined or calibrated according to the literature survey.

1.7.4 Ethical requirements

- Before the practical part of the research commenced, permission was obtained from the Dean of the Faculty and dissertation supervisor;
- Ethical clearance was obtained from the University to conduct this research;
- Each company that was approached was given a letter of request, and permission was obtained for the interviews to be conducted;
- Honesty, fairness, and respect were observed throughout the study.

The researcher also respected the rights and dignity of the informants. The research participants were accorded the necessary privacy, confidentiality and autonomy. Questionnaires with attached letters of guarantee of privacy, autonomy and confidentiality were sent to participants. The researcher was also mindful of cultural and individual differences among people, such as age, gender, religion and socio-legal-economic status.

1.7.5 Sampling and sampling techniques

The population of private equity financiers comprises all institutions registered with the South African Venture Capital Association (SAVCA), Business angels and the banks. The sampling involved institutions in Gauteng and Western Cape provinces. The researcher first contacted SAVCA, and through referrals by them, contacts where made with the relevant institutions involved in the private equity capital market. The same process was followed in relation to business angels. The process of snowballing proceeded until the required sample population was reached. The sampling frame comprised of all role players involved in the private equity capital finance market. The sample population transcended ethnic and gender boundaries, to present viewpoints as widely varied as possible.

1.7.6 Method of data collection and data analysis

The dissertation documents equity capital finance in South Africa, in particular the private equity capital finance for SMEs. The study covers the Venture capital market, Angel capital market, government, ALTX and JSE. Much of the research is informed by the theoretical background presented in the literature review section. Data and information on private equity capital finance was collected through questionnaires, analysed and compared with secondary data already in existence in the country. The environment in which the equity capital financiers operate was also explored.

1.8 Chapter Outline

1.8.1 Chapter 1: Background of the study

Chapter 1 gives an overview of the structure of the dissertation within the background of the South African context. Global experience on private equity capital finance is mirrored as well. The following issues are addressed: the role of private equity to enterprise development in South Africa, the intervention of the government in encouraging private equity investment to SMEs and the correlation between enterprise development and private equity investment in South Africa. The research problem and objectives are followed by the research design and methodology.

1.8.2 Chapter 2: The role of private equity capital to enterprise development

Chapter 2 is the core of the study. It provides a comprehensive literature review on the definition of private equity investment and its contributions to enterprise development in South Africa. A global perspective of private equity investment case studies are also factored into the study.

1.8.3 Chapter 3: Data collection

Chapter 3 describes the research methodology applied in the study, the design of the questions for the empirical research formulated and the distributions of the questionnaires to the relevant target groups. Chapter 3 also describes the identification of the sample population and how the data gathered is analysed.

1.8.4 Chapter 4: Research results and tabulation

Chapter 4 pays attention to the interpretation of the empirical research results by means of quantitative analysis. The results are integrated with concepts identified in the literature review section to accurately determine the role of private equity investment to enterprise development in South Africa. Tables, pie charts and graphs are included to demonstrate the findings.

1.8.5 Chapter 5: Discussion of the research results

The findings of the research results are discussed using the research objectives as barometers. Each research objective is tabled and compared with the research results to check whether the study has been able to address the identified problem. Where the research objective is not met, a further research is recommended for the study in question.

1.8.6 Chapter 6: Conclusion and recommendation for further research

Chapter 6 gives a concluding overview of the research. The obstacles and problems identified are recommended for further research in subsequent studies. This chapter also brings to the fore key considerations and provides recommendations on problems identified. The chapter provides a summary of the research and conclusions relating to problems of private equity capital investment to enterprise development in South Africa.

1.9 Conclusion

This chapter provides an overview of this research dissertation. In this chapter the research is introduced, the problem statement and objectives are detailed, which crystallise the research problem. For the research problem to simplified and researchable, the research objectives were included. A brief background of the state of private equity in South Africa is given. This includes the forms of private equity which exist in the industry, the industry players as well as the intervention of the government in making sure that private equity capital becomes a success in South Africa so that the performance of SMEs' is enhanced. Chapter 1 includes the preliminary review of the relevant literature in preparation for the literature review. A brief synopsis of each chapter is then provided. Having provided an overview of this study in this chapter, the next chapter is a full review of literature on issues related to this study.

CHAPTER 2: LITERATURE REVIEW AND THEORETICAL FRAMEWORK

2.1 Introduction

South Africa is a developing country full of economic promise because of its abundance of raw materials such as minerals and agricultural produce. The challenge that is facing the country is the availability of capital. Chapter 2 looks into the sources of equity capital and how these can help to stimulate the economy. The listed security market is discussed. The unlisted security markets are alternative ways considered and discussed as sources of equity capital. Government intervention to make equity capital available is another alternative which the literature review has captured. This chapter notes the partnership between the Department of Trade and Industry (DTI) and the Johannesburg Stock Exchange in the formation of the Alternative Stock Exchange as a means of making private equity capital finance available to SMEs. The chapter also draws attention to the contribution of venture capital finance in the development of the country's economy. Broad relevant experiences and lessons for South Africa and from other countries are also highlighted in this chapter. The literature review supports the fact that other countries concurred with private equity financing as it serves as a gap-filler between self-financing and conventional capital market activity.

2.2 Equity capital

Equity is explained as the capital required for financing daily activities of the organisation when a firm is created, and the original shareholders will decide on the number of shares to be authorised (the authorised share capital). The authorised share capital is the maximum amount of share capital that the company can issue, unless shareholders vote to change the limit. In many cases firms do not issue to the amount specified (Equity Gap Financing, 2007).

The financial resources provided by the owners of a business constitute the equity capital or equity finance of the business. This is distinct from the borrowings made on behalf of a company or a business which are also used to fund the operations (Equity Gap Financing, 2007). These borrowings (debt capital) are liabilities of the business, as this is owed and payable to another party. Assets are items of value that can readily be converted into cash - they are economic resources owned by the business or company (Borrowed Capital…2003).

Firer, Jordan, Ross, Westerfield and Bradford (2004: 24) further explain equity capital in the form of the accounting equation which accountants have developed. This equation states that 'owners' equity (O) is equal to total assets (A) minus total liabilities (L) simply O = A - L. This equation separates debt capital from the capital contributed by owners. Firer et al. (2004: 24) again assert that equity capital finance is obtained by selling ordinary shares in a business to those who desire to invest.

Firer et al. (2004: 24) define the owners' equity, also called the shareholders' equity or net worth, as "the difference between the total value of the assets (current assets and non-current assets) and the total value of the liabilities (current and long-term)". A balance sheet reflects the residual value for the owners if all were sold and debts paid. A balance balances because the value of the right-hand side always equals the value of the left-hand side. In business terms, assets is equal to the sum of its liabilities and owner's equity: Assets = Liabilities + Owners' equity" (Firer et al., 2004: 24).

2.3 Sources of equity capital

Equity capital is defined as money that in contrast to debt capital is not repaid to the investors in the normal course of business. It represents the risk capital staked by the owners through purchase of the firm's common stock (ordinary shares). Its value is computed by estimating the current market value of everything owned by the firm from which the total of all liabilities are subtracted. On the balance sheet of the firm, equity capital is listed as stockholders' equity or owners' equity. This form of financing is also called equity financing or share capital. There are two types of shares for companies listed on a stock exchange: Ordinary shares and Preference shares (Equity Capital, 2005).

2.3.1 Ordinary shares

Amis and Stevenson (2001:120) describe ordinary shares as the 'complete faith option'. Jones (2003:79-80) refers to this as a portion of the financial structure of a company that is most at risk because the owners of a business are the last to share in the assets of a company if it is sold or liquidated and worse, they have no security over these assets. Shareholders other than employees, creditors and third party lenders are usually defined by a monetary amount. Ordinary shareholders enjoy the benefits of upside protection in the sense that they have an advantage of unlimited claim on the excess of assets over liabilities, although there is no guarantee as to the exact value of this amount.

Jones (2003:80) argues that a venture capitalist will usually use a pure ordinary share structure as an investment vehicle only when they have absolute trust in the entrepreneur or in the success of the venture.

2.3.2 Preference shares

Jones (2003:80-81) refers to preference shares as hybrid instruments representing both the qualities of equity and debt. Preference shares are part of the equity of a company, but their participation in the assets and profits are pre-defined. They have a preferential claim on assets above that of ordinary shares, but this claim would be capped at face value plus accrued dividends and would be subordinated to secured debts.

Firer et al. (2004: 233-234) explain that preference shareholders enjoy priority dividends over ordinary shareholders, normally with a fixed dividend rate and usually without voting rights. Preference shares can be cumulative and non-cumulative. The board of directors may decide not to pay the dividends on preference shares, and their decision may have nothing to do with the current profits of the company. Preference dividends are not debts of the firm. Directors elected by the ordinary shareholders can defer preference dividends indefinitely. However, in such cases, ordinary shareholders must forgo dividends and holders of preference shares are granted voting and other rights, if preference dividends are in arrears.

2.4 Equity capital markets

Equity capital is traded in markets across the world. In recent years there have been changes introduced with less formal platforms than the traditional securities exchange. A securities market which caters for SMMEs and with less stringent regulations has also been introduced (Equity Capital, 2005).

2.4.1 A stock or securities exchange

A stock exchange is an organisation which provides the platform to facilitate the trading of stocks and other securities. They facilitate the issue and redemption of securities and financial instruments. This involves trade in company shares and other investment products. In order for a security to be traded, it is required to be listed and traders must be members. The initial offering of stocks and bonds to investors is proposed in the primary market and subsequently done in the secondary market (Stock Exchange, 2003). The stock exchange provides a market to big and listed companies only. It does not cater for small and growing companies. In South Africa this is facilitated through the JSE (Stock Exchange, 2003).

2.4.2 Unlisted securities market

In some parts of the world, such as the United States of America, the Unlisted Security Market (USM) was introduced to assist small and medium-sized firms to raise capital. Here the requirements for admission to the USM are less onerous than for the stock exchange. For a company to be listed, it needs to have certain monetary values and adhere to stringent regulations set by the stock exchange (Security Markets, 2008).

2.4.3 The alternative investment market

The alternative Investment Market (AIM) was first introduced in 1995 in London. The driving philosophy behind AIM is to offer young and developing companies access to new sources of finance while providing investors with the opportunity to buy and sell in a trading environment. Costs are less and the rules are simplified. AIM companies are expected to comply with strict rules regarding the publication of price-sensitive information and the quality of annual and interim reports. When a company is floated a detailed prospectus is required (Security Markets, 2008).

2.4.4 The alternative exchange

In October 2003, the JSE launched 'an Alternative Exchange' called the ALTX, as a division of the JSE, modelled loosely on the Alternative Investment Market in London. The South African DTI is involved, as it is believed it will support small and medium-sized companies and promote black economic empowerment (BEE). The partnership between the JSE Limited and the DTI that formed the ALTX, gives smaller companies the opportunity to issue new shares, raise capital, widen their investor base and have their shares traded in a regulated market. The ALTX is specifically aimed at fast-growing businesses, start-ups, family-owned businesses, BEE companies and junior mining companies (An Alternative Exchange... 2003).

'The ALTX has lower fees and less stringent listing requirements. Companies with pre-tax profits of R8 million or less, and a minimum capital of R2 million, can apply for an ALTX listing. Other important requirements for ALTX listings are that: 'all directors must attend an induction programme, there must at least be 100 public shareholders, and company announcement must be published on the Johannesburg Securities Exchange news services and the ALTX site' (Security Markets…2008).

It is more appropriate for small businesses, as those companies wishing to list on ALTX require a share capital of R2 million in keeping with the less stringent requirements, whereas for the main JSE, a share capital of R25 million is required. What is required is a spread of 10% over 100 public shareholders, whilst on the JSE main board a company requires 300 public shareholders owning 20% of the shares (The Alternative Exchange, 2006).

2.4.5 The primary and secondary markets

These markets (JSE and ALTX) comprise a primary and a secondary market. The primary market, as shown in Figure 2.1, is where firms can raise new finance by selling shares to investors (Equity Gap Financing, 2007).

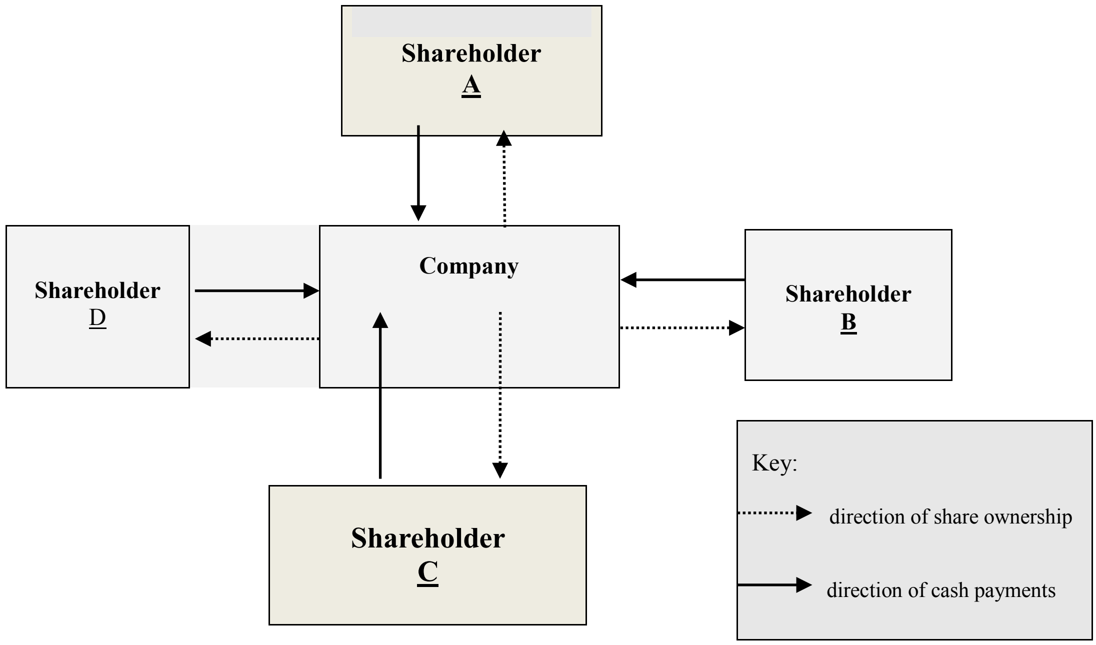

Figure 2.1: The Primary Market (Equity Gap Financing, 2007)

The secondary market, as shown in Figure 2.2, is where existing securities are sold by one investor to another (Equity Gap Financing, 2007). The investment remains in the company but the ownership changes hands between different shareholders. Thus, the flow of cash from the sale does not involve the company. However, trading values do impact on the perceived value of the company.

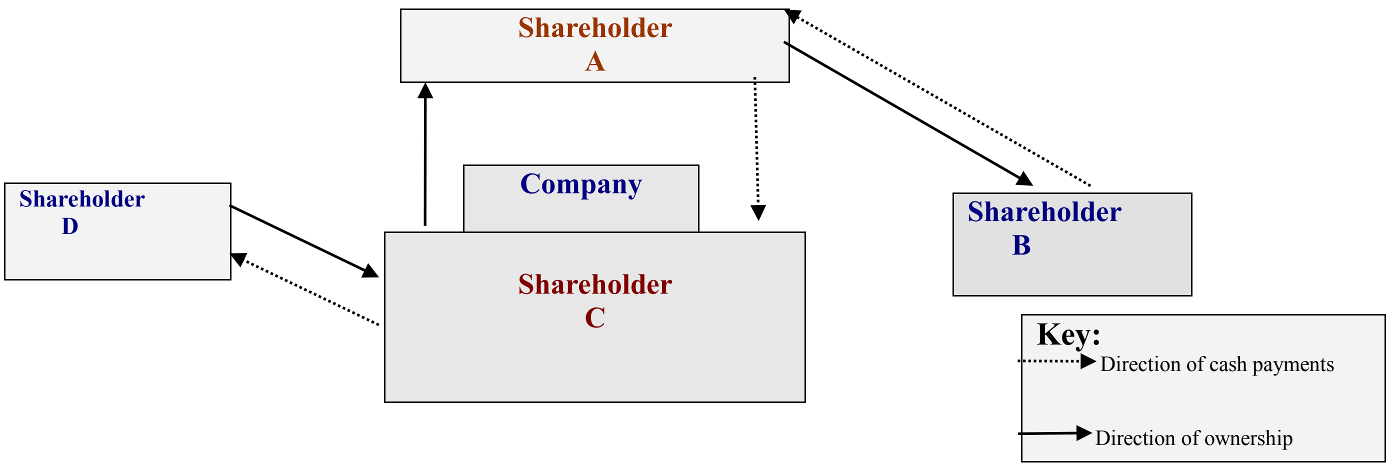

Figure 2.2: The Secondary Market (Equity Gap Financing, 2007)

2.4.6 The process of issuing shares

When a company is formed there will be the original owners, who have provided operating capital or the idea to launch the organisation. These shareholders (commonly known as promoters) in the organisation will decide on how many shares are to be offered for purchase by investors through the stock exchange. This is termed as the authorised share capital, being the maximum amount of share capital that the company can issue, until such time as the then current shareholders vote to change the limit. It is not necessary for all shares to be issued at the original time of issue (Equity Gap Financing, 2007).

When a company decides to become listed, it is a major step. This usually results in substantial investment in the company, which can lead to an accelerated phase of business growth. The full implications must be considered before this is done as this is a major legal undertaking, with greater responsibilities for the company (Equity Gap Financing, 2007).

Jones (2003: 116) concurs with the above statements by explaining that an Initial Public Offering (IPO) is the term given for the new listing of a company's shares on a public stock exchange. Jones (2003: 116) further asserts that venture capitalists aspire to achieve the stock exchange listing, as that it is their time to exit. It is the aspiration of SMEs to advance to the stage of listing because it is an indication of having achieved the growth stage which gives the venture capitalist the opportunity to exit. At this stage the venture capitalist shall have afforded the SMEs access to funding for further growth through the Securities Exchange, through the ALTX or JSE.

2.5 Equity for the unquoted firms

Not every company (especially the relatively small and medium firms - SMEs) has the opportunity of access to the Stock Exchange. Considering the ways in which listed companies can access equity capital, it is in line to consider some of the ways in which unquoted firms or companies can raise equity capital. The variances between the listed companies and the unquoted companies, in particular the SMEs, represent finance gap or equity gap. It is incumbent upon every country or a region of a country to consider alternative ways for unquoted firms to raise equity capital, as this stimulates economic growth.

2.5.1 Venture capital

Referring to Bangladesh, Venture Impact (2004: 15) argues that the venture capital industry is an opportunity to address the financing needs of SMEs. The venture capitalists become more involved in the management of the companies into which they invest. They also exercise due diligence processes prior to investing. Venture Impact (2004: 15) also argues that this source of funding addresses the needs of entrepreneurial companies that generally do not have the size, assets and operating histories necessary to obtain capital from more traditional sources, such as public markets and banks.

Gladstone (1988: 56) refers to this as the 'participative management approach' of the venture capitalists which provides equities and or loans to SMEs, from which traditional bankers usually shy away. In contrast to banks which seek to protect their investments through securities and other forms of collateral, venture investors secure their investments by participating actively in the running and operation of the SMEs, as collateral or pledge is not their priority.

2.5.2 Collateral Base Approach

Hayes et al. (2006: 36) assert that "to broaden the collateral-based approach to lending, banks are being encouraged to finance SMEs with insufficient collateral". This might be done through an external party providing the collateral or guarantees required. Unfortunately, to the extent that the schemes concerned run counter to basic free market principles they tend to be unsustainable. This sector is called the Meso-finance sector. Khula Enterprise Finance and the Industrial Development Corporation (IDC) in co-operation with ABSA bank are involved in such agreements where they stand guarantor on behalf of those enterprises which cannot provide collaterals (Hayes et al., 2006: 36).

There is no evidence of any significant structural barriers to the supply of bank or private equity finance to suitable SME applicants on mutually satisfactory terms and conditions in contemporary Britain. It is stated that for the business finance market, the main obstacles to funding appear to be rather on the demand side than on the supply side (Assets Based Lending, 2003). The following issues create bottlenecks to adequate financing of the SMEs sector:

- Lack of satisfactory business plans, accounting and other information;

- Inadequate assets for use as security such as insufficient high level of profitability, gearing, liquidity, stability and other business financial performance criteria on the part of funding applicants (Assets Based Lending, 2003).

2.5.3 Viability based approach

An alternative suggestion is to broaden the viability based approach. Since this approach is concerned with the business itself, the aim has been to provide better general business development assistance to reduce risk and increase returns. This often entails a detailed review and assistance with the business plan. A common aim or feature of the viability-based approach is the provision of appropriate finance that is tailored to the cash flows of the SME (Viability Based Approach, 2003).

Although the returns generated by this approach in less developed countries may never be attractive to Western venture capitalists, they can be significantly better than conventional collateral-based lending, whilst at the same time being less risky than the typical venture capitalist project. Some investors have promoted this approach as a means of achieving wider social benefits, while others have been interested in developing it largely in order to generate better financial-economic returns for shareholders, other investors, employees, and clients (Viability Based Approach, 2003).

2.6 The finance gap

Businesses which find themselves too large or too fast growing to ask the individual shareholders for more funds or to obtain sufficient bank finance, and which are not ready to launch on the stock market, are confronted with pockets of under-finance called the ‘financing gap’ (Equity Gap Financing, 2007). Such companies usually rely on retained earnings, capital funding from owners and bank borrowings. However, this is frequently insufficient to finance growth aspirations. Thus, between large firms with access to the stock market and small firms financed by internally generated funds, personal and bank loans, there is a financing gap (Figure 2.3).

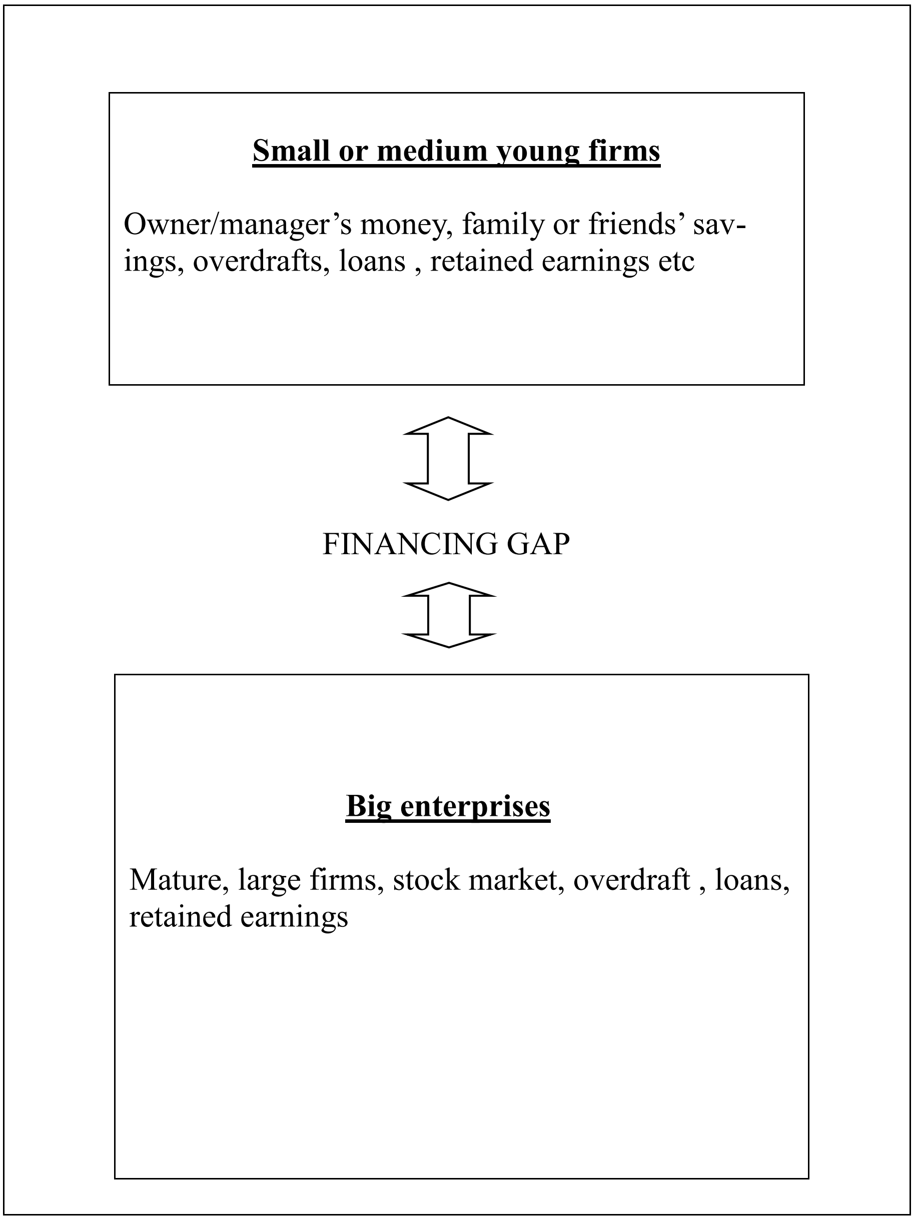

Figure 2.3: Financing gap (Equity Gap Financing, 2007)

2.7 Funding the gap

The equity gap is not limited to South Africa; it is a global problem. Different countries have different intervention methods of managing this challenge. For example, small to medium enterprises (SMEs) make an important contribution to the output, employment and productivity of the UK. Access to finance is essential for growing businesses to invest, to implement new technologies and strategies and to contribute to a more productive economy. External sources of finance are particularly important for start-up and small businesses, which often lack retained profits to re-invest to support their own growth (Finance Gap Financing, 2007).

‘The issue of adequate financing for SMEs has been engaging the attention of policy makers, international institutions, researchers and others. There is consensus that a financing gap exists which is more pervasive in emerging markets than in developed country markets. Even some Organization for Economic Cooperation and Development (OECD) countries are reported to have partial financing gaps, particularly in equity finance. The financing gap can be broken down for analytical purposes into equity gap, working capital gap, long term investment capital gap and financing gap for high growth or technology-based SMEs’ (Funding the Finance Gab, 2004).

The finance gap is synonymous with the equity gap which is the variance between what large companies could raise through stock market and what smaller companies could also raise through bank loans and retained earnings. Many commentators and analysts have asserted that there exists a ‘financing gap’ for SMEs. Some businesses require much larger funding than that which can be provided by the business angels, but do not need the levels of funding venture capitalists would consider (Funding the Finance Gab, 2004).

To finance the gap, the South African government, through the Department of Trade and Industry, has introduced various ways of rescuing the situation. ’The government has introduced Khula Credit Guarantee, which provides a range of guarantee products to registered commercial banks and other private sector financial institutions that offer financial services to the SME sector. The guarantee scheme is based on a risk-sharing arrangement; whereby Khula partners with financiers assume a portion of risk associated with lending in the SMME sector’ (Report, R40/2002: 11). Credit guarantees are as follows:

2.7.1 Individual guarantee scheme

An individual guarantee scheme affords the entrepreneur the opportunity to access funding from participating financial institutions. The scheme enables the entrepreneur to access funding for the purposes of establishing, expanding or purchasing a business. Facilities secured under the Khula guarantee scheme often include term loans, bank overdrafts, revolving credit, instalment sale, bank guarantees as well as construction performance guarantees. The financier itself carries out credit assessments of all applications. Upon satisfying itself that the applications conform with all its necessary lending requirements, the financier will then approach Khula for a guarantee, if and when it needs cover beyond that which the client can provide (Report, R40/2002: 11). However, this does not overrule the normal application procedure which the client undertakes in approaching the bank and fulfilling all the requirements of the financier until the funding is released.

2.7.2 Portfolio guarantee scheme

In this scheme, Khula is in partnership with approved Registered Financial Intermediaries (RFIs), which are involved in lending to a specific targeted SMEs market. Funds may be used to finance fixed assets and/or working capital. Sectors will include women, rural, disabled, the youth and other specific programmes such as Emerging Contractors. Khula will assume a risk of 50-80% (Report, R40/2002: 12).

2.7.3 Danida business-to-business programme

The government of South Africa has partnered with the Danish government with the aim of supporting SMEs and the previously disadvantaged entrepreneurs. The objective of the Business-to-Business (B2B) programme is to develop and strengthen business opportunities and create employment for eligible entrepreneurs. This is achieved through support to the development of commercially viable businesses, based on formation of business partnerships between South African and Danish companies. The support will cover expenses connected with the transfer of management, business skills and technology from Danish to South African companies and provide access to financing for the South African companies (Report, R40/2002: 12).

In the partnership between the two countries, the government of South Africa is using Khula as a driver of the project. Khula provides guarantees for loans on behalf of the beneficiaries as advised and authorised by the Royal Danish Embassy (Danida) on such terms and conditions as may be agreed upon between Danida, Khula, the beneficiary and the lender concerned. The guarantee will be considered for loans aimed exclusively at procurement of shares, purchasing of machinery and capital equipment essential for the business to succeed (Report, R40/2002: 14).

2.7.4 Khula/Enablis partnership

Reddy (2006) expresses that in South Africa, Khula Enterprise and Enablis partnered in a new pre-venture capital SME Fund called the Enablis Khula Loan Fund. This is a bold step taken by the government to support SMEs which cannot get help from private equity investors and debt capital financiers. This fund is the first of its kind in South Africa. It is a bold pre-venture capital funding for SME entrepreneurs. Fundamentally the government is trying to reach out to those entrepreneurs with start-up and early-stage capital requirements to take them to the next level where they can be attractive to private equity investors. This is in support of the South African Government's stated objectives of supporting small business and entrepreneurship. Reddy (2006) again states that the existing financing environment requires the intervention of the organisations such as Enablis which can bridge the gap between financing products offered by the private equity sector and the needs of an entrepreneur who starts up or runs a small business. Bridging this gap essentially requires the understanding of how to get the small entrepreneur from the point of starting up a business to a point where venture capital investors will view this business as substantially strong enough to warrant an investment.

2.8 Private equity

The government alone cannot conquer the mammoth task of the financing gap. Intervention by private companies can be of great advantage to the development and growth of SMEs in South Africa. There is a need for private equity funders to stimulate the growth of businesses.

The KPMG Private Equity Report (2007) explains private equity as a long-term, committed share capital that helps companies to grow and succeed, unlike debt financing which entails the legal right to interest on a loan and repayment of the capital, irrespective of success or failure. Private equity is invested in exchange for a stake in the company and as a shareholder, the investor's returns are dependent on the growth and profitability of the business.

'The entity that makes the investments is usually structured as a limited partnership and is known as a private equity fund. The investors in this fund, known as limited partners, primarily include pension funds, insurance companies and wealthy individuals. A private equity fund is managed by a general partner, who is tasked with deciding where and how to invest the fund's money, in accordance with the focus defined in the fund's terms of reference' (KPMG Private Equity Report, 2007).

The KPMG Private Equity Report (2008) states that different private equity funds have different objectives, but whatever the objectives, the investment plan is usually for the long-term, mostly for a three- to five-year period. Not only is there financial investment support, but also management guidance, experience and expertise on the board and even at the level of operation. The KPMG Private Equity Report (2008), further elaborates that the various funds specialise in different ventures, such as start-up companies (venture capital funds), mid-stage/mature enterprises that need expansion support (growth capital funds), management buy-out of existing equity holders in a public to private deal, instances of privatisation of government-owned assets and a takeover of a division of a larger company or the acquisition of a private company from retiring shareholders. Private equity funds usually realise their investment by exiting through an initial public offering or sale of their stake to another company. 'In the emerging markets of Asia, private equity investment has predominantly been growth capital, even when conducted by the larger buyout private equity houses.'

BVCA (2006) explains that in the UK, Continental Europe and much of the rest of the world, 'private equity' means the equity financing of unquoted companies at many stages in the life of a company, from start-up to expansion, together with management buy-outs and buy-ins of established companies that have real growth potential which can be enhanced with private equity support. 'Venture capital' is a sub-set of private equity, covering early stages of funding from seed to expansion capital. The key elements of private equity and venture capital are investments in unquoted companies (equity capital by nature and medium- to long-term) and targeted at companies with growth potential, which can ultimately be realised through trade sales or flotation on the public markets.

Timmoms, Spinelli and Zacharakis (2004: 124) explain private equity in the form of private placements which are synonymous with private equities. Where a private company has decided not to go public, private placements are an attractive source of equity capital. This form of funding is suited where the goal of the company is to raise a specific amount of capital in a short period of time. Rather than an initial public offering, in this form of transaction stock is offered to a few private investors. Most frequently this is distributed amongst a small group of friends, relatives or acquaintances. Alternatively, a broker may be approached to circulate the proposal among a few investors who have expressed an interest in small companies. The time period for this type of arrangement is usually shorter.

KPMG Private Equity Report (2001) reports that, South African companies have long invested in unlisted businesses. Why then has private equity become such a popular catch phrase of late? The answer lies in the international development of a professional private equity management industry. The success in terms of growth achieved by private equity funds in the US and, to a lesser extent in Europe, has resulted in the development of professional private equity firms in other parts of the world, including South Africa. In South Africa, the four major commercial banks and their predecessors pioneered leveraged buy-outs. This was largely driven by disinvestments from South Africa in the early 1980s. These buy-outs, encouraged by the international success of private equity, formed the foundation for private equity market.

‘Leverage is the term used to explain the firm’s capital structure. The use of debt in a firm’s financial structure is called financial leverage. The more debt a firm has (as a percentage of assets), the greater its degree of financial leverage. It is explained that debt acts like a lever in the sense that using it can greatly magnify both gains and losses. Financial leverage increases the shareholder’s financial reward, but it can also increase the potential for financial distress and business failures’ (Firers, Jordan, Ross, Westerfield & Bradford: 2004: 26).

Hunger and Wheelan (2004:170) express that in a leverage buy-out, a company is acquired in a transaction financed largely by debt usually obtained from a third party, such as an insurance company, investment banker or private equity funders. Ultimately the debt is paid with money generated from the acquired company’s operations or by the sales of its assets. In effect the acquired company pays for its own acquisition.

2.8.1 Types of private equity firms

Hayes et al. (2006:14) state that there are two types of private equity firms. Each private equity firms specialises in its own type of investment in accordance with the type of service and customers to be serviced.

2.8.1.1 Captive Private Equity firms

According to Hayes et al. (2006:14), captive private equity firms obtain the funds they provide from a parent organisation. These parent companies may be financial services firms, firms operating in other sectors or the government. According to the nature of the parent organisation, the captives may be divided into the following categories: financial services captives, non-financial services captives, government captives and semi-captive services. Semi-Captives are those institutions which raise funds from institutional investors. In South Africa, examples of financial services captives are the private equity teams of the major banks such as the Rand Merchant Bank, Investec, Nedbank, Standard Bank etc.

The KPMG Private Equity Report (2001), notes that "some private equity firms manage assets exclusively off their own or parent company balances". Examples of government captives are the Industrial Development Corporation (IDC) and other international Development Funding Institutions (DFIs), such as the US International Finance Corporation (IFC), which are also significant private equity investors.

2.8.1.2 Independent funds

Hayes et al. (2006:14) further assert that independent private equity firms raise their funds for investment from external sources, mainly institutional investors such as banks, insurance companies and pension funds. Ethos and Brait are the two dominant independent private equity firms in South Africa. Other examples of independent funds are Horizon Equity, Tiso, Actis, Medu and Treacle.

According to KPMG Private Equity Report (2001), independent funds raise cash commitments from third party investors. Generally, in terms of the agreement between the third party investors and the private equity fund manager, the private equity firm draws down on the commitments as and when investments are made. The independent funds are the dominant type of firms in the UK, Europe and in the US, where these funds are structured as limited partnerships. Private equity firms typically act as the general partner of the limited partnership, whilst institutions and other investors become limited partners.

KPMG Private Equity Report (2001) further solidifies that independent funds are different from captive funds in that once funding has been raised it is closed with no further commitment being accepted from third parties. Once the maximum draw down time period expires, it is usual for the third parties' commitments to expire. This is mostly on a time schedule and is based on the 'use it or lose it' principle. Professional private equity managers usually earn income from a combination of a management fee based on total commitments plus an enhanced carried interest, which is based on the performance of the fund relative to a benchmark. Captive fund managers usually do not charge any management fees.

2.9 Forms of private equity

The KPMG Private Equity Survey (2007) states that there are four broad sub-classes of private equity, namely:

- **Venture capital:** Investment in another company whereby the investor plays an active role in the affairs of the investee company such as participation in the board of the other company as well as management involvement;

- **Development capital:** Capital for funding the development, growth and expansion of a company which is breaking even or trading profitably;

- **Buy-out funding:** Funding of the purchase of another company or business or the purchase of controlling interest of a corporation's shares or product lines;

- **Mezzanine capital:** Debt which incorporates equity-based options, such as warrants, with a lower-priority debt. Mezzanine debt is actually closer to equity than debt, in that the debt is usually only of importance in the event of bankruptcy. Mezzanine debt is often used to finance acquisitions and buy-outs.

Table 2.1 provides an explanation of the terminology used in the KPMG Private Equity Survey (2007), as the definition varies from country to country.

Table 2.1: Stages of venture capital: adapted from, KPMG Private Equity Survey 2007

Equity categories	Stage of business development	Funding application
Venture Capital	Seed Capital	Research, evaluation and development financing for an initial concept or business before the business has reached the start-up phase
	Start-up and early stage development	Financing for product development and initial marketing. Funding for new companies being set up or for the development of those which 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
Buyout	Management buy in(MBI) Management buy out (MBO)	Funding to enable a management team or empowerment partner 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 generally 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 individuals, other venture-backers or the public through the stock market. Unlike venture and development capital, the proceeds of replacement capital transactions are generally paid to the previous owners of the entity.

2.9.1 Venture Capital

Ericson and Vinturella (2004: 190) assert that the entrepreneur gains more from venture capital investment because it provides more than just money. In addition to investment capital, they provide management expertise, experience and connections. The presence of venture capital speeds up the professionalisation of the firm. Firms receiving venture capital are more likely to adopt stock option plans, hire vice presidents, formalise human resource policies and bring in an outside CEO. In general, venture capitalists help build the internal organisation of the company, in addition to providing financial support. In return for their investment, venture capitalists will take an equity position in the company, usually in proportion to the amount of their investment and the level of risk involved.

Samial-Suwailem (1998: 32) explains venture capital as a form of equity financing in which the investor actively participates in the financed business. The objective is to add value to the recipient company during the financing period. A venture capital firm manages funds provided by investors and directs them to the most promising ventures, mainly in the form of equities. The venture capitalist, which is responsible for managing investors' funds, provides financial and strategic assistance to the recipient company and actively participates in its management. The support continues until the venture materialises, at which stage an outside investor might be interested in owning the company or it might be ready for public listing. Returns then are redistributed to investors.

2.9.2 Development capital

Kadhikwa et al. (2005: 5) explain development capital as a form of venture capital that specialises in providing finance to companies for use in product development and initial marketing. At this stage companies have not yet sold their products commercially. The venture capitalists may also continue to provide finance to companies that have completed product development and which require funds to start commercial sales. This type of venture capital also plays a role in the expansion stage, refinancing of bank debt and secondary purchase (purchase of existing shares in a company from another venture capital firm or from other shareholders).

2.9.2.1 Buy-out funding

Kadhikwa et al. (2005: 5) regard private equity as another form of funding of management buy-outs (MBOs) and management buy-ins (MBIs), as well as the funding for privatisation of public entities. With management buy-outs, the current management of a company acquires an existing product line or business with the use of funds from private equity providers. In the case of management buy-ins, the funds are acquired by external managers to acquire a stake in an existing company. This non-venture form of private equity may also be used in the purchase of equity of public listed companies, which are then de-listed to become private companies.

Kadhikwa et al. (2005: 5) express that empirical evidence suggests that the performance of non-venture backed (MBO/MBI) companies is partly attributed to the incentive structure provided to the management team and the employees. Therefore, it is argued that the provision of incentives to all the stakeholders, more particularly the employees and management, is crucial for the future success of a company. The management and the employees must also become owners. The incentives resulting from the MBO/MBI encourage management and employees to work hard.

Webb (1990: 4) states that management buy-out refers to the purchase of a firm, part thereof or some of its assets, by an individual or management team who typically work for the firm. The team usually secures voting control and/or the prospect of control after the operation of an incentive ratchet. Normally, most of the finance is secured on the assets, or on the equity of the new organisation, but these conditions are mandatory.

2.9.2.2 Mezzanine Capital

The KPMG and SAVCA Reports (2008: 51) state that mezzanine capital is a debt which ranks behind senior secured debt, but ahead of trade credit and shareholders' funds in terms of security. Mezzanine debt is often used in higher leveraged transactions to maximise funding availability from a company's own balance sheet. It may provide for equity-like features such as attached share purchase warrants or participation in cash-flow.

Timmoms, Spinelli and Zacharakis (2004: 123) regard mezzanine capital as capital that is senior debt financing and common stock. In some cases it takes the form of redeemable preferred stock, but in most cases it is subordinated debt that carries an equity 'kicker' consisting of warrants or a conversion feature into common stock. Timmoms et al. (2004: 123) again state that "mezzanine capital usually comes into play after the early-stage risks have passed". This subordinated debt capital has many characteristics of debt, but can also serve as equity to underpin senior debt. Mezzanine capital is generally unsecured debt, with a fixed percentage return and maturity value of five to ten years Timmoms et al. (2004: 123).

2.10 Due Diligence

Jones (2003: 34) states that due diligence is the term given to a thorough investigation of the potential investment and it embodies all the qualitative and quantitative tools that each particular venture capitalist uses in his/her respective evaluation technique. Once a potential investment has been sourced and assessed on an investment basis, a due diligence process usually follows. The due diligence increases in complexity as the opportunity passes each test. If a fatal error is discovered at any stage of the process, the investment would more than likely be shelved.

Jones (2003: 34) refers to the basic areas that are addressed during the due diligence processes, which are:

- The venture capitalist team meets several times with the entrepreneur and the management so as to gather as much information as is necessary and to get a 'gut-feel' for the people involved;
- The venture capitalist team's in-house accountant and the lawyer analyse all financial and legal information that is presented by management. The accountant will scrutinise the business plan that has been presented and will carefully analyse all actual and projected financial statements and to verify the assets and liabilities;
- The venture capitalist team conducts 'desktop research' in order to address macro-economic and industry wide issues. Information sources used are: industry reports, government data, economic data etc;
- Formally, the venture capitalists will work through the firm's evaluation checklist systematically so that an informed and objective investment decision can be made;
- Informally, the venture capitalist will also evaluate an investment opportunity with his/her 'gut-feel'.

Timmoms et al. (2004: 120) note that a due diligence is carried out no matter whether the funding source is from an angel investor or venture capitalist. The due diligence process provides the potential investor with a verification of the claims and facts in the business plan. The claims made by the management team about their qualifications and experiences, market research, the attractiveness of their products or services, and other claims will be thoroughly examined. The investor will want to talk with directors, advisors, management team, key customers and major suppliers.

Timmoms (1994: 492) notes "that it may take several weeks or more for the due diligence process for a start-up but also notes that if the investor knows the entrepreneur, the time frame may be shorter". Timmoms (1994: 492) asserts that this process "is usually painstaking for investors as they verify all aspects". They will want to talk with directors, advisors, former bosses and previous partners. While this is going on, the investee company needs to do own due diligence on the venture fund, ask for the names and phone numbers of their successful deals, some that did not work out, and the names of all presidents they ended up replacing (Timmoms, J.A, 1994: 492).

Sagari and Guidotti (1992), as cited by Jones (2003: 35), assert that the quality of due diligence may be one of the factors that the pension fund and other institutional investors look at in the process of choosing a venture partnership in which to invest. Jones (2003) suggests that as pension funds, with their risk-averse nature, are still relatively small investors in venture capital in South Africa, the due diligence process should be considered.

According to the KPMG and SAVCA Reports (2001), in 2000 only 28% of the third party venture capital funding was from the pension and endowment industry compared, with 47% in the USA. The KPMG and SAVCA Reports (2001) also note that these institutional investors would, over time, reduce the perceived risk if thorough due diligence methodologies are applied. It is also noted that this could increase the level of third party funding and, therefore, aid in the growth of the venture capital industry.

2.11 The classification of SMMEs

In South Africa, SMMEs are defined in terms of the National Small Business Amendment Act 29 of 2004. The Act defines a small business as a company with a work force of less than 50 and an annual turnover of R3m to R32m, depending on the sector in which it is classified. Table 2.2 indicates the classification of SMMEs according to sectors. The classification helps investors to evaluate and estimate the returns they may expect from a given firm within the sector or industry (NSBAA, 2004). This also helps with the due diligence processes because if the values in the financial records are astronomically high, the investors can be alerted. As a result a thorough check may be instituted.

Table 2.2: Classification of SMMEs (adapted from National Small Business Amendment Act 29 of 2004)

Column 1	Column 2	Column 3	Column 4	Column 5
Sector or sub-sector in accordance with the Standard Industrial Classification	Size of class	The total full-time equivalent of paid employees	Total turnover	Total gross asset value (fixed property excluded)
Agriculture	Medium	100	R 5 m	R 5 m
	Small	50	R 3 m	R 3 m
	Very small	10	R 0.50 m	R 0.50 m
	Micro	5	R 0.20 m	R 0.10 m
Mining and Quarrying	Medium	200	R 39 m	R 23 m
	Small	50	R 10 m	R 6 m
	Very small	20	R 4 m	R 2 m
	Micro	5	R 0.20 m	R 0.10 m
Manufacturing	Medium	200	R 51 m	R 19 m
	Small	50	R 13 m	R 5 m
	Very small	20	R 5 m	R 2 m
	Micro	5	R 0.20 m	R 0.10 m
Electricity, Gas and Water	Medium	200	R 51 m	R 19 m
	Small	50	R 13 m	R 5 m
	Very small	20	R 5.10 m	R 1.90 m
	Micro	5	R 0.20 m	R 0.10 m
Construction	Medium	200	R 26 m	R 5 m
	Small	50	R 6 m	R 1 m
	Very small	20	R 3 m	R 0.50 m
	Micro	5	R 0.20 m	R 0.10 m
Retail and Motor Trade and Repair Services	Medium	200	R 39 m	R 6 m
	Small	50	R 19 m	R 3 m
	Very small	20	R 4 m	R 0.60 m
	Micro	5	R 0.20 m	R 0.10 m
Wholesale Trade, Commercial Agents and Allied Services	Medium	200	R 64 m	R 10 m
	Small	50	R 32 m	R 5 m
	Very small	20	R 6 m	R 0.60 m
	Micro	5	R 0.20 m	R 0.10 m
Catering, Accommodation and other Trade	Medium	200	R 13 m	R 3 m
	Small	50	R 6 m	R 1 m
	Very small	20	R 5.10 m	R 1.90 m
	Micro	5	R 0.20 m	R 0.10 m
Transport, Storage and Communications	Medium	200	R 26 m	R 6 m
	Small	50	R 13 m	R 3 m
	Very small	20	R 3 m	R 0.60 m
	Micro	5	R 0.20 m	R 0.10 m
Finance and Business Services	Medium	200	R 26 m	R 5 m
	Small	50	R 13 m	R 3 m
	Very small	20	R 3 m	R 0.50 m
	Micro	5	R 0.20 m	R 0.10 m
Community, Social and Personal Services	Medium	200	R 13 m	R 6 m
	Small	50	R 6 m	R 3 m
	Very small	20	R 1 m	R 0.60 m
	Micro	5	R 0.20 m	R 0.10 m

2.12 Evaluating an Investment

'In financing terms, the terminology "capital structure" denotes the manner in which a company finances its assets through some combination of equity, debt or hybrid securities' (Financial Models, 2003). In order to assess whether to invest in an organisation, professional investors such as commercial banks and private equity investors make use of financial models such as the Internal Rate of Return (IRR), the Net Present Value (NPV) and the Weighted Average Cost of Capital (WACC) (Financial Models, 2003). Some of these valuation models are discussed further below.

2.12.1 Weighted Average cost of capital

According to Gitman (1994: 415), the Weighted Average Cost of Capital (WACC) reflects, on average, the firm's cost of capital. This is determined by weighing the cost of each specific type of capital by its proportion in the firm's capital structure. Firer et al. (2004: 474) explain WACC as the overall return the firm must earn on its existing assets to maintain the value of its shares and its debt. It is also the required rate of return on any new investments by the firm that has essentially the same risks as its existing operations. So, if evaluating the cash flows from a proposed expansion of an operation, this is the discount rate that would be used.

The WACC is the return that the providers of a company's capital require. Calculating WACC requires knowledge of the rates of return required for each source of capital. The cost of capital will be different for each source of capital and the class of securities a company has, reflecting the different risks. The WACC is the weighted average of the costs of each of the different types of capital. The weights are the proportion of the company's capital that comes from each source (Weighted Average Cost of Capital, 2003).

The WACC is the rate a company is expected to pay to finance its assets. It is the minimum return a company must earn on an existing asset base to satisfy its creditors, owners and other providers of capital. Companies raise money from a number of sources: common equity, preferred equity, straight debt, convertible debt, exchangeable debt, warrants and options, pension liabilities, executive stock options, and so on. Different securities are expected to generate different returns. WACC is calculated taking into account the relative weights of each component of the capital structure (Weighted Average Cost of Capital, 2005).

Gitman (1994: 416) emphasises that once the costs of the specific sources of financing have been determined, the WACC can be calculated. This calculation multiplies specific costs of each type of financing of the company (Stocks, Retained Earnings and Debt) by its proportion within the company's total capitalisation. The weighted values are then summed up. Assuming the cost structure of the company's capital is as follows:

- Cost of preferred stock = 10.6%
- Cost of retained earnings = 13.0%
- Cost of new common stock = 14.0%
- Cost of long term debt = 5.6%

The weightings are given to each form of capital is shown in Table 2.3.

Table 2.3: WACC Weighting (adapted from Gitman, 1994)

Source of Capital	Weight
Long-term Debt	40%
Preferred Stock	10%
Common Stock Equity	50%
Total	**100%**

Table 2.4 details how the WACC is calculated, using the weights as reflected in Table 2.3 multiplied by the cost of each form of capital and finally summing the values to give the WACC (Gitman, 1994: 416).

Table 2.4: Calculating WACC (Source: Gitman, 1994)

Source of capital	Weight (1)	Cost (2)	Weighted cost (1)*(2)
Long-term debt	.40	5.6%	2.2%
Preferred stock	.10	10.6%	1.1%
Common stock equity	.50	13.0%	6.5%
Totals	1.00		9.8% = WACC

To explain WACC in simple terms, it can be considered that a company is equivalent to a bag of money. This money has been raised from two types of sources: debt and equity. Retained earnings is money remaining after operations, debt servicing and shareholders' dividends. If debt holders require a 10% return on their investment and shareholders require a 20% return, then, on average, projects funded by the bag of money will have to return 15% to satisfy debt and equity holders. The 15% is WACC (Weighted Average Cost of Capital, 2008).

The calculation of WACC is very important as this is used extensively to evaluate and select investments. It is also important for SMEs to understand this concept as it will help to understand the costs involved and their associated risks.

2.12.2 Net Present Value

Net Present Value (NPV) estimates a project's value by discounting the cash inflow (DCF) of the company. In other words, NPV is an indicator of how much value an investment or project may add to a company. To make this valuation, it is necessary to estimate the size of all incremental cash inflows from the project at the time they fall due. All future cash inflows are discounted and summed up in order to determine the (NPV). A 'decision rule' is then used to assess whether or not the project should be accepted, whereby all positive NPV projects in an unconstrained environment, are accepted or if projects are mutually exclusive, accept the one with highest NPV' (Net Present Value, 2008).

It is obvious that the NPV would be affected by the discount rate applied to the calculation. It is thus critically important to select the correct rate in order to make the right decision. Often referred to as the hurdle rate, this is the minimum acceptable return on an investment. 'A common practice in choosing a discount rate for a project is to apply a WACC that applies to the entire firm, but a higher discount rate may be more appropriate when a project's risk is higher than the risk of the firm as a whole' (Capital Budgeting…2008).

The present value is the current value of all future cash inflows, be it negative or positive. The value of each cash flow needs to be adjusted for risk and the time value of money. A net present value (NPV) includes all cash flows including initial cash flows such as the cost of purchasing an asset, whereas a present value does not (Net present value…2001).

A discount rate needs to adjust for risk and time value, and it is applied like this:

$$NPV = \frac{Cf_0}{r} + \frac{Cf_1}{(1+r)} + \frac{Cf_2}{(1+r)^2} + \frac{Cf_3}{(1+r)^3} \dots \dots \dots \dots \dots \dots .$$

Where CF1 is the cash flow the investor receives in the first year, CF2 the cash flow the investor receives in the second year etc. and r is the discount rate. The series of discounted cash flows need to be at least positive for the investment to be accepted (Net Present Value, 2001).

The NPV is the present value of all future cash flows projected to their time of occurrence and then discounted at an appropriate cost of capital or hurdle rate, less the cost of the investment. Figure 2.4 depicts the net present value of a project. The projected cash flows are discounted back to the time of calculation (year 0) (Weaver & Weston, 2005: 229).

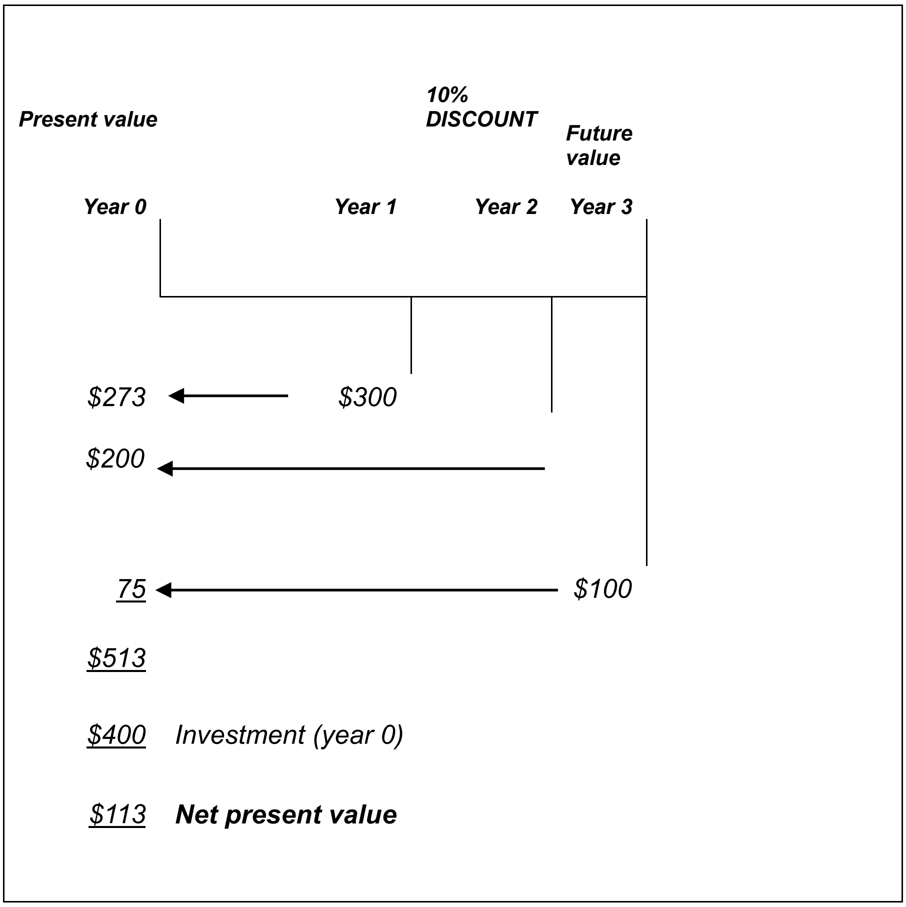

Figure 2.4: Calculating NPV (adapted from Weaver & Weston, 2005)

2.12.3 Internal Rate of Return

'The internal rate of return (IRR) is the rate which the firm expects to earn if the project is purchased and held for its economic life. The IRR is the discount rate that equates the present value of a project's expected cash flows to the initial amount invested. The project's IRR, which is the expected return, is acceptable only when it is greater than the rate of return required by the firm for such an investment' (Brigham & Besley, 2005: 260).

The internal rate of return (IRR) is the flip side of the net present value because it is the discount rate (interest) that makes the net present values of cash inflows equal to zero. In other words it is the percentage value of the NPV' (Stancill, 2004: 127).

‘The internal rate of return provides a measure of the compounded average annual rate of return that a project will provide. If the IRR exceeds the required return for a project, the project will be accepted. Because it is a measure of the percentage return, many analysts prefer it. The internal rate of return is a popular profitability measure because, as a percentage, it is easy to understand and easy to compare to the required rate of return’ (Timothy & Todd, 2004: 350). The concept of IRR is most relevant to SMEs involved in project-related businesses because this helps them in costing and financial projection of the project.

Figure 2.5 and Table 2.5 below show the relationship between the risk and the stage of business development in the venture capital market. The younger the business, the more uncertainty the future prospects of the business. Jones (2003: 55) asserts that future uncertainty is the rationale behind this because the older and more established a venture, the more predictable its prospects become and the lower the risk and required rate of return (ignoring all investment specific risks and other impeding factors).

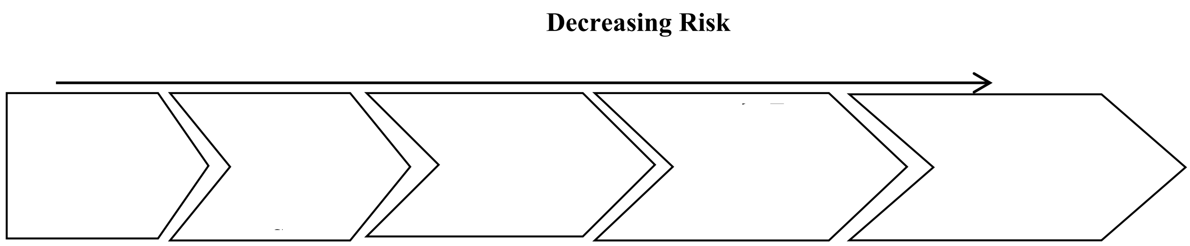

Figure: 2.5 Risk versus stage of business development (adapted from Lyons: 2001)

Table 2.5: Risks and returns (adapted from Lyons, 2001)

RISK AND RETURN	
Investment Stage	**Minimum IRR Expected**
MBO	30%-40%
MBI	40%-50%
Pre-IPO	30%-40%
Expansion	40%-60%
Early stage	50%-70%
Start-up	70%-90%
Seed	80%-100%

2.13 The contribution of private equity capital to enterprise development in South Africa

As stated in the introduction to this chapter, South Africa is a developing country, which is full of economic promise because of its availability of raw materials such as minerals and agricultural produce. This section explores the contribution of private equity to enterprise development in the South African context.

2.13.1 The role of private equity

'The private equity industry has benefited from the global trend towards recognising the asset class as an attractive investment vehicle for investors in South Africa, combined with its growing reputation as an effective means of economic development for governments and development agencies. The local industry was given a more formal representation with the formation of SAVCA in 1998, which has since undertaken various initiatives aimed at the effective growth and sustainability of the industry' (SAVCA, 2006: 10).

The KPMG and SAVCA Reports (2008:8) suggest that, in order to develop businesses, private equity investment can provide benefits beyond just cash effect. This is because such investments 'have considerable impacts in terms of productivity, skills development (national competitiveness) and job creation, as it includes the transfer and exchange of know-how and not only the flow of capital' (KPMG & SAVCA Reports, 2008: 8).

The KPMG and SAVCA Reports (2008: 8) again state that private equity fund managers play a vital role in managing their investments into companies, as they derive a return from the increased valuation of their investments (not just debt repayment and an associated interest rate) and, hence, focus on business development for the companies in which they invest. The report indicates again that in South Africa the private equity industry represents a significant sector within the overall financial services industry, and an attractive asset class within the broader capital markets. As seen across a range of indicators, the profile of the local private equity industry is that of a productive contributor to the development of the South African economy, particularly in the context of policies such as BEE - which address economic imbalances of the past - and the promotion of entrepreneurial initiatives, and positions South Africa to compete successfully into the future. Through the use of leverage in certain transactions, private equity investors can also assist in improving the capital efficiency of their investee companies (KPMG & SAVCA Reports, 2008: 8).

2.13.2 Private Equity's contribution to South Africa's BEE goals

The Black Economic Empowerment (BEE) policy is strategy-aimed to increase the opportunities for the historically disadvantaged (HDI) community to enable them to participate at all levels in the economy. It tries to create opportunities for the HDIs because they did not have these opportunities. BEE redresses those imbalances of the past through ownership, management and control over companies and resources (KPMG & SAVCA Reports, 2008: 15).

Jones (2003: 4) is of the opinion that the social development in South Africa is promoted by means of private equity through its BEE management and participation. BEE dominates the private equity industry and is promoted in two ways, firstly through the ownership and management structure of the private equity managers, and secondly through the funding sources for private equity transactions which take place in the market. Industry participants estimate that more than 90% of total private equity transactions in the market and 100% of buy-out transactions have an element of BEE.

Hayes et al. (2006: 55-56) examine the growth in underlying companies and expected high returns by investors, and private equity is said to have a material impact on economic and employment growth in its home economies. The EVCA and BVCA have conducted studies which attempt to quantify this impact in Europe and the UK. In SA, the social impact of private equity is associated primarily with BEE through investor participation in transactions and the promotion of BEE in investee companies. The impact of BEE is arguably more significant in private equity than in the listed company environment.

2.13.3 The economic and social impact of private equity

In general, there is an assertion that there is enough evidence to believe that venture-backed companies perform superiorly compared to similar non-venture-backed ones. This is consistent with the premise that venture capital addresses agency problems better than traditional finance (Samial-Suwailem, 1998: 15).

According to Jones (2003: 4), venture capital offers several additional advantages. In the South African context, the industry can play an increasingly important role in economic empowerment, social upliftment and economic growth. Historically, small and medium-sized enterprises (SMEs) have found it very difficult to raise capital through the conventional route, therefore stunting economic growth and job creation. The lack of capital flow to the historically underdeveloped sectors of South Africa has been both a symptom and cause of poverty. The venture capital industry is potentially a part of the solution to this problem (Jones, 2003: 4).

KNC and Associates (which is a private consulting firm with a specific interest in Black Economic Empowerment) were commissioned by the Swedish government to research venture capital as a resource to develop small business in South Africa. They view venture capital as a conduit for real black economic empowerment and economic growth (KNC and Associates, 2001: 8).

Jones (2003: 25) mentioned that despite the above-mentioned benefits, many SMEs have found it very difficult to tap into this source of funding. Venture capital and private equity funds to date have favoured the larger investment opportunities over the smaller ones. The reasons for this appear to be the lower risk profile of larger investments, high transaction costs (more efficient to spread over one larger deal than many smaller deals) and limited resources. Therefore, even though the industry is ideal for the promotion of the smaller entrepreneurs and the development of black economic empowerment, KNC and Associates (2001), as quoted by Jones (2003: 5), found that only 4% of total venture capital funds have been invested in small and medium-sized enterprises with black ownership. Through its R300 million investment in the industry in 2000, the IDC aimed to help stimulate new start-ups and thereby to facilitate job creation and economic empowerment. Since 2001, the Public Investment Corporation (PIC) has become involved in funding BEE deals, some of which have been venture capital in nature. The aim of these types of investments is that they act as catalysts to raise further funds from alternative sources.

Hayes et al. (2006: 40), acknowledge that pension funds are known to support development goals, and the Government Employees Pension Fund (GEPF), one of the few pension funds to invest in private equity, pursues a specific strategy to this end.

‘The GEPF allocates approximately 3.5% of assets to private equity investments where private equity is widely defined and includes infrastructure and development funds. Of this target allocation, 50% is invested with traditional but black-owned private equity funds such as Sphere Holdings. The remaining 50% is invested with infrastructure and development vehicles such as the Old Mutual Infrastructure Fund. With respect to economically targeted investments, government captives such as the Industrial Development Corporation (IDC), the National Empowerment Fund (NEF), the South African Enterprise Development Fund (SAEDF), Government Employees Pension Fund (GEPF) and the International Finance Corporation (IFC), have explicit economic and social development objectives and follow appropriate strategies. SA Government captives tend to follow own investment strategies focused on economic development. However, foreign government captives, in particular the IFC, invest in local independent private equity managers in the context of their overall investment strategies’ (Hayes et al., 2003: 49).

2.14 Economic effect of venture capital investment, an international experience

According to Schilit (1991), as quoted in Jones (2003: 5), the venture capital industry is not a new fad as in the case of South Africa. It was started in Spain by Queen Isabella at the end of the fifteenth century. Queen Isabella went beyond being merely the financier by providing management expertise and recruitment assistance, thereby adding value to her investment.

It is, therefore, very difficult to deliberate on the contribution of private equity to enterprise development in South Africa without mentioning the international level of the contribution of private equity to enterprise development. This section, therefore, looks at the effect of private equity to business development of other international countries.

2.14.1 An experience from the United States of America

Lucey, Megginson, and Smart (2008: 479) concur with the study published by the National Venture Capital Association which documented the Scale and Economic effect of 30 years of Venture Capital investment in the United States. The key result of that study was that between 1970 and 2000 American venture capitalists invested $273.3 billion into 16278 companies in all 50 states. In all the investments, not less than $192 billion of that investment occurred during the period 1995 – 2000. The firms (companies) backed by venture capital employed 7.6 million people and generated $1.3 trillion in sales during 2000, representing 5.9 percent of the nation’s jobs and 13.1 percent of America' Gross Domestic Product. This study also reports that, 'over a period of 30 years, venture capital financed companies had approximately twice the sales compared to their counterparts, paid almost three times the federal taxes, generated almost twice the exports, and invested almost three times as much in Research and Development (R&D) per $1000 in assets as did the average non-venture capital backed companies'. The study documents that for every $36 000 in venture capital investment, one new job is created on average (Lucey et al., 2008: 479).

Venture Impact (2004) reports that in the United States of America**,** 9.4% of the total work force is employed in venture capital backed companies, with 9.6% of the total sales in 2003. 'It is found that the employment growth rate of VC backed companies in terms of being in the industrial sector is also quite impressive (as shown in Table 2.6). For instance, while total employment growth rate in the biotechnology sector is seen as 5%, the growth rate of venture backed companies in this sector is 23%. Although, the semiconductor sector and computer hardware sector show negative growth (-10% and -1%) rates, they, however, are in a better position vis-à-vis the total employment growth rate (-26% and -14% respectively) manifested by these industries' (Venture Impact, 2004).

Table 2.6: The contribution of VC backed firms to economic growth (adapted from NCVA Report, 2004

Companies given in the industry	VC backed companies employment growth	Total employment growth
Biotechnology	23%	5%
Business/financial	4%	-1%
Communications	5%	-18%
Computer hardware and service	-1%	-14%
Computer Software	17%	-8%
Healthcare products	16%	-2%
Healthcare service	10%	9%
Industrial/energy	1%	-9%
Retailing and Media	12%	-1%
Total	7%	-2%

Venture Economies (2004) report that “evidence from real life reports that venture capitalists have boosted America’s economic strength by way of creating 10.1 million jobs, which is an additional 600 000 jobs in 2003, compared to 9.5 million jobs in 2002”. A comparison of the growth rate of jobs created in venture capital backed companies against all private sector companies during the years 2003 and 2004 reveals that venture capital (VC) backed companies account for 6.32% as against –2.3% of the private sector companies (table 2.7). The table also indicates that the sales growth rate of the venture capital backed companies in 2003 has increased by 12.5% as compared to the previous year while sales growth rate of the private sectors companies accounted for 6.5% during the same period (Venture Economies, 2004).

Table 2.7: VC’s job creation and sales growth (adapted from Venture Economies, 2004)

	Job creation and sales growth			
	Year 2002	Year 2003	Growth	All PS Growth
Job creation	9.5million	10.1million	6.32%	-2.30%
Sales	$1.6 Trillion	$1.8 Trillion	12.50%	6.50%

2.14.2 An experience from the United Kingdom

“An impressive record was observed in the UK venture capital industry. It is reported in the British Venture Capital Association (BVCA) Report (2003), that venture capital backed companies in the UK accounted for 19% employment growth compared to growth rates of 9% and 6% of FTSEMd-250 and FTSE100 companies respectively. During the same time, the national level employment growth rate was recorded at only 0.50%. In terms of sales growth, venture capital backed companies represented 21% in 2003, which was 33.3%, and 52% higher than that of FTSE Mid-250 and FTSE 100 companies respectively” (BVCA Report, 2003).

2.14.3 An experience from the Asia Pacific

In Asia Pacific, private equity has helped many companies become regional and global players, an undertaking that requires not only financial backing but more importantly, technical expertise, management skills and an international network of contacts (KPMG & SAVCA Report, 2006).

’The head of Private Equity, Mr. Satish Deshpande, at NV Advisory Services in India, points to a small Indian auto-parts maker whose acquisition of two enterprises in the UK and the US has placed it on track to grow by more than 30 percent annually over the next few years. Mr. Deshpande said that this was made possible because one of the founding partners is on the board of major auto companies in the US; this company was able to make introductions and help the company get short-listed in the bidding. In Mr. Deshpande’s view, the fact that the Indian company had private equity investment was a critical factor given the undeveloped credit rating system in India’ (KPMG & SAVCA Reports, 2006). This indicates the value that private equity adds to the development and growth of enterprises.

’Little Sheep, a restaurant chain in China known for its hotpot cuisine, became more efficient, effective and profitable with the injection of international know-how by two non-executive directors brought in by 3i (an investment company), Mr. Nish Kankiwala, former CEO of Burger King International and Yuka Yeung, KFC’s Hong Kong Master Franchisee CEO’ (KPMG & SAVCA Reports, 2006).

‘In Australia, pay TV provider Austar was burdened in 2002 by AUD 400 million in debt, an obligation it was unable to service because its Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) was only AUD 22.6 million. Financial engineering, combined with a focus on business fundamentals, by CHAMP Private Equity helped turn its fortunes around. Austar’s stock price, at about AUD 0.25 in 2002, had soared 420 percent to AUD 1.30 when CHAMP exited in 2005’ (KPMG & SAVCA Reports, 2006).

2.15 Conclusion

The medium-sized enterprises in South Africa suffer greatly as they do not fit well within the existing financial structure. Private equity capital seems to be the possible solution, and there seems to be hope for SMEs in the private equity market. The management and the technical expertise provided to the investee company is a panacea for skills problems in the SMEs market. The country has a host of private equity investors with tight market structures. This does not give the less formalised SMEs a chance. If the government can pull out all relevant legislation together to form a non-profit making private equity finance institution, it will be one of a kind globally.

This would give those SMEs an opportunity to move forward, as their frustrations will have been resolved. Alternatively, the country can apply tax incentives to those private equity funders who specialise in the SMEs and the historically disadvantaged population for the purpose of MBIs and MBOs. At the moment the Public Investment Corporation (PIC) is doing that, but a fierce approach is needed.

CHAPTER 3: RESEARCH METHODOLOGY

3.1 Introduction

Leedy and Ormrod (2005:2), define research as a systematic process of collecting, analysing and interpreting information (data) in order to increase our understanding of the phenomenon about which we are interested or concerned'. Welman and Kruger (2001: 2), as quoted by Mutezo (2005: 56), define research as 'a process involving the application of various methods and techniques in order to create scientifically obtained knowledge by using objective methods and procedures'. In this chapter the research methodology used in this study on the contribution of private equity capital to enterprise development in South Africa is discussed. The germane of this chapter is to bring forth the methods and techniques applied to obtain the findings presented in this research.

This chapter elaborates on the research methodology employed. Some of the key issues covered in this chapter include the basic type of research design, a definition of the population, the measurement instrument, the data collection methods employed and the statistical techniques applied to analyse the data.

3.2 Data Collection

This pioneering research – with its broad objective of understanding the SME equity landscape and the techniques used for sustainable investment – was not suited to an hypothesis-driven approach. Desk research and questionnaires as data collection methods were, however, used in the research.

3.3 Research design and methodology

Kerlinger (1986: 279) defines a research design 'as the plan and structure of investigation so conceived as to obtain the answers to the research questions'. The plan is the overall scheme or programme of the research.

In selecting the research methodology for this study the distinction is made between the two basic types of research designs was considered: experimental or quantitative and non-experimental (qualitative) research designs. Wellman and Kruger (2001: 69), as quoted by Mutezo (2005: 59), explain experimental research as 'all interventions which refer to the exposure of research subjects to something to which they otherwise would not have been subjected'. Kerlinger (1986: 348) provides the following definition of a non-experimental research design:

> *'Non-experimental (qualitative) research is systematic, empirical inquiry in which the scientist does not have direct control of the independent variable because their manifestations have already occurred or because they are inherently not manipulable'.*

Mutezo (2005: 59) indicates that within non-experimental research designs there are different types of research. These include descriptive research, historical and correlative designs. Salkind (2000: 11) suggests the purpose of descriptive research is 'to describe the characteristics of an existing phenomenon'. Historical research relates to events that have occurred in the past until current events and correlative research examines the relationship between variables (Mutezo, 2005: 59).

3.4 Population and sampling frame

The population is defined as a 'collection of all the observations of a random variable under study and about which one is trying to draw conclusions in practice. A population must be defined in very specific terms to include only those units with characteristics that are relevant to the problem' (Wegner, 2003: 5).

A qualitative method of research is followed in the form of snowballing. It was not possible to identify all members of the study population. However, once one case of the desired population was identified they helped to identify further cases; once no new cases were identified or when the sample size is large enough to justify reliable results the research can be concluded (Saunders, Lewis & Thornhill, 2003: 176). It is for this reason that snowball sampling is considered most appropriate for the study.

The study targeted two distinct populations. The targeted populations of the study are those of the SMEs and the private equity investors. Zikmund (1997: 417) describes the target population as 'the complete group of specific population element relevant to the research project'. For the purposes of this study, the target population comprises businesses from the small and medium enterprise level and the private equity investors which include commercial banks. The geographical locations of the study are Gauteng and the Western Cape of South Africa.

Having defined the population, it becomes possible to construct the sampling frame. Mutezo (2005: 60) describes a sampling frame as a 'listing of all the elements in a population and the actual sample is drawn from the listing'. It is possible that bias could exist between the opinion of the members of the sample frame and the population. Therefore, adequacy of the sampling frame is crucial in determining the quality of the sample drawn. The sampling frame comprises all people who are hands-on with regard to the private equity finance. The individual companies selected will not conform to ethnic or gender stereotypes, but will attempt to present viewpoints that are as varied as possible

Due to the fact that there is no proper list of all small and medium enterprises (SMEs) in South Africa, the population of the SMEs was drawn from various equity investors across the country. Government institutions such as the Small Enterprise Development Agency and National Youth Development Agency were also consulted for the list.

3.4.1 Sampling technique

The population of the private equity financiers comprises all institutions registered with the South African Venture Capital Association (SAVCA), the Business Angels and the banks. The sampling involved private equity institutions in Gauteng and the Western Cape provinces to represent the whole population. The researcher first contacted SAVCA about the phenomenon of private equity, and SAVCA then referred the researcher to all its affiliates involved in the private equity market. The same applies to the business angels. This snowballing will keep on rolling until the required sample population is reached.

3.4.2 Sample size

‘The sample size is influenced by the research proposition, variances within the population and the sampling technique. Large samples are more precise than small samples. The level of precision, or in other words the level of sampling error one is willing to accept in a research also influences sample size’ (Mutezo, 2005: 61).

In the light of the above statement, a total of 200 questionnaires were distributed to the small and medium enterprise participants and the private equity players around Gauteng and the Western Cape provinces. The two provinces were chosen because they are the hub and headquarters of the majority of private equity players. A total of 78 completed questionnaires were returned, giving a response rate of 39% as shown in Table 3.1. Whilst it appears to be a low response rate, a sample of 78 responses was considered equate for the purposes of this study. Therefore, the sample consisted of 78 participants who have experience in private equity and have access to finance from various funding institutions.

Table 3.1: Distribution of questionnaire

Number distributed	Number returned	Percentage of total returned
200	78	39%

3.5 Research instruments

In scientific research, ’variables must be measured’ (Graziano & Raulin, 1998: 68). There are four basic types of measurement options. The different levels of measurements include:

- **Nominal scale:** this is ’the lowest level of measurement; the scale with the least matching to the number system. Classification of variables is into unordered qualitative categories’ (Craziano and Raulin: 1998: 71). An example of the above statement is the gender variable in the current study;

- **Ordinal scale:** ’Classification into ordered qualitative categories, e.g., social class (I, II, III, etc.), where the values have a distinct order, but their categories are qualitative in that there is no natural (numerical) distance between their positive values’ (Graziano & Raulin:

1998: 78). An example of ordinal scale in the current study is the education level of respondents;

- **Interval:** 'When the measurement conveys information about the ordering of magnitude of the measurement and about the distance between the values' (Sekeran, 2003:71). The rating of services of service quality in question 18, while strictly speaking are ordinal in nature, are often considered as interval scales by researchers to enable the calculation of means and parametric significance testing;

- **Ratio: '**There are measurements where there is an equal distance between the numbers, as with interval scales, yet it also has an absolute zero' (Graziano & Raulin, 1998:68). No ratio variables were included in the current study.

The current study made use of one instrument (Appendix A) designed specifically for the population targeted SMEs and private equity players. The measurement instruments took the format of questionnaires. Salkind (2000: 136) defines questionnaires as a 'paper-and-pencil set of structured and focused questions'. The following are the advantages of using questionnaires:

- It is possible to survey a broader population as surveys can be mailed;

- They are cheaper than one-on-one interviews;

- People may be more willing to be truthful because their anonymity is all but guaranteed (Salkind, 2000: 136).

3.6 Validity and Reliability

There is no simple answer to which of the available methods of data collection the researcher should use when collecting data. There are, however, three major criteria for evaluating the data collection tool/questionnaire (Cooper & Schindler, 2003: 231):

- Validity refers to the extent to which the test measures what we actually wish to measure;

- Reliability has to do with the accuracy and precision of a measurement procedure; and

- Practicality is concerned with a wide range of factors of economy, convenience and interpretability.

The survey was done via mail, and a follow-up telephone survey was carried out on those who failed to responded. For the semi-formal businesses, questionnaires were handed out at business centres and funding institutions.

3.6.1 Format of the questionnaire

The questionnaire (Appendix A) was sent out, focusing on the SMEs and private equity investors in the targeted geographical areas. The questionnaire was structured as follows:

Section A: Demographic Information

This section used close-ended questions to gather information on gender, age, home language and education. Participants were simply required to mark with an X the space containing the applicable response. The questions in this section were in a multiple choice format which allowed participants to choose one correct answer. The rationale behind these demographic questions is that it places the results in a frame of reference and might provide insights into differences between demographic groups or correlation with regards to SMEs and funders' behaviour.

Section B: Profile of Business Activities

Closed-ended questions were used to gather information such as:

- The number of years of experience in business;
- The positions or roles in these businesses;
- Access to finance and;
- Support from equity funders;

The intervention by the government was also queried, as was the management expertise provided by the equity funders. The correlation between the business performance and equity investment was also questioned.

The questionnaires were distributed with a covering letter (Appendix B) which included the following information:

- An explanation of the relevance of the study;
- A brief description of the objectives of the study;
- Instructions on how to complete the questionnaire;
- Assurance of confidentiality;
- Contact details if any difficulties were encountered.

3.7 Data analysis and statistical techniques used

The two major components of statistical discipline are descriptive statistics and inferential statistics. Rosnow and Rosenthal (1999: 10) define descriptive statistics as the condensing of large volumes of data into small summary measures. The authors define inferential statistics as the area of statistics which extends the information extracted from a sample to the actual environment in which the problem arises.

3.7.1 Descriptive Statistics

The current study uses descriptive statistics for frequency counts, mean scores, standard deviations and cross tabulations. Kerlinger (1986:127) defines frequencies as 'the number of objects in sets or sub-sets'. This simply means the number of times a certain answer appears in the data. 'The mean calculates an average across a number of observations and the standard deviation is the square root of the variance around the mean, in other words, how well the mean represents the data' (Field, 2005: 6).

3.8 Statistical significance

Test statistics, such as inferential techniques, are used to tell the researcher about the true state of the population, inferred from the sample. Field (2005: 31) explains that there are two possibilities in the real world (in the actual population).

- there is, in reality, an effect on the population; or
- there is no effect on the population.

Although there is no way of knowing the true situation, Fields (2005: 31) explains that 'by looking at the test statistically and the associated probability, one can decide which of the two is the most likely'.

A general decision rule is set, against which the p-value is evaluated when deciding whether the observed effect in the sample is true for the population. For the current study this is 0.05. Therefore, all p-values less than 0.05 are considered as an indication of an effect on the population.

3.9 Statistical Analysis Software

All statistical analyses in this study were computed using the SPSS statistical package for Windows version (SPSS 11.1: 2001). SPSS is the acronym for the software, Statistical Package for the Social Science.

3.10 Conclusion

It is very important to have a proper research instrument in place, because a good research document with an improper research instrument might lead to improper research results. In this research, a snowballing sampling was used and there were 78 respondents. No pilot study was undertaken, but colleagues were about comprehension of the questionnaire before it was distributed. Research ethics were adhered to in terms of the requirements for the institution. This chapter prepares for the next chapter which provides an analysis of the data collected for this study.

CHAPTER 4: PRESENTATION OF RESULTS

4.1 Introduction

In this chapter the results of this study are presented. The analysis of data was conducted using Statistical Software SPSS V17.0. The information is presented in frequency tables and bar charts for all variables, in order to determine the distribution of variables. The Durbin-Watson model test and 95% confidence interval was also done to determine the correlation between the predictor variables and the responses. Demographic information was requested in order to compile a profile of professional participants and provide information which might have a bearing on the findings of the study.

4.2 Responses

Questionnaires were distributed to the sample selected. The number of responses was 78, equating to a response rate of 39 %.

4.3 Demographic Information

<u>Age distribution</u>

The age distribution of respondents is presented in Figure 4.1. This is done in five age bands.

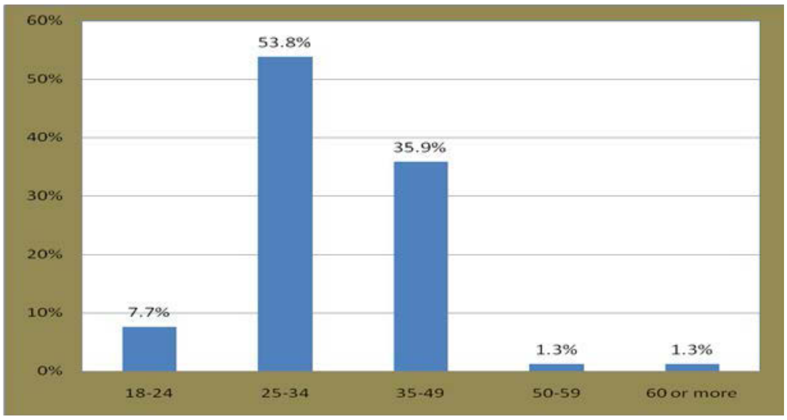

Figure 4.1: Age distribution of respondents

The age group distribution of the participants shows that the majority of respondents, i.e. 41 (53.8%), are in the age group 25 – 34 years while 28 (35.9%) are aged 35 – 49. A smaller number of respondents, i.e. 7.7%, are in the age group 18 – 24, and 1.3% in each of the groups is above 50 years of age.

<u>Gender Distribution</u>

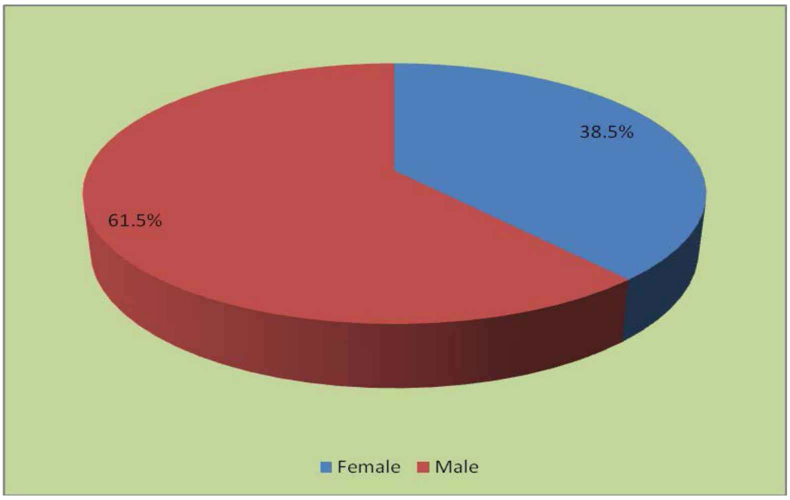

Figure 4.2: Gender distribution of respondents

Of the 78 respondents, 48 were males and 30 were females. As indicated in Figure 4.2, 61.5% of respondents were males and 38.5% were females.

<u>Marital Status</u>

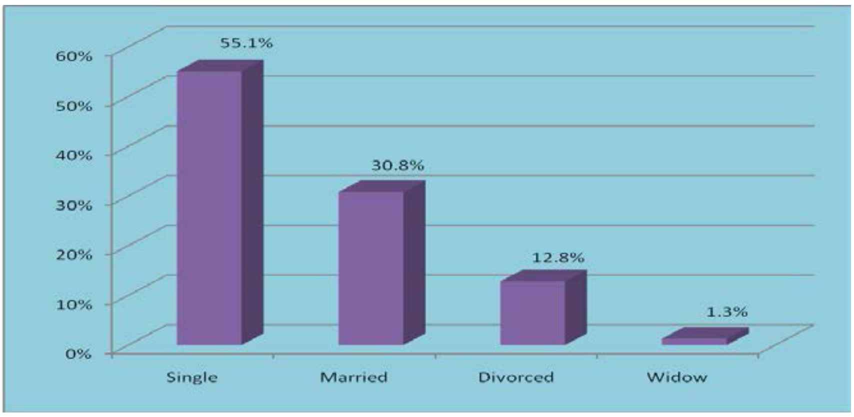

Figure 4.3: Marital status distribution

Of the 78 respondents 43 (55.1%) are single, 24 (30.8%) are married, 10 (12.8%) are divorced and just one (1.3%) is widowed.

Formal Education

Table 4.1 presents the data on education in a cross tabulation of years of formal education and the highest academic/professional qualification.

Table 4.1: Highest academic and years of formal education beyond secondary school

		How many years of formal education do you have beyond secondary/high school					
		1yr	2yrs	3yrs	4yrs	5yrs	**Total**
What is the highest academic/professional qualification	**Below matric**	4 5.1%	0 .0%	0 .0%	0 .0%	1 1.3%	**5** **6.4%**
	Post matric certificate	2 2.6%	2 2.6%	1 1.3%	0 .0%	3 3.8%	**8** **10.3%**
	Matric	2 2.6%	2 2.6%	4 5.1%	1 1.3%	1 1.3%	**10** **12.8%**
	Degree	0 .0%	0 .0%	8 10.3%	9 11.5%	10 12.8%	**27** **34.6%**
	PG Degree/ Diploma	0 .0%	1 1.3%	7 9.0%	8 10.3%	12 15.4%	**28** **35.9%**
Total		**8** **10.3%**	**5** **6.4%**	**20** **25.6%**	**18** **23.1%**	**27** **34.6%**	**78** **100.0%**

The data in Table 4.1 shows that the majority, being 28 (35.9%) of the respondents, had postgraduate degree/diploma as their highest academic/professional qualification. Within this group of respondents, 12 had five years of formal education beyond school. One respondent in this group stated that he/she had only two years of formal education beyond school, which clearly indicates the respondent did not understand the question clearly. To obtain a postgraduate (PG) degree or diploma, they would first require an undergraduate qualification of at least three years. An assumption is made that this respondent was referring to the length of study for the PG degree/diploma. There were 27 (34.6%) respondents that indicated their highest academic qualification as an undergraduate degree.

It is interesting to note that one respondent who did not pass matric, has five years of formal education beyond school.

Figure 4.4 provides a graphical presentation of years in business of the respondents.

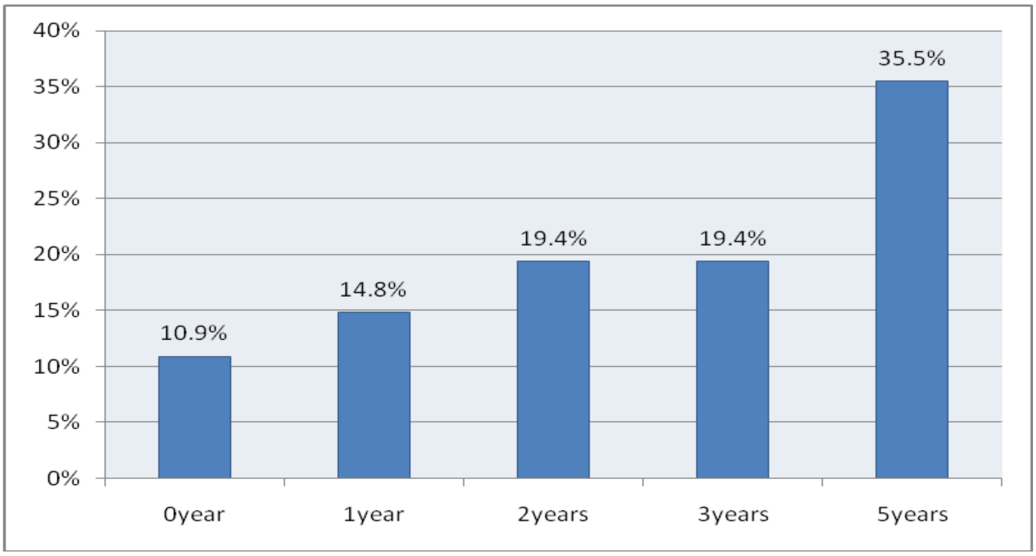

Figure 4.4: Years in business

From figure 4.4, it can be seen that the majority of respondents, 25 (35.5%), have been in a business for 5 years, and 15 (19.4%) for 2–3 years. This means that respondents are well-experienced.

<u>Organisational Function</u>

Figure 4.5 represents in graphical format the respondents' functional area within their organisation.

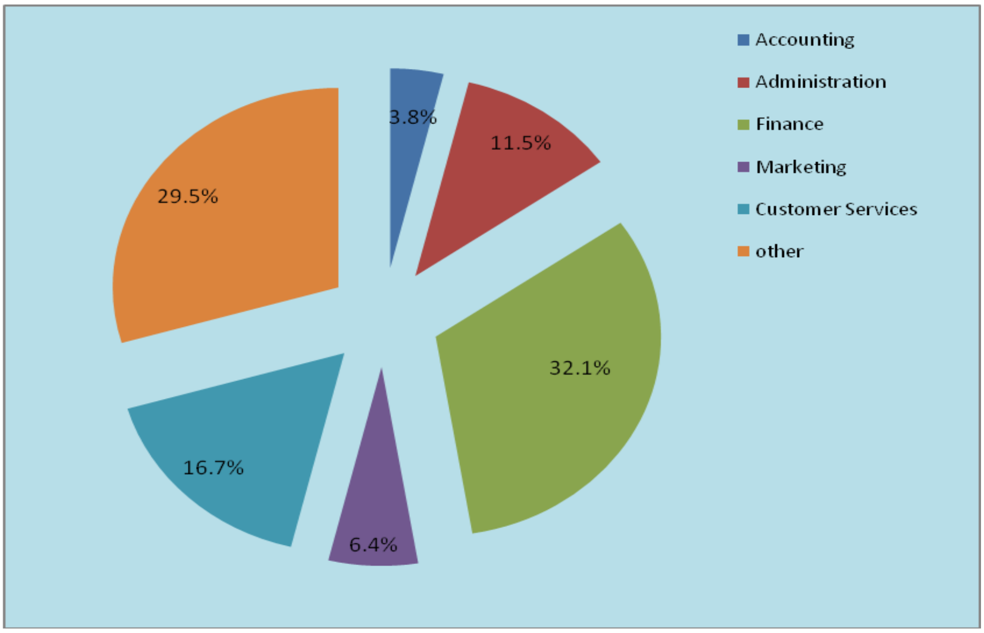

Figure 4.5: Organisational function

From figure 4.5, it can be seen that 25 (32.1%), were in the finance department, and 23 (29.5%) indicated 'other' as their department.

4.4 SME Funding

Table 4.2 represents the responses using a frequency table of the seven statements in Likert format.

It is clear that 60.3% (47) of the respondents strongly disagree and disagree that private business finance for SMEs is easily accessible in their area; 16 (20.5%) respondents strongly agree and agree and 15 (19.2%) were unsure.

There were 49 (62.8%) respondents who were familiar with government business finance facilities for SMEs, 13 (16.7%) who were not familiar and 16 (20.5%) who were unsure.

There were 33 (42.3%) respondents who indicated that government business finances for SMEs is not accessible in their area, but 42 (53.8%) strongly agree and agree that the government is trying its best to accelerate funding for SMEs.

Table 4.2: Responses in a frequency table of the seven statements

Variables	Strongly disagree		Disagree		Unsure		Agree		Strongly agree	
	Freq	***%***	***Freq***	***%***	***Freq***	***%***	***Freq***	***%***	***Freq***	***%***
Private business finance for SMEs is easily accessible in my area	27 34.6	%	20 25.6	%	15 19.2	%	7 9.0	%	9 11.5	%
I am familiar with government business finance facilities for SMEs	7 9.0	%	6 7.7	%	16 20.5	%	21 26.9	%	28 35.9	%
Government business finance for SMEs is accessible in my area	18 23.1	%	15 19.2	%	22 28.2	%	12 15.4	%	11 14.1	%
The government is trying its best to accelerate funding for SMEs	7 9.0	%	14 17.9	%	15 19.2	%	20 25.6	%	22 28.2	%
If the government incentivizes private equity funding, can small business development be accelerated?	2 2.6	%	4 5.1	%	17 21.8	%	28 35.9	%	27 34.6	%
I am familiar with private equity investors	10 12.8	%	17 21.8	%	20 25.6	%	20 25.6	%	11 14.1	%
There is a strong correlation between enterprise development and the availability of business funding	14 17.9	%	9 11.5	%	19 24.4	%	18 23.1	%	18 23.1 %	

Participants were asked: 'If the government incentivises private equity funding, can small business development be accelerated?' and 70.5% (55) respondents believed positively in this statement, 21.8% (17) respondents were unsure and 7.7% (6) respondents disagreed and strongly disagreed.

Of the respondents, 31 (39.7%) are familiar with private equity investors, 20 (25.6%) are unsure and 27 (34.6%) respondents strongly disagree and disagree.

On the issue of whether there is a strong correlation between enterprise development and the availability of business funding, 36 (46.2%) respondents strongly agree and agree, with 19 (24.4%) being unsure and 23 (29.5%) who strongly disagree and disagree.

4.5 The effectiveness of private equity on enterprise development

This section deals with an analysis of the responses to the Likert statements regarding the understanding of private equity funding and assistance.

Table 4.3: Responses in a frequency table of the ten statements

Variables	Strongly disagree		disagree		Unsure		Agree		Strongly agree	
	Freq	***%***	***Freq***	***%***	***Freq***	***%***	***Freq***	***%***	***Freq***	***%***
I am aware of the existence of private equity funding in the SMEs sector	2 2.6	%	10 12.8	%	16 20.5	%	42 53.8	%	8 10.3	%
Most SMEs are doing well as a result of private equity funding	2 2.6	%	15 19.2	%	33 42.3	%	23 29.5	%	5 6.4	%
Government should encourage private equity investment	1 1.3	%	3 3.8	%	8 10.3	%	31 39.7	%	35 44.9	%
The intervention of private equity investors in the management of businesses promote efficient running of the business	2 2.6	%	3 3.8	%	16 20.5	%	36 46.2	%	21 26.9	%
Most SMEs need the intervention of private equity investors	0		5 6.4	%	15 19.2	%	39 50	%	19 24.4	%
SMEs should be made aware of the available private equity investors	0		0		4 5.1	%	40 51.3	%	34 43.6	%
The business skills and expertise brought by private equity investors increases business performance	1 1.3	%	3 3.8	%	9 11.5	%	34 43.6	%	31 39.7	%
Businesses which enjoy management aid by private equity investors experience business growth.	1 1.3	%	2 2.6	%	18 23.4	%	31 39.7	%	26 33.3	%
There is a correlation between private equity growth and business development	0		7 9.0	%	14 17.9	%	35 44.9	%	22 28.2	%
There is a correlation between private equity investment and SMEs growth & development	1 1.3	%	6 7.7	%	15 19.2	%	34 43.6	%	22 28.2	%

The majority of the respondents, 50 (64.1%), are aware of the existence of private equity funding in the SME sector and (42.3%) respondents are unsure whether most SMEs were doing well as a result of private equity funding.

The majority of the respondents, 66 (84.6%), strongly agree and agree that government should encourage private equity investment, 8 (10.3%) respondents were unsure and 3 (3.8%) disagree and 1 (1.3%) strongly disagree.

When participants were asked whether the intervention of private equity investors in the management of businesses promotes efficient running of the business, 57 (73.1%) responded positively, 16 (20.5%) respondents were unsure, 3 (3.8%) disagree and 2 (2.6%) strongly disagree.

Of the respondents, 58 (74.4%) strongly agree and agree that most SMEs need the intervention of private equity investors, 15(19.2%) disagree and 0% strongly disagree.

There are 74 (95%) respondents who strongly agree and agree that SMEs should be made aware of the available private equity investors, with 65 (83%) agreeing and strongly agreeing that the business skills and expertise brought by private equity investors increase business performance. It is understandable that no respondents disagreed (including strongly) that SMEs should be made aware of available private equity investors, but it is surprising to note that 4 respondents were unsure.

A majority of 57 (73.1%) responded positively that businesses which enjoy management aid by private equity investors experience business growth, and there is a correlation between private equity growth and business development. Of the respondents, 56 (71.8%) responded positively that there is a correlation between private equity investment and SMEs growth and development.

4.6 Summary statistics

Table 4.4 represents the mean and standard deviations (SD) for the responses to the statements regarding SME funding. Statistical analyses were performed using the Durbin-Watson model test and a 95% confidence interval. A p-value less than 0.05 indicates statistical significance.

Table 4.4: Mean, SD, Confidence Levels – SMMEs Funding

Variables	Mean	SD	95% Confidence Interval		P- value
Private business finance for SMEs is easily accessible in my area	2.37	1.349	-.172	.045	.244
I am familiar with government business finance facilities for SMEs	3.73	1.276	-.115	.120	.968
Government business finance for SMEs is accessible in my area	2.78	1.345	-.202	.058	.271
The government is trying its best to accelerate funding for SMEs	3.46	1.316	-.052	.160	.312
If the government incentivizes private equity funding, can small business development be accelerated?	3.95	1.005	-.061	.192	.304
I am familiar with private equity investors.	3.06	1.252	-.107	.107	.997
There is a strong correlation between enterprise development and the availability of business funding	3.22	1.402	-.087	.137	.662

Table 4.5 represents the mean and standard deviations (SD) for the responses to the statements regarding the effectiveness of private equity on enterprise development. Statistical analyses were performed using the Durbin-Watson model test and a 95% confidence interval. A p-value less than 0.05 indicates statistical significance. As none of the results in Table 4.4 indicates a p-value of <0.05, there is no statistical significance.

Table 4.5: Mean, SD, Confidence Levels – Effectiveness of Private Equity

Variables	Mean	SD	95% Confidence Interval		P- value
I am aware of the existence of private equity funding in the SMEs sector	3.56	.934	-.174	.131	.776
Most SMEs are doing well as a result of private equity funding	3.18	.908	-.188	.100	.545
Government should encourage private equity investment	4.23	.882	.035	.351	.018
The intervention of private equity investors in the management of businesses promote efficient running of the business	3.91	.928	-.225	.106	.476
Most SMEs need the intervention of private equity investors	3.92	.834	-.277	.140	.516
SMEs should be made aware of the available private equity investors.	4.38	.586	-.119	.316	.371
The business skills and expertise brought by private equity investors increases business performance	4.17	.874	-.220	.168	.788
Businesses which enjoy management aid by private equity investors experience business growth	4.01	.890	-.356	.128	.349
There is a correlation between private equity growth and business development	3.92	.908	-.248	.247	.998
There is a correlation between private equity investment and SMEs growth and development	3.90	.948	-.152	.285	.545

4.7 Conclusion

This chapter provides the results of the data analysis from the responses received. A total of 78 responses were received, 39% representing the response rate of which 61.5% were male and 38.5% were females. The respondents indicated that they have ample business experience as 25 (35.5%) of the respondents have been in a business for 5 years, 15 (19.4%) 3 years, 15 (19.4%) 2 years, 11.5 (14.8%) 1 year and 10.9% of the respondents have 0 years of experience. This means that respondents are well-experienced. The analysis was conducted on the respondents' understanding of a broad selection of statements about business funding. The next chapter discusses the findings from the analysis of the results.

CHAPTER 5: DISCUSSION OF RESULTS

5.1 Introduction

The research analysis presented in Chapter 4 serves as a window to this chapter as it provides the researcher with an indication of whether there is a correlation between the research objectives and the research findings. The results will either concur with or refute the research and the previous work done. The aim is to make a meaningful contribution to the business community and society at large. The research discussion aims to unpack the correlations and the variances, with the aim of making recommendations derived from the discussions of the results.

5.2 Research findings

The research results, in collaboration with the literature review, give answers to the research questions and research objectives. The research questions and objectives are the reason for the existence of the research document. Each objective is evaluated against the research results and the literature review including the previous work done.

5.2.1 To explore the contribution of private equity finance to SMEs

The research results show that there is a high correlation between SMEs and the intervention equity investment. Of the respondents, 46.2% and 26.9% agree and strongly agree respectively that there is a high correlation between SMEs and the intervention of private equity investment. The KPMG and SAVCA Report (2008: 8) states that private equity fund managers play a vital role in managing their investments into companies, as they derive a return from the increased valuation of their investments (not just debt repayment and an associated interest rate) and, hence, focus on business development for the companies in which they invest.

The venture capitalists have made a significant contribution to the SMEs. Struggling SMEs who could not get help from traditional commercial banks because of stringent lending criteria, but private equity financiers are providing a package that accommodates the SMEs. The private equity financiers offer technical expertise and management contributions to struggling entrepreneurs. Venture Impact (2004) reports that in the United States of America, 9.4% of the total work force is employed in venture capital backed companies, with 9.6% of the total sales in 2003. It is found that the employment growth rate of VC backed companies in terms of being in the industrial sector is also quite impressive.

According to Jones (2003: 4), venture capital offers several additional advantages. In the South African context, the industry can play an increasingly important role in economic empowerment, social upliftment and economic growth. Historically small and medium-sized enterprises (SMEs) have found it very difficult to raise capital through the conventional route, therefore, stunting economic growth and job creation.

In order to evaluate the contribution of private equity in South Africa one must first consider its international contribution. Private equity is a new concept in South Africa, but not in other countries such as the USA and the United Kingdom. It is not surprising to see such a high correlation between private equity and SMEs development as this study has shown. KPMG's Private Equity Report (2007) asserts that in the emerging markets of Asia, private equity investment has predominantly seen a growth in capital.

The research results also show that there is a very high correlation between the business skills and expertise brought by private equity investors and the business performance. By far the majority of respondents agree and strongly agree at 43.6% and 39.7% respectively. Commercial banks are reluctant to finance struggling entrepreneurs, as they have no business or management skills. Private equity investors bridge the gap by including technical skills and management skills when investing in these struggling entrepreneurs' businesses.

The KPMG and SAVCA Reports (2006) cement the positive contribution by private equity capital, making an example of 'Little Sheep', a restaurant chain in China known for its hotpot cuisine. It became more efficient, effective and profitable with the cash investment injection from international know-how by two non-executive directors brought in by 3i (an investment company), Mr. Nish Kankiwala, former CEO of Burger King International, and Yuka Yeung, KFC's Hong Kong Master Franchisee CEO. This shows that high correlation between the business skills and expertise brought by private equity investors and the business performance.

5.2.2 To explore the availability of private equity capital in South Africa

From Table 4.5 it is observed that SMEs suffer from several problems which hamper their growth. Statistical findings show that government should encourage private equity investment (with $p<0.05$, mean=4.23, SD=0.882 and 95% CI (0.035-0.351)) which shows a higher statistical difference.

There is a strong correlation between enterprise development and the availability of business funding. Private business finance for SMEs is not easily accessible, and although participants are familiar with government business facilities for SMEs the results in table 4.5 also show that there is no statistical significance ($p>0.05$). From Table 4.2 it is shown that 34.6% of respondents strongly disagree and 25.6% disagree that business finance is readily available, but however, 35.9% and 34.6% of the respondents agree and strongly agree respectively that if government can incentives private equity funding, small business development can be accelerated. On the same breath, Table 4.3 shows a total of 84.6% respondents agreeing that the government should encourage private equity investment. A total of 69.5% of respondents also agreed in Table 4.2 that SMEs can be accelerated if the government incentivise private equity investment. If one looks at the following responses in Figure 4.2: Private business finance for SMEs being easily accessible in the area and government business finance for SMEs being accessible in the area, there are almost an equal number of respondents who agree/strongly agree and those that are unsure. This indicates that there appears to be a lack of knowledge of both private and government funding initiatives.

There is a correlation between private equity investment and SMEs growth and development. There is no statistical significance ($p>0.05$) that government business finance for SMEs is accelerating SMEs funding. Participants are aware of the existence of private equity funding in the SMEs sector, and SMEs should be made aware of the available private equity investors. Respondents are not familiar with private equity investors. The government needs to look into various way of introducing incentives aimed at promoting private equity funding.

5.2.3 To explore the interventions made by the government towards equity capital finance

In Table 4.4The results show that there is no statistical significance (p=0.312, mean=3.46, SD=1.316, at a 95% Confidence Interval (CI) of 0.160 and -0.312) that the government is trying its best to accelerate SMEs funding. From Table 4.2 the results show that 25.6% and 28.2% of the respondents agree and strongly agree respectively that the government is trying its best to accelerate SMEs funding. Reddy (2006) asserts that the government has taken a bold step through Khula Enterprise Finance in partnership with the Enablis as a pre-venture capital funding.

Also, the government, through the Meso-finance sector, Khula Enterprise Finance and the IDC in co-operation with ABSA bank, are involved in an agreement whereby they stand guarantor on behalf of those enterprises which cannot provide collateral (Hanning & Joubert, 203: 20).

The ALTX is specifically aimed at fast-growing businesses, start-ups, family-owned businesses, BEE companies and junior mining companies. A partnership between the JSE Limited and the Department of Trade and Industry (DTI), ALTX gives smaller companies the opportunity to issue new shares, raise capital, widen their investor base and have their shares traded in a regulated market (South Africa. Info, 2008). From the results of this study it seems that despite government's intervention there is little improvement in getting finance to the SMEs sector, especially those that traditional banks do not fund.

The government through its communication media needs to popularise its intervention because it appears that the business community is not aware of its interventions or that there might be is some bureaucratic red tapes in existence.

5.3 Conclusion

The research results indicate a positive correlation between private equity investment and enterprise development in South Africa. This is also supported by the international experience as discussed in Chapter Two. The example of 'Little Sheep', a restaurant chain in China known for its hotpot cuisine, has grown into a huge efficient and profitable entity immediately after the involvement of private equity investors. However, the results of this study show that in South Africa there is still more to be done irrespective of the positive relations between private equity investment and enterprise development. It seems that the notion of private equity investment is not properly disseminated to the relevant target groups.

CHAPTER 6: CONCLUSIONS AND RECOMMENDATIONS FOR FURTHER RESEARCH

6.1 Introduction

Enterprise development is the foundation of every country's economic prosperity. Productivity, employment and economic growth are highly dependent on the development of enterprises in a country. Within the context of SMEs in South Africa, there is still a lot of work to be done in this sector. SMEs have a major role to play, but their greatest enemy is the non availability or lack of access to finance by this sector. Investors mostly consider SMEs to be a very risky investment, making it very difficult for this sector to access financial assistance. Due to this, private equity investment seems to be the relevant source of financing for this sector. This stems from the fact that private equity investment seems to be the correct choice of investment what is often considered a high risk sector like SMEs, because the risk can be mitigated through the active participation of the investor in the management of the affairs of the business. 'Private equity means the equity financing of unquoted companies at many stages in the life of a company from start-up to expansion together with management buy-outs and buy-ins often by established companies. Private equity capital is essentially money that is invested into a company in exchange for an ownership interest in return for a share of the profits and part ownership of the business' (KPMG Report, 2001: 08). The investor is not only the provider of finance, but through active involvement of the investor in the business, skills and knowledge can be transferred during the investment period. The venture capitalist forms part of the management of the investee business. This makes it easier to transfer business expertise to the SMEs or investee company.

6.2 Implication of this research

The SAVCA was formerly launched in 1998, more than a decade ago, but it appears from this research that the association is not marketing itself properly or at all. Table 4.2 supports this statement, where respondents were asked whether they are familiar with private equity investment. The respondents agree and strongly agree at 25.6% and 14.1% respectively being familiar with private equity investment. In Table 4.3 the same respondents strongly agree and agree at 43.6% and 51.3% respectively that SMEs should be made aware of the private equity investors as they bring in skills and expertise which increase business performance. It is, therefore, incumbent for the SAVCA and the government-funded DFIs, such as the IDC, Khula enterprise, NEF, PIC and the others, to make it a point that their footprints are visible to the business community at large.

6.3 Recommendations for Further Research

This research has shown a clear indication of the need for improvements to the role of private equity finance programmes. Furthermore, due to the increase in skills transfer of investors' involvement, it is clear that this type of investment should be encouraged. The contribution of private equity to enterprise development in South Africa is a bit obscure. It is difficult to quantify the contribution of angel investors, as the market is not fully formalised as in the United Kingdom and the United States of America. It is recommended that further research should be undertaken to formalise the angel investing/angel investment process in South Africa because there is no formal structure governing angel investments like SAVCA. 'The process needs to be researched and a model for the angel investment process must be established. In addition to the above statements, guidelines for the transfer of knowledge in the investment process may also contribute to the success rate of new ventures' (Cadle, 2009: 194).

Government should play a meaningful role to make sure that private equity investment becomes a real phenomenon and not just a big business term. Research should be done to see how improvement could be made to increase the use of private equity funding. Once there is more widespread use of this source of funding, then further research can be undertaken to empirically ascertain it effectiveness.

6.4 Conclusion

The main objective of the study was to determine the contribution of private equity investment to enterprise development in South Africa. Enterprise development is characterised by productivity, employment level, profit margin and a percentage contribution to the country's GDP.

According to Jones (2003: 21), private equity was seen to be a very risky investment, but in the 1990s European investors began to react favourably to this new asset class. Private equity was generating impressive returns and the investors wanted to be part of that trend.

'Private equity investors have a considerable impact on productivity, skills development, national competitiveness and job creation, as they include the transfer and exchange of know-how and not only the flow of capital' (Falkena *et al.*, 2001: 8).

Private equity backed companies view the contribution to their businesses by private equity investors as positive. In addition to providing funding, private equity investors are also an important source of guidance and advice for the companies in which they invest (Selkirk, 2006: 14). The research results on the effectiveness of private equity on enterprise development: About 74.4% of respondents in the research conducted felt that most enterprises or SMEs need the intervention of private equity investors; 73.1% felt that the intervention of private equity investors in the management of businesses promote efficient running of the business; 83.3% felt that the business skills and expertise brought by private equity investors increases business growth, and lastly, 73.1% of the respondents felt that there is a correlation between private equity growth and business development.

The data collected shows a positive relationship between enterprise development and the availability of private equity investment. However, the results indicate that programmes and funding available are not reaching the desired target. Skills development and knowledge transfer are a positive outcome from angel investments and thus this should be encouraged. The BEE code of practice includes enterprise development as one of its pillars. It is, therefore, proposed that the same needs to be done with the private equity investment, with the government introducing a policy document which will encourage private equity investment with the sole purpose of fostering enterprise development in the country.

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APPENDIX 1: COVERING LETTER

UNIVERSITY OF KWA-ZULU NATAL

GRADUATE SCHOOL OF BUSINESS

MBA Research Project

Researcher: Charlie Sam Nhleko (072 248 4696 / 083 513 8088)

Supervisor: Ms. Gill Manion (082 801 0357)

The contribution of Private Equity Capital to Enterprise Development in South Africa

The purpose of this survey is to solicit information from participants regarding the contribution of private equity to enterprise development in South Africa. The information and ratings you provide us will go a long way in helping us identify the solutions. In this questionnaire, you are asked to indicate what is true for you, there is no 'wrong' or 'correct' answers to the questions. Work as quickly as possible. If you wish to make a comment please write it directly on the booklet itself. Make sure you answer all questions.

APPENDIX 2

UNIVERSITY OF KWA-ZULU NATAL

GRADUATE SCHOOL OF BUSINESS

MBA Research Project

Researcher: Charlie Sam Nhleko (072 248 4696 / 083 513 8088)

Supervisor: Ms. Gill Manion (082 801 0357)

Dear Respondent,

I, Charlie Sam Nhleko an MBA student, at the Graduate school of Business, of the University of Kwa Zulu Natal invite you to participate in a research project entitled 'The contribution of Private Equity Capital on the Development of SMEs in South Africa' The purpose of the project is to evaluate how the private equity funding can help to elevate business development in the country.

Through your participation I hope to understand and explore the current trends in the private market both locally and internationally. The results of the survey are intended to contribute to provide recommendations for the enhancement of the Private Equity Capital.

Your participation is voluntary. You may refuse to participate or withdraw from the project at any time with no negative consequences. Confidential anonymity is the name of the game, and records identifying you as a participant will be maintained by the UKZN's Graduate School of Business

If you have any questions or concerns about completing the questionnaire or about participating in this study, you may contact me or my supervisor at the numbers listed above.

It should take you about 15-20 minutes to complete this survey, which I hope you will take the time to complete.

Sincerely

Investigator's signature_______________________________ Date 28 January 2008

CONSENT

I, __________________________________ the undersigned have read and understand the above information. I hereby consent to participate in the study outlined in this document. I understand that participation is voluntary and I may withdraw at any stage of the process.

Participant’s signature______________________________________ Date_____________________

APPENDIX 3: QUESTIONNAIRE

Tick the box or the number corresponding to your answer with an X

1. Your age group is 18-24 25-34 35-49 50-59 60 or more

2. Sex Female Male

3. Marital status Single Married Divorcee Widow Other: specify

4. How many years of formal education do you have beyond secondary / high school?

   0 1 2 3 4 5 or more years

   4(a) What is your highest academic / professional qualification?

	Qualification	Tick
1	Below Matric	
2	Matric	
3	Post Matric Certificate	
4	Degree	
5	PG Degree/Diploma	

5. How many years have been in business?

   0 1 2 3 4 5 or more years

6. Please indicate your main organisational function

   Accounting

   Administration

   Finance

   Human Resources

   Marketing

   Operations

   Customer Services

   Other (Please specify) -----------------------

QUESTIONNAIRE:

Please rank the following on a scale of 1 to 5, with 1 (the least) being strongly disagree and 5 (the highest) being strongly agree.

<u>Tick the number corresponding to your answer with an X in the boxes underneath the number.</u>

1. Private business finance for SMEs is easily accessible in my area.
   - Strongly Disagree 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ Strongly Agree

Job creation and sales growth

	Year 2002	Year 2003	Growth	All PS Gr
Job creation	9.5million	10.1million	6.32%	
Sales	$1.6 Trillion	$1.8 Trillion	12.50%	

2. I am familiar with government business finance facilities for SMEs.
   - Strongly Disagree 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ Strongly Agree

3. Government business finance for SMEs is accessible in my area
   - Strongly Disagree 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ Strongly Agree

4. The government is trying its best in accelerating SMEs funding.
   - Strongly Disagree 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ Strongly Agree

5. If the government can encourage private equity funding, can small business development can be accelerated?
   - Strongly Disagree 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ Strongly Agree

6. I am familiar with private equity investors.
   - Strongly Disagree 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ Strongly Agree

7. There is a strong correlation between enterprise development and the availability of business funding.
   - Strongly Disagree 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ Strongly Agree

The effectiveness of private equity on enterprise development (Please mark with a tick)

	Strongly disagree	disagree	Unsure	Agree	Strongly agree
8. I am aware of the existence of private equity funding in the SMEs sector					
9. Most SMEs are doing well as a result of private equity funding					
10. Government should encourage private equity investment					
11. The intervention of private equity investors in the management of businesses promote efficient running of the business					
12. Most SMEs needs the intervention of private equity investors					
13. SMEs should be made aware of the available private equity investors					
14. The business skills and expertise brought by private equity investors increase the business performance					
15. Businesses which enjoy management aid by private equity investors experience business growth.					
16. There is a correlation between private equity growth and business development					
17. There is a correlation between private equity investment and SMEs growth & development					