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**AN EXPLORATORY STUDY TO DETERMINE IF
THE VENTURE CAPITAL SCHEMES FRAMEWORK
CAN BE INTRODUCED TO SOUTH AFRICA**

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Topic : An exploratory study to determine if the
Venture Capital Schemes Framework can
be introduced to South Africa

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DECLARATION

“I, Rajendran Govender, hereby declare that:

- the work in this report is my own original work,
- all sources used or referred to have been documented and recognised,
- this report has not been previously submitted in full or partial fulfilment of the requirements for an equivalent, or higher qualification at any other educational institution.”



Rajendran Govender

September 2003

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ABSTRACT

The South African government has indicated that the National Small Business Act of 1996 had failed to get the small business sector working successfully as engine for growth. Thus, government policy measures, using an institutional network alone, to create a thriving SME economy, has not succeeded. The Minister called for small business and other institutions to develop suggestions for inclusion in a new business strategy document.

One such strategy, as proposed by this thesis, involves the introduction and implementation of the Venture Capital Schemes (VCS) Framework. The purpose of the dissertation is to conduct an exploratory study of the VCS framework and to determine if the VCS framework is worthwhile pursuing in South Africa, following its successful introduction in the United Kingdom.

To achieve effective implementation of the VCT framework, specific issues to the various components and key players require addressing:

- Are there potential high-growth SMEs that are being overlooked?
- Is there a definite ‘equity gap’ to satisfy the needs of potential SMEs that is not being serviced?
- Are there sufficient investors who can be attracted to fund this ‘equity gap’?
- Are there sufficient rewards for the private sector financial institutions (venture capitalists and associated network) to be willing to manage and drive the VCT framework?

To obtain the required information, a discussion / interview was conducted with Business Partners Limited – East Fund (a leading South African venture capitalist who is involved in both ‘pure’ venture capital funding as well as having integral ties with SMEs).

The Venture Capital Schemes Framework, in theory, appears to be a viable option. However, the response indicates that the larger venture capital / private equity firms will not be willing to drive the VCS framework, since it requires an adjustment to their investment philosophy. The response has also indicated that a RFI with a

reasonable network of resources, operating as a private company, will be in the best position to drive the VCS framework. It will also be able to attract competition from the smaller venture capital / private equity firms, accounting firms and business advisors, to create a vibrant VCT market (industry). Hence, a thriving SME economy could become a reality.

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CHAPTER ONE: INTRODUCTION

1.1. Preamble

The South African Trade and Industry Minister, Alec Irwin, stated at the 13th annual conference of the Southern African Entrepreneurship and Small Business Association in Johannesburg in August 2001 that the National Small Business Act of 1996 had failed to get the small business sector working successfully as engine for growth. The Minister called for small business and other institutions to develop suggestions for inclusion in a new business strategy document.

It is against this background that an academic inquiry (MBA [Strategic Financial Management] Thesis) has been initiated. The object of the investigation will be to ascertain if the Venture Capital Schemes (VCS) framework as applied to the United Kingdom (UK), with the necessary modifications, can be introduced to South Africa.

1.2. Background to the problem

A major challenge facing the South African government is how best to use its finite resources to support Small Medium Micro Enterprises (SMMEs) or entrepreneurship, and how its overall support interfaces with access to finance and the role of private financial institutions in service provision.

A major challenge is to ensure that that if firms become viable entities on the non-financial side (display growth potential), then the financial market (both public and private sectors) should not prejudice them should they require finance.

The 1995 White Paper on National Strategy for the Development and Promotion of Small Business in SA has been the first major effort by the South African government to design a policy framework particularly targeting the entire spectrum of small enterprise sector.

The overall objective of the strategy was to create an enabling environment for SMME growth. In response to the challenges set out in the White Paper, a four-

pronged new institutional network at national level were established to drive the National Small Business Strategy.

The originally well-intended policy measures suffered from sub optimal implementation. General distrust to external agencies among SMMEs on the one hand, and the incapacity of support institutions to persuasively raise awareness about their existence and effectiveness on the other, are said to lie at the heart of the problem. Moreover, the poor coordination of services results in a replication of services, and clustering of institutions in urban areas.

Thus, government policy measures, using an institutional network alone, to create a thriving SME economy, will not suffice. To this end, the private sector financial institutions (venture capitalists and associated network) should be invited to work alongside the institutional network with lured incentives to create a competitive small firm economy.

1.3. Statement of the Problem

The South African government has been unable to foster a thriving entrepreneurial spirit despite its valiant attempts and support initiatives to help steer small business to greater success rates. **In short, South Africa does not have a booming SME economy.**

The poor success of small firms, have been researched partially, the broad problem areas, weakness and shortcomings are listed below:

- i. The problem lies in the small firms themselves, that is the SMME economy lacks ambition and drive (entrepreneurial spirit) in the quest to pursue growth
- ii. The problem lies in the area that there are insufficient growth prospects in the offering to small firms.
- iii. The problem lies in the area of financial intermediation services to potential high-growth firms, both financial services (funding constraints, that is potential high-growth firms are not receiving the financial aid they require to enable them to grow) and non-financial services (additional skills and managerial services provided by business advisors) are lacking.

In 1995, the United Kingdom (UK), launched the Venture Capital Schemes Framework (VCS), a policy strategy devised by the Inland Revenue Services in collaboration with the key players, to provide solutions to alleviate some of the problems, weakness and shortcomings mentioned in the three categories listed above.

The objectives of the Venture Capital Schemes are:

1. The **immediate objective** of the schemes is that the tax incentives provided by the EIS and the VCT scheme should improve the post-tax returns for investors, thereby encouraging them to invest more in the companies covered by the schemes (i.e. the schemes should increase the supply of finance).
2. The **intermediate objective** of the schemes is that the companies should then be enabled to use the funds (coupled with managerial advise) to improve their performance.
3. The **ultimate objective** is that the UK economy should benefit by having a more competitive small firms economy.

The UK has been able to implement the VCS framework, with a modest level of success, in creating a competitive small firms economy. **The main issue arising is why South Africa has not considered such a framework as part of its policy strategy, to create a competitive small firms economy.**

The main objective of the study is to determine, from an exploratory basis, if the VCS framework can be applied to South Africa along similar lines as the UK to achieve similar goals, that is, to foster a thriving SME economy, providing solutions to some of the problem areas, weaknesses and shortcomings, mentioned above. The qualitative approach to the study, in a limited scale, will attempt to gain an appreciation of the workings of the VCS framework. The study will attempt to unearth factors that limit (hinder) its application in South Africa, which can be used for consideration in a more detailed study.

1.4. Purpose of the Dissertation

The government has indicated that the National Small Business Act of 1996 had failed to get the small business sector working successfully as engine for growth. Thus, government policy measures, using an institutional network alone, to create a thriving SME economy, has not succeeded. The Minister called for small business and other institutions to develop suggestions for inclusion in a new business strategy document.

One such strategy, as proposed by this thesis, involves the introduction and implementation of the Venture Capital Schemes (VCS) Framework. The individual components of the VCS Framework can be phased in over a period of time. In essence, the government reduces its responsibility of creating a thriving SMME economy and pass some of the responsibility over to the private sector financial institutions (venture capitalists and associated network), individuals and companies in exchange for incentives (tax breaks, etc).

The purpose of the dissertation is to conduct an exploratory study (using qualitative methods) of the VCS framework and to determine if the VCS framework is worthwhile pursuing in South Africa. The qualitative approach to the study, in a limited scale, will attempt to gain an appreciation of the workings of the VCS framework. The study will also attempt to unearth factors (if any) that limit its application in South Africa, which can be used for consideration in a more detailed study.

In this study, the VCS framework will be limited to one component only, namely Venture Capital Trusts (VCT). The other components, namely, Enterprise Investment Scheme (EIS) and the Corporate Venturing Scheme (CVS) will not be studied since it shares similarities with the VCT and may complicate the study. However, references will be made to it to achieve clarity and completeness.

In order to apply the VCT framework, the various components and key players need to be identified and address issues specific to the various components and key players. The issues that need to be addressed are:

- Are there potential high-growth SMEs that are being overlooked?

- Is there a definite 'equity gap' to satisfy the needs of potential SMEs that is not being serviced?
- Are there sufficient investors who can be attracted to fund this 'equity gap'?
- Are there sufficient rewards for the private sector financial institutions (venture capitalists and associated network) to be willing to manage and drive the VCT framework?

The answers to these issues and questions will revolve around a discussion focussed interview with a leading South African venture capitalist who is involved in both 'pure' venture capital funding as well as having integral ties with SMEs.

The limitation of the research study is that it will only generate sufficient awareness and light on the topic of Venture Capital Schemes. This is the deliberate intention of the research, since it merely proposes to understand the key issues which may be further investigated for preparing a strategy (for implementation) to create a thriving SME economy or to uncover reasons as to why it cannot be implemented.

CHAPTER 2: LITERATURE REVIEW

2.1 Introduction

The South African Trade and Industry Minister, Alec Irwin, stated at the 13th annual conference of the Southern African Entrepreneurship and Small Business Association in Johannesburg in August 2001 that the National Small Business Act of 1996 had failed to get the small business sector working successfully as engine for growth. The Minister called for small business and other institutions to develop suggestions for inclusion in a new business strategy document.

It is against this background that an academic inquiry has been initiated. The inquiry specifically addresses the viability of the introduction of VCS to South Africa, to create a thriving SME economy in South Africa.

2.2 Literature Review Format

2.2.1. Framework of VCS as applied to the UK

2.2.1.1 Summary of VCS explaining the objectives, rules and regulations.

2.2.1.2 The effectiveness of VCS in UK since its introduction (Inland Revenue research report)

2.2.2 Assessment of the effectiveness of South Africa's institutional support network to assist SMEs

2.2.3 Models and approaches for SMEs to pursue growth

2.2.3.1 Perren – Factors in the growth of micro-enterprises

2.2.3.2 Porter – Diamond on National Competitive Advantage

2.2.4 Secondary data analysis of SMEs

2.2.5 Secondary data analysis as to who will serve as VCT managers

2.2.1.1 Summary of the Venture Capital Schemes

This section of the work draws on experiences of the UK government policies for creating a thriving SME economy. It attempts to draw parallels between the SA SME economy and the UK SME economy at the time of implementation of the Venture Capital Schemes. It shall also assess the different components and criteria required for the implementation of the VCS.

The rationale for implementation of the Venture Capital Schemes is that smaller, unquoted companies find it difficult to raise external equity finance for one or more of the following reasons:

1. Information costs.

The costs to an investor of obtaining the information needed to appraise the risks and expected returns from an investment tend to be high, relative to the size of investment, in the case of smaller companies.

2. Asymmetric Information and principal / agent problems.

A business owner is likely to be better placed than prospective external venture capitalists to assess the prospects for his/her business. The latter might wish to compensate for this by seeking higher returns and exercising a degree of control over how the business is run. However, entrepreneurs may be reluctant, to dilute their control by bringing in external equity. As a result, profitable investment and growth opportunities may be forgone.

3. Inexperienced management.

Entrepreneurs, scientists, engineers etc. who wish to exploit their ideas commercially may lack managerial skills, making external investors reluctant to put in funds. The EIS allows for the possibility of investors taking a managerial role in a company, following their investment. Similarly, a VCT's managers may have more influence than an individual investor could have over how a company receiving funds is run.

Objectives of the Schemes

Both the VCT and EIS schemes have similar broad objectives:

1. The **immediate objective** of the schemes is that the tax incentives provided by the EIS and the VCT scheme should improve the post-tax returns for investors, thereby encouraging them to invest more in the companies covered by the schemes (i.e. the schemes should increase the supply of finance).
2. The **intermediate objective** of the schemes is that the companies should then be enabled to use the funds (together with assistance from business advisors) to improve their performance.
3. The **ultimate objective** is that the UK economy should benefit by having a more competitive small firms economy.

It becomes evident from the rationale and objectives of the UK VCS that the South African SME economy has similar problem areas and shortcomings (as discussed in the problem statement) to that of its UK counterpart.

The key players in the VCS framework are:

- Investors (individuals wrt VCT and EIS and companies wrt CVS)
- Qualifying companies (potential high-growth SMEs requiring finance)
- VCT managers (venture capitalists and associated network who will drive the VCT framework)

What is now required, is to determine if the key players can be found in South Africa and the extent to which each of them can satisfy their requirements in the creation of a VCS in SA.

The full literature review giving a brief outline of the four schemes and the participants of each scheme, together with the rules and regulations of the schemes, is presented in Appendix I. It also includes pertinent facts about investor profiles and investor expectations. Also included are sections of assistance to VCT managers,

namely, development of the VCT market, the VCT investment remit and performance of the VCT funds. These sections will provide valuable guidance and enhance the requirements and expectations of VCT managers.

2.2.1.1 The effectiveness of VCS in UK since its introduction

Comprehensive research into the Enterprise Investment Scheme and Venture Capital Trusts was undertaken by PACEC (Public and Corporate Economic Consultants) of the UK. The research results were published in April 2003, almost nine years after the introduction of the schemes.

The objectives of the research were to:

1. Provide a quantitative and qualitative analysis of the effects of the schemes on the supply of finance to smaller, higher risk, trading companies;
2. Provide information on how investing companies have used the funds that they may have raised through the schemes and on what difference this has made to their financing and performance; and
3. Provide a first evaluation of the wider economic effects of the schemes and their cost-effectiveness.

A summary of the report is presented in the following format:

Chapter 1:	Introduction
Chapter 2:	Literature review
Chapter 3:	Characteristics of investors and companies involved in the schemes
Chapter 4:	Effects of the schemes on investors and the supply of finance
Chapter 5:	Effects of the schemes on companies
Chapter 6:	The role of advisors
Chapter 7:	The wider economic effects of the schemes
Chapter 8:	Overall conclusions on the effectiveness and cost-effectiveness of the schemes

This section of the review provides a basis for the discussion/interview with potential VCT managers and what modifications will be necessary to implement such a scheme in South Africa.

Summary of report

Chapter 1: Introduction

The report sets out the results of research into the Enterprise Investment Scheme (EIS) and the Venture Capital Trust (VCT) scheme, undertaken by PACEC for the Inland Revenue.

Both schemes provide tax incentives to individuals to encourage the supply of equity finance to smaller, unquoted, trading companies. The EIS was introduced in January 1994 and the VCT scheme was introduced in April 1995. The former provides reliefs to investors' direct equity holdings in qualifying companies, whereas the latter provides reliefs for indirect portfolio investments administered by professional fund management companies. It is intended that the tax reliefs should encourage investors to increase the supply of finance to companies that might otherwise have difficulties in obtaining it, and that those companies should be able to improve their performance as a result.

A cumulative total of nearly £2.2 billion was invested through the EIS between its launch and tax year 2000/01. The equivalent amount invested through the VCT scheme between its launch and 2000/01 was just over £1.4 billion. The cumulative cost of the EIS to the public purse, in terms of tax forgone, was £750 million to the end of 2000/01. The equivalent for the VCT scheme was £400 million.

The schemes share broad objectives.

The **immediate objective** is that the tax incentives provided should improve the post-tax returns for investors, thereby encouraging them to invest more in the companies covered by the schemes.

The **intermediate objective** is that the companies should then be enabled to use the funds to improve their performance.

The **ultimate objective** is that the UK economy should benefit by having a more competitive small firms economy.

Chapter 2: Literature review

In summary, the review found that the last decade has seen the introduction and reinforcement of a number of related policy initiatives designed to improve the flow of debt and equity finance to smaller, start-up, younger, and high-tech SMEs. This has coincided with an apparent amelioration of reported constraints, arising from financial markets, on the growth and performance characteristics of these firms. However, major areas of uncertainty remain in relation to the impact of particular schemes such as EIS and VCT, on which there is virtually no empirical evidence in the literature. The current research, therefore, fills an important gap in knowledge.

Chapter 3: Characteristics of investors and companies involved in the schemes

The research showed that EIS investors are slightly younger and less likely to be retired than their VCT counterparts. The two groups are similar in terms of their income, but EIS investors are more dispersed than VCT investors in terms of their wealth distribution. The comparison group investors (who were a sample of self-assessment tax payers with similar characteristics to scheme investors in terms of tax liability and income) comprised a greater proportion of females and pre-retirement age people than both of the other groups. Even though they had similar levels of income, the comparison group investors were also markedly less wealthy than both EIS and VCT investors, even though they have similar levels of income.

It was also found that there are two distinct types of EIS investors, and that the two types have different investment patterns from one another. 'Deferral-only' EIS investors (i.e. those attracted into the scheme mainly or solely to access the opportunity to defer their liabilities on other capital gains) tend to invest significantly more than 'mainstream' EIS investors (who are attracted into the scheme for a variety of tax and non-tax reasons).

Overall, EIS companies are smaller, younger and less likely to be listed on AIM or OFEX than VCT companies, but both groups are equally ambitious to grow. Comparison group companies (who were a group of SMEs with similar characteristics as in-scheme companies in terms of size and sector, and were

eligible to use the schemes) are older, less likely to be listed and less growth-orientated than both groups of in-scheme companies.

Reflecting their larger size, VCT companies had raised more finance through their scheme than the EIS companies had. They were also more likely than EIS companies to describe themselves as 'going for growth'. Conversely, they were less likely to be start-ups. High-tech EIS and VCT companies were not found to be greatly different from their conventional technology counterparts, in terms of their background characteristics and financing patterns using the schemes. But they were less likely to describe themselves as mature.

Chapter 4: Effects of the schemes on investors and the supply of finance

This chapter considered a number of questions related to the objective that the schemes should improve the supply of finance to eligible companies:

- **How much of the finance provided through the schemes was additional (i.e. would not have been invested anyway)?** Depending on the scheme and precisely how the calculations are made, it is estimated that between 52% and 87% of the finance provided through the schemes, would not have been invested in small, unquoted companies anyway by those investors, if the schemes had not existed.
- **What features of the schemes encouraged investors to invest? What have been the discouraging features? What have been the relative compliance costs?** Taking all investors together, the single most attractive feature of both schemes is the front-end income tax relief. However, secondary attractive features differ according to type of scheme and, to a lesser extent, according to sub-group of investor. The single most unattractive feature is the qualifying period for tax reliefs. Measured in terms of difficulties in understanding and complying with scheme rules, the relative compliance costs of the VCT scheme do not appear to be great, although they are great for a sizeable minority of EIS investors.

- **What has been the impact of changes to scheme rules?** Few EIS investors and a minority of VCT investors claimed to be aware of changes to scheme rules. However, amongst those aware, the effect of the changes has, if anything, made investors more positive in their attitudes towards the investing through the schemes.
- **How do investors plan their exit strategies?** About half of the investors who have given the matter thought are likely to hold on to their scheme shares beyond the end of the qualifying period. However, only just over half of EIS investors, and fewer than four in ten VCT investors, have actually considered the issue.
- **How have rates of return on scheme investments compared with returns on comparable investments?** Post-tax rates of return on EIS investments have compared unfavourably with rates of return on comparable investments, although this is not the case for all sub-groups of investors. On balance, post-tax rates of return on VCT investments have been about the same as those on comparable investments.
- **Would investors invest through the schemes again?** Despite the fact that EIS investors appeared to have had relatively poor experiences of the scheme, more than two-thirds of both groups of investors said that, assuming they had the funds available, they would consider investing through the schemes again.

Chapter 5: Effects of the schemes on companies

In relation to the intermediate objective that schemes should enable companies to improve their performance, the principal findings can be summarised as follows:

- **To what extent have the schemes provided benefits over and above the supply of finance, e.g. increased expertise from investors?** Nearly half of the EIS companies and nearly four in ten VCT companies indicated that

using the scheme enabled them to attract investors or fund managers who also provided them with business advice and expertise. This extra support was generally described as extremely or very helpful. There was also evidence to suggest that obtaining finance through the schemes then enables some companies to obtain other external finance, which they had not previously been able to obtain.

- **What has been the impact of the schemes on company performance in terms of profitability, productivity, survival etc.?** Objective econometric analysis of the survey data concluded that use of the schemes had a positive impact on companies' growth. The companies' subjective assessments of the impact of the schemes on a range of performance indicators, was also positive, but quantitatively small.

- **How has the impact varied according to type of company (e.g. sector, size)?**

Many variations in the survey results according to sub-group of companies were found, although the variations noted did not always have obvious interpretations. Moreover, there was not the same consistent pattern in the variations amongst companies as there was in the variations amongst investors. However, measured in terms of the number of statistically significant survey findings, VCT companies do appear a slightly more homogeneous group than EIS companies.

- **To what extent are the effects and impacts of the schemes on companies additional (i.e. would not have happened in the absence of the schemes)?**

The additionality of the supply of EIS and VCT finance to companies was not measured in the same ways as the additionality of the supply of finance from investors was measured, although there were strong suggestions of additionality. Instead, the focus was on the additionality of companies' actions associated with raising finance through the schemes. At first sight, this type of additionality did not appear to be great, but there is reason to believe that simple measurements understate its degree.

It is also worth noting that both sets of companies' implied satisfaction ratings are high and that, consequently, attitudes towards using the schemes again are generally positive. Companies indicating that they are unlikely to use the schemes again, or expressing doubts on the matter, often show signs of having outgrown the schemes.

Chapter 6: The role of advisors

The findings from advisors were, by and large, consistent with the findings from investors and companies. But, focusing on instances where the results from the survey of advisors conflicted with equivalent results from the surveys of investors and companies, the main findings of this chapter can be summarised as follows:

- Advisors perceive the attractions of the schemes to investors in broadly the same way that investors themselves perceive them. But they tend to under-estimate the importance of loss relief to EIS investors, and of tax-free dividends and the portfolio nature of the scheme to VCT investors.
- Advisors think that the VCT scheme is the more difficult of the two to understand, but the investors implied the opposite.
- Advisors' perceptions of rates of return on VCT investments (compared to rates of return on other investments) were similar to VCT investors' own perceptions, but they over-estimated comparative rates of return on EIS investments.
- The advisors also under-estimated the extent to which VCT companies are able to satisfy their objectives in being involved in the scheme.
- Overall, the advisors' attitudes towards using the schemes again in the future were more positive than those of the companies.

Chapter 7: The wider economic effects of the schemes

The overall conclusion drawn from this chapter is that there are wider benefits associated with the schemes and that any wider disbenefits do not appear to be great.

The other key findings are that:

- The rationale for the schemes was valid during the period considered by this research.
- The schemes do not play a major role in the overall supply of funds to SMEs, but they play a significant and growing role in the supply of private equity funds in the UK.
- The schemes appear to be reasonably effective in targeting the companies for which they were intended.
- The schemes are associated with important supply-side gains, a substantial proportion of which are additional (i.e. would not accrue anyway).
- The substitution and displacement effects associated with the schemes appear to be moderate.

Chapter 8: Overall conclusions on the effectiveness and cost-effectiveness of the schemes

Assessing the effectiveness and cost-effectiveness of the schemes proved to be hazardous, and it was necessary to attach caveats to many of the cost and effect estimates. In the absence of performance targets and external benchmarks, the report compares the two schemes with one another, even though they operate under different rules and aim to address different needs. Nonetheless, the key conclusions may be summarised as follows:

- **Effectiveness of the Enterprise Investment Scheme**

Because more than half of the monies invested would not have been invested by those same investors in the absence of the scheme, the EIS is adjudged to have satisfied its immediate objective to an extent. The additionality of finance through the EIS has been lower than through the VCT scheme partly because the EIS scheme has attracted a significant minority of investors who would probably have invested anyway to support friends and acquaintances. Concerning the intermediate objective, it was found that EIS companies were changed and affected positively in a range of ways as a result of the scheme; and that many of them would not have taken alternative action to secure the same benefits, if they hadn't been able to use the scheme. As a result of the changes and effects reported, there were moderate improvements in company performance for a sizeable minority of firms. It was also found that the effects of the EIS on firms were of the sort that would lead to competitiveness improvements, rather than short-term, one-off, gains. There were also positive spill-over effects into the wider economy, and any negative internal and external effects appeared to be moderate. Thus, it is concluded that the EIS has gone some way towards satisfying its ultimate objective.

- **Effectiveness of the Venture Capital Trusts scheme**

The large majority of the monies invested would not have been invested by those same investors in the absence of the scheme. The VCT scheme is, therefore, adjudged to have satisfied its immediate objective to a large extent, although some companies invested in could have got the finance from elsewhere. Despite the differences between the schemes in terms of the ways firms used the finance raised, the effect of the VCT scheme on company performance was not greatly different from the effect of the EIS. Consequently, it is concluded that the VCT scheme has been fairly effective in relation to its intermediate objective. There was little to distinguish between the two schemes in terms of their effects on small firm competitiveness and the UK economy. Thus, it is concluded that the VCT scheme has also gone some way towards satisfying its ultimate objective.

- **Cost-effectiveness of the Enterprise Investment Scheme**

The estimated cost of the EIS in terms of tax forgone has been 55-66 pence for every additional £1 invested through it. In relation to the effects of the scheme on company performance, it was shown that for every £1 million in tax forgone EIS companies are estimated, amongst other things, to have increased their sales turnover by £3.3 million and have increased their employment by 65 jobs. However, without external benchmarks, it is difficult to say how good a performance this represents.

- **Cost-effectiveness of the Venture Capital Trusts scheme**

The equivalent data for the VCT scheme implied that its estimated cost in terms of tax forgone has been 33-41 pence for every additional £1 invested. The VCT scheme seems to be significantly more cost-effective than the EIS, but the respective estimates relate to the amount of money invested through the schemes, rather than to the amounts supplied immediately to small firms. Conversely, it was also shown that the VCT scheme appeared to be less cost-effective than the EIS in terms of its effects on company performance (for every £1 million in tax forgone, VCT companies are estimated, amongst other things, to have increased their sales turnover by £0.6 million and have increased their employment by 9 jobs). However, it was also cautioned that the data were likely to have exaggerated the cost-effectiveness of the EIS relative to that of the VCT.

2.2.2 Assessment of the effectiveness of South Africa's institutional support network to assist SMEs

The 1995 White Paper on National Strategy for the Development and Promotion of Small Business in SA has been the first major effort by the South African government to design a policy framework particularly targeting the entire spectrum of small enterprise sector.

The overall objective of the strategy was to create an enabling environment for SMME growth. In response to the challenges set out in the White Paper, a four-pronged new institutional network at national level were established to drive the National Small Business Strategy:

- The Centre for Small Business Promotion (CSBP) of the DTI
- National Small Business Council (NSBC)
- Ntsika Enterprise Promotion Agency (Ntsika or NEPA)
- Khula Enterprise Finance.

The originally well-intended policy measures suffer from sub optimal implementation. General distrust to external agencies among SMMEs on the one hand, and the incapacity of support institutions to persuasively raise awareness about their existence and effectiveness on the other, are said to lie at the heart of the problem. Moreover, the poor coordination of services results in a replication of services, and clustering of institutions in urban areas.

The specific problems mentioned below are discussed in the Trade and Industrial Policy Strategies (TIPS) draft report "The Economics of SMMEs in South Africa", February 2002, Cassim et al, Pages 38-39.

- No outreach to SMMEs
- Uneven distribution of services
- High search costs of service provision
- Cumbersome administration and discontinuity of programmes

Apart from these general findings, research evidence about the shortcomings of specific programmes is critical for their revision. Such analysis could reveal, for

example, whether the low usage of a specific support programme is an indicator of its low relevance to SMMEs. The reasons for only few SMMEs approaching support institutions despite being aware of them need to be explored.

The general findings indicate that the **institutional support network to assist SMEs** needs to be revised. Cassim et al. have also made an observation that South African SMMEs have seemingly neither developed a culture to use private consultants and tend to underestimate the usefulness of these services.

Appropriate revisions and recommendations should be adopted along the following lines:

- i. Ntsika should be tasked with compiling a comprehensive SME directory. The SME directory should the criteria of age, sector, location, size, background, growth potential, ownership details and types of finance seeking should it be required
- ii. Khula and the The Enterprise Organisation (TEO) should focus on
 - The identification of types of enterprises that are relevant for SME finance purposes (according to the criteria of age, sector, location, size, background, growth potential) and the main types of finance to consider (equity, short-term and long-term debt).
 - For each type of enterprise, the identification of the average demand for various types of external capital, according to their growth potential, their current financial structure, and typical capital intensity. The desirable upgrade of a certain number of companies into the next higher category should also be considered in the model.
 - The analysis should also include “product market/demand” based on geographic regional scale (focusing also on rural and semi-urban areas) on what enterprises are favourable (for both local/domestic demand and export demand).
 - The data of this section of the potential high-growth SMEs should also form part of the Ntsika database. Hence, Ntsika, Khula and the TEO will actively follow a programme of resource sharing.

- iii. Khula and the TEO should be given the mandate to create a thriving and competitive SME sector (as part of the National Small Business Strategy) using the criteria of section ii above. It should be allowed to directly compete or at least form partnerships with the private sector financial institutions (venture capitalists and associated network).
- iv. The private sector financial institutions (venture capitalists and associated network) should be given access to the Ntsika directory to reduce the information and search costs of locating potential high-growth SMEs.

The SMME Policy Framework in post apartheid South Africa is discussed in-depth in the Trade and Industrial Policy Strategies (TIPS) draft report “The Economics of SMMEs in South Africa”, February 2002, Cassim et al, Pages 33-47 and downloadable from the website www.tips.org.za. A summary of the description of the **South Africa’s SMME Support Network** is given in Appendix II.

2.2.3 Models and approaches for SMEs to pursue growth

It has become evident that only SMEs that display growth potential are likely to attract capital, and more especially appeal to venture capitalists to raise equity finance on their behalf. SMEs that are frequently denied access to equity capital should revise their business plans and incorporate a growth strategy that will appeal to suppliers of finance or at least get their attention. Two such ‘models and approaches’ is presented in this review:

- Factors in the growth of micro-enterprises: Developing a framework and exploring the implications by Lew Perren, 1996, PhD Thesis – University of Brighton
- National Competitive Advantage: Porter’s Diamond by Michael Porter of Harvard Business School

2.2.3.1 Factors in the growth of micro-enterprises: Developing a framework and exploring the implications

The research examines the micro-enterprises pursuing gradual growth. The research findings develop an empirically verified framework that explains how growth is influenced by a myriad of interacting factors. This leads to a discussion of the policy implications of the framework and explores the managerial implications of the framework. Also the research can be applied to small firms to pursue gradual growth. A summary of the paper (including the empirically verified framework) is shown in Appendix III. A very brief summary is presented below.

MANAGERIAL AND POLICY IMPLICATIONS

- Four interim growth drivers influence micro-enterprise development: owner’s growth motivation, expertise in managing growth, resource access and demand.
- The interim growth drivers are in turn influenced by a myriad of independent factors.
- The framework provides micro-enterprise owner-managers and their advisers with a checklist of potential compensating factors for each of the interim

growth drivers. This should provide an agenda for stimulating growth beyond the micro-enterprise phase.

- Micro-enterprises need timely and tailored support, rather than any form of standard supply-side policies, which will be wasteful and not address real needs. What is needed is support that is owner-manager centred, rather than adviser-centred.
- The diagnostic toolkit provides micro-enterprise owner-managers and their advisers with a systematic way of exploring the influences on the interim growth drivers and highlighting ways of compensating deficits in particular factors.
- Adopting a Socratic questioning approach helps unleash owner-managers' intimate knowledge about their businesses and empowers them to think creatively about growth opportunities.
- Owner-manager centred approaches like this should be encouraged, as they can help develop diagnostic skills and self-awareness. They may also reduce the risk of over dependence on external advisers.

2.2.3.2 National Competitive Advantage: Porter's Diamond

Although this thesis was written with an international focus, it does however have implications for SMEs pursuing growth. Such SMEs need to place themselves in context of the big picture and see how they fit in, if they are to aim for the top of success ladder. Also, government is a major player in this theory. Furthermore, this theory is a reasonable starting point for Khula and TEO to assess potential high-growth SMEs.

The theory essentially examines why a nation achieves success international success in a particular industry. Porter's thesis is that four broad attributes of a nation shape the environment in which local firms compete, and the attributes promote or impede the creation of a competitive advantage. These four attributes are Factor endowments, Demand conditions, Related and supporting industries, and Firm strategy, structure, and domestic rivalry, which constitutes the *diamond*.

Porter maintains that two additional variables can influence the national diamond in important ways: chance and government. Chance events, such as major innovations, create discontinuities that can unfreeze or reshape industry structure and provide the opportunity for one nation's firms to supplant another's. Government, by its choice of policies, can detract or improve national advantage. For example, regulation can alter home demand conditions, antitrust policies can influence the intensity of rivalry within an industry, and government investments in education can change factor endowments.

Porter's argument is that the degree to which an industry (enterprise) will achieve success is a function of the combined impact of Factor endowments, Demand conditions, Related and supporting industries, and Firm strategy, structure, and domestic rivalry.

Government can influence each of the four components of the diamond either positively or negatively. Factor endowments can be affected by subsidies, policies towards capital markets, policies towards education, and the like. Government can shape domestic demand through local product standards or with regulations that mandate and influence buyer needs. Government policy can influence supporting and related industries through regulation and influence rivalry through such devices as capital market regulation, tax policy and antitrust laws.

2.2.4 Secondary data analysis of SMEs

In the application of the Venture Capital Schemes (VCS) with respect to the rationale and objectives, two important issues concerning SMEs need to be addressed in order to effectively implement the VCS:

- Are there high-growth SMEs that are being overlooked by suppliers of finance?
- Is there an equity gap to service the needs of SMEs?

Although much research has been done on SMMEs, very little has been done in relation to addressing the above issues and providing reasonable conclusions.

The TIPS draft report, “The Economics of SMMEs in South Africa” by Cassim et al, February 2002, incorporating the 1999 World Bank survey, have reviewed South Africa’s SMME structure with respect size, profile and performance with the intention of providing an explanation of the lack of impact of policy measures thus far, and to put forward new suggestions. A summary of the relevant information is presented in Appendix V.

The review did not receive sufficient information, to warrant any conclusions. Also, Cassim et al has indicated SMEs lack the necessary expertise and skills (and manpower) to identify the role they play in the terms of the national economy. Moreover, support institutions tasked with the responsibility of identifying prospective enterprises that show growth potential, may have also have fallen short of their task.

However, a more focused research output should consider the following:

- The identification of types of enterprises relevant for SME finance purposes (according to the criteria of age, sector, location, size, background, growth potential) and the main types of finance to consider (equity, short-term and long-term debt).
- For each type of enterprise, the identification of the average demand for various types of external capital, according to their growth potential, their current financial structure, and typical capital intensity. The desirable upgrade

of a certain number of companies into the next higher category should also be considered in the model.

2.2.5 Secondary data analysis as to who will serve as VCT managers

This section of the review addresses the most important component of the VCT framework, that is, who will serve as VCT managers and drive the VCT framework? Also, do they have necessary skills and expertise, and more importantly, what relationship do they have with the SME economy?

The information of this section is drawn from:

1. KPMG and the Southern African Venture Capital and Private Equity Association. 2001 Private Equity Survey. April 2002.
2. Southern African Venture Capital and Private Equity Association (SAVCA). Directory 2002.

Although KPMG's background research identified 74 companies that potentially may be classified as private equity firms or are involved in the management of private equity funds, it is not specified as to which companies conduct deals with SMEs. Their research shows that South Africa's private equity industry boasts total funds under management of R35.3 billion (inclusive of undrawn commitments of R8.4 billion).

The venture capital/private equity sector, hence, is not small in South Africa. But, considering that "private equity" includes all equity investments in non-listed companies, the size of the sector is not necessarily an indicator of the importance of equity as a source of finance for SMEs. Although very little evidence is available in this area, there is a strong presumption that only a small portion is directed to SMEs (presumably less than R5 billion).

At present, venture capital is under-developed on the SMME segment, because of both a lack of interest of many venture capital firms, and a lack of readiness of SMMEs. Entrepreneurs tend to be discouraged from when they consider the need to give up a part of the control on what they consider to be their ownership.

Investments

Private equity investments in portfolio companies reduced from R3.6 billion in 251 companies in 2000 to R2.3 billion in 259 companies in 2001. The number of new investments increased from 207 in 2000 to 216 in 2001. The average new deal size has decreased from R15.1 million to R9.5 million reflecting the number and value of larger buy-out transactions.

Venture Capital providers - SAVCA Membership Directory

SAVCA distinguishes its membership between full members and associate members.

Full membership

Full membership is open exclusively to organisational units or persons defined as venture capitalists and/or private equity investors:

- Who can prove substantial activity in the management of equity or quasi-equity financing for the start-up and/or development of enterprises that have significant growth potential in terms of products, technology, business concepts and services;
- Whose main objective is long term capital gains to remunerate risks;
- Who can provide active management support to investees.

Associate membership

Associate membership is open to persons or companies representing a special interest group that can influence the development of venture capital and private equity in Southern Africa.

Persons eligible to become Associate members include, but are not limited to banks, development capital organisations, consultants, lawyers, accountants, financial advisers and stockbrokers, pension funds, insurance companies, development organisations and associations, private individuals and national associations for venture capitalists.

Full member association with SMEs

There is no concise information in this respect. Using only the ‘minimum investment’ as a guide, and limiting this amount to R2 million suggests that 30 of the 69 full members may have any involvement with SMEs. Also an important consideration in the application of the VCT framework is what and how involvement Full Member VC providers have with individuals in raising their finance. This information is presented in Appendix VI.

Associate member association with SMEs

There is no concise information in this respect. The 2002 SAVCA directory lists 23 associate members that may have any involvement with SMEs. Also an important consideration is what and how much involvement Associate Member VC providers have with individuals in raising their finance as well as in the provision of business advisory services. The information presented in Appendix VII contains a summary of the Associate member listing and the core services they provide.

Finally, should the venture capital / private equity firms serve as VCT managers, it may necessitate a revamp of the venture capital industry in terms of information and communication channels. Richard Harrison and Colin Mason have done substantial work in this area. The collective work (including those of co-workers) has been presented in a set of complete papers titled “Evaluating the impact of business introduction services – Informal Venture Capital”. A synopsis is presented in Appendix VIII.

CHAPTER 3: METHODOLOGY AND DATA COLLECTION

The literature review has shown that the VCT scheme consists of three components (key players), namely:

- Investors,
- SMEs, and
- VCT managers.

Although all three players contribute and are essential for the implementation of the VCT scheme, it rests with the VCT managers to:

- Attract investors who will supply the funds, and
- Find potential SMEs to which the funds can be applied.

Hence, the objective of the research, that is to determine if the introduction of Venture Capital Schemes (VCS) framework to South Africa is viable or not, need only be determined from the perspective of the VCT managers. To this end, the South African Venture Capital Association was examined in the literature review to determine if its members and/or associates could fit the role of VCT managers. The review showed that it would be difficult (beyond the scope of an MBA dissertation) to obtain a statistically representative sample of potential VCT managers, since a true population does not exist. Hence, no hypothesis is tested.

It is for this reason that the exploratory route of investigation (embodying the case study method) was chosen as the preferred method to test the objective of the research. The method of data collection (qualitative methods) involved the use of a structured discussion type interview with a potential would-be VCT manager, with the intention of obtaining the following responses:

- Provide answers / responses to the questionnaire as if the VCT framework was already implemented, that is, how their firm will go about using the VCT framework to obtain the maximum benefits for their firm,
- Prompt the respondent to provide reasons (factors) as to why the VCT framework should or cannot be implemented from their perspective as well as in general, with the use of additional issues and questions (not included in the questionnaire),

- Prompt the respondent to provide recommendations as to whom they consider to be ideal VCT managers to drive the VCT framework (if not themselves) and,
- Prompt the respondent to provide recommendations as to what the ideal VCT framework should constitute and consider.

To enable the respondent to answer the questionnaire with a reasonable degree of accuracy, and also to meet the requirements of an acceptable feasibility determination, the structured questionnaire together with relevant and additional information, for example, the rules and regulations governing VCTs was given to the would-be VCT manager two weeks in advance, in order that the would-be VCT manager obtain some degree of familiarity with the VCT framework.

The number of potential VCT managers was reduced to one from thirty candidates (refer to Appendix VI), namely, Business Partners Limited - East Fund, using the following short-listing criteria:

- VCTs operate through a medium of funding via individuals. At present only eight candidates obtain funding from individuals,
- To eliminate bias of whether a generalist or focussed VCT would be implemented, candidates displaying industry preferences were eliminated. This reduced the number of candidates to only four.
- Finally, the VCT would service a certain geographic area to reduce (minimize) its operating costs. In this regard, only one would be in a position to service the needs of the Kwa-Zulu Natal provincial region, the other three being located in the Gauteng province.

The survey instrument being the questionnaire was divided into eight sections with statement type questions. The responses for the questions employ the Likert rating scale and forced ranking scale technique. The questionnaire design with would-be (potential) VCT manager is as follows:

- Section 1: The marketing and the identification of investors, and attractive features of the scheme that will appeal to investors
- Section 2: Marketing and the identification of potential firms (high growth and/or ability to generate high returns) and attractive features that will appeal to firms
- Section 3: Supply of finance
- Section 4: Management of firms
- Section 5: Scale and Nature of Deals
- Section 6: Rates of return
- Section 7: General
- Section 8: Other comments/observations with regard to the rationale and objectives of the VCT scheme.

CHAPTER 4: RESULTS (Findings and Discussion)

4.1 Questionnaire design and Response

The questionnaire together with the responses of the with would-be (potential) VCT manager, is shown below.

Section 1: Marketing and the identification of Investors and attractive features of the scheme that will appeal to investors.

Question 1. Which of the following methods would you use to identify investors?

(rank and assign % probability usage)

1. IFAs, accountants and stockbrokers (with a commission) _____
2. Intermediaries _____
3. Direct advertising in the financial press _____
4. Targeted mailshots to individual investors _____
5. Exhibitions and roadshows _____
6. Other _____

Response: *Business Partners (BP) prefers e-mails to prospective clients.*

On average, usage will be in the order of < 30%

Question 2 What type of investor would you prefer to attract?

1. High net worth individual _____
2. High income earner _____
3. Any earner _____
4. Any individual who wishes to use the scheme _____

Response: *Business Partners (BP) prefers that the initial marketing and introduction to the public at large, will be undertaken by the administrators of the scheme (SARS). Unsure, but at present many High net worth individuals use the services provided by BP.*

Question 3 Features of the VCT scheme that will be most attractive to investors?

1. Front-end income tax relief _____
2. CGT deferral for gains on other assets _____
3. Exemption from capital gains in share value _____
4. The size of the investment that attracts tax relief _____
5. Prospects of tax-free dividends _____
6. Investments are in a managed portfolio of firms _____
7. Not sure _____
8. Other _____

Response: Not sure. BP prefers that upfront mass marketing be used so that investors will be in the position to decide for themselves if there are any attractive features. Will vary from client to client.

Question 4 Features of the VCT scheme that will be most unattractive to investors?

1. The limit on the rate of tax relief _____
2. The limit on the size of the investment that attracts tax relief _____
3. The type of company that can be invested in _____
4. Difficulty in complying with scheme rules _____
5. The time period required to hold shares for tax relief _____
6. The absence of tax relief on shares that are sold at a loss _____
7. None of the above – no particular unattractive features _____
8. Not sure _____
9. Other _____

Response: Not sure. BP prefers that upfront mass marketing be used so that investors will be in the position to decide for themselves if there are any unattractive features. Will vary from client to client.

Question 5 How easy or difficult do you think it is for investors to understand and conform to the rules of the schemes?

1. Easy – there are no problems using the scheme _____
2. Average – any difficulties are as expected of the schemes _____
3. Difficult – some difficulties with rules and procedures _____
4. Very difficult – rules are difficult to understand/comply with _____

Response: Difficult to very difficult. It depends on how mass media markets the concept.

Question 6 Generalising, how would you say this scheme would compare with your clients other equity investments?

1. Less risky _____
2. No more risky _____
3. More risky _____
4. Not sure yet _____
5. Don't know – not assessed _____

Response: Difficult to say, since all equity investments are risky.

Section 2. Marketing and the identification of potential firms (high growth and/or ability to generate high returns) and attractive features that will appeal to firms

Question 7 Which of the following methods would you use to identify firms? (rank and assign % probability usage)

- | | | |
|----|--|-------|
| 1. | Industry contacts (inhouse or external) | _____ |
| 2. | Accountants and banks | _____ |
| 3. | Already known clients | _____ |
| 4. | Universities | _____ |
| 5. | Aggressive methods – active research staff to spot potential investments | _____ |
| 6. | Consultants/ other professional advisors | _____ |
| 7. | Chamber of Commerce / Trade Associations | _____ |
| 8. | Business Support agency | _____ |
| 9. | Other | _____ |

Response: Currently BP uses referrals network. BP is more often approached by prospective clients. BP uses chartered accounting firms as its own intermediaries to monitor and control the accounting aspects of the firm and to serve as BP’s representatives on the firm’s management team and to report to BP.

Question 8 How easy or difficult do you think it is for firms to understand and conform with the rules of the schemes?

- | | | |
|----|--|-------|
| 1. | Easy – there are no problems using the scheme | _____ |
| 2. | Average – any difficulties are as expected of the schemes | _____ |
| 3. | Difficult – some difficulties with rules and procedures | _____ |
| 4. | Very difficult – rules are difficult to understand/comply with | _____ |

Response: Difficult to very difficult

Question 9 What do you consider to be the main purpose of firms requiring Finance – hence issuing VCT shares (rank and assign % probability usage)

- | | |
|---|-------|
| 1. To provide working capital | _____ |
| 2. To finance Research & Development | _____ |
| 3. As part of a management buy-out or buy-in | _____ |
| 4. To finance the purchase of plant and machinery | _____ |
| 5. To finance the purchase of another business | _____ |
| 6. To finance the purchase of buildings | _____ |
| 7. To finance the purchase of other assets | _____ |
| 8. To clear a bank overdraft | _____ |
| 9. To use in a company intending to float | _____ |
| 10. Other | _____ |

Response: Difficult to say as to what it actually might be, but from experience very often involves working capital, purchase of buildings and purchase of plant & equipment. BP works on a restructuring process, and would not assist in the purchase of plant & equipment, since this an area for the banks to finance, since it can hold the plant & equipment as security. With regards to buildings it would fund it 100%.

Section 3: Supply of finance

Question 10 VCTs should fill a gap primarily in both the equity and debt market that is not filled by other investors, such as business angels and ‘pure’ venture capitalists. What ‘range of amount – Rmillions’ do you consider this gap should fill?

- | | | |
|----|-------|-------|
| 1. | < 1 | _____ |
| 2. | 1 – 2 | _____ |
| 3. | 2 – 5 | _____ |
| 4. | > 5 | _____ |
| 5. | Other | _____ |

Response: Here it depends on each VCT’s investment philosophy. BP’s range is R150 k to R15 million for current deals. It will in all probability use the same range since it has accumulated vast experience and handling of such deals.

Question 11 To what extent do you think the scheme will improve the overall supply of finance to small, higher risk, unquoted trading companies

- | | | |
|----|-------------------------|-------|
| 1. | To a great extent | _____ |
| 2. | To a significant extent | _____ |
| 3. | To a small extent | _____ |
| 4. | Not at all | _____ |
| 5. | Don’t know | _____ |

Response: Don’t really know, but ‘gut feel’ suggests to a ‘small extent’

Question 12 To what extent do you think the scheme will improve the quality of finance to these firms (ie. the costs of finance and other terms and conditions)?

- | | | |
|----|-------------------------|-------|
| 1. | To a great extent | _____ |
| 2. | To a significant extent | _____ |
| 3. | To a small extent | _____ |
| 4. | Not at all | _____ |
| 5. | Don't know | _____ |

Response: *Not at all, since BP will apply the same policy as it currently does with all its equity investments.*

Question 13 Generalising as far as possible, to what extent do you think the expectations of companies raising finance through the scheme will be satisfied?

- | | | |
|----|--|-------|
| 1. | Expectations wholly or largely satisfied | _____ |
| 2. | Expectations partly satisfied | _____ |
| 3. | Expectations satisfied to a small extent | _____ |
| 4. | Not applicable – investments have no particular expectations | _____ |

Response: *Not applicable – investments have no particular expectations other than to obtain funding. Anything over and above this is considered a bonus.*

Section 4 Management of firms

Question 14 To what extent do you think the scheme will improve the strategic and management support for these firms (eg. presence on the board and advice etc.)?

- | | | |
|----|-------------------------|-------|
| 1. | To a great extent | _____ |
| 2. | To a significant extent | _____ |
| 3. | To a small extent | _____ |
| 4. | Not at all | _____ |
| 5. | Don't know | _____ |

Response: To a significant extent, BP normally funds deals with sound viability and management team. Its' intermediaries who monitor and control on their behalf, will provide on-going support.

Question 15 In your opinion, what do you consider the main way a firm will be changed or affected as a result of raising finance by issuing VCT shares?

(rank and assign % probability usage)

- | | | |
|-----|--|-------|
| 1. | Free up finance for other development | _____ |
| 2. | More ambitious to grow | _____ |
| 3. | Invest more in R & D | _____ |
| 4. | Increase capital expenditure | _____ |
| 5. | Lever in further development finance | _____ |
| 6. | Change / improve marketing activities | _____ |
| 7. | Improve efficiency in other ways | _____ |
| 8. | Reduce company's debt | _____ |
| 9. | Launch new/improved product/service | _____ |
| 10. | Strengthen management team | _____ |
| 11. | Innovate in other ways | _____ |
| 12. | Acquire intellectual property to exploit | _____ |
| 13. | Improve quality of products/service | _____ |
| 14. | Reduce costs | _____ |
| 15. | Buy in additional expertise | _____ |
| 16. | Improve skills of non-managerial workforce | _____ |

Response: *Here to, it will largely depend on a matter of restructuring.*

Section 5: Scale and Nature of Deals

Question 16 What size of fund (R millions) would you ideally prefer to raise and manage to attain the best returns for both yourselves and investors?

1. < 10 _____
2. 10 – 20 _____
3. 20 – 30 _____
4. 30 – 40 _____
5. > 40 _____

Response: *It is difficult to say with certainty, since each deal will vary in its risk/return profile and the size of the investment. Currently BP East Fund manages a fund in excess of R300 million.*

Question 17 What type of VCT fund would you prefer to establish and what the reasoning be?

1. Generalist (investing in firms across a range of sectors, such as media, retailing and engineering firms at a growth stage), or
2. Specialist (focussing, for example, on high tech sectors and early stage businesses)

Response: *It will definitely be a specialist fund but more inclined towards a focussed fund utilising the experience of the investment manager of a specific sector. It may also not include high-tech sector since high-tech sector have shown great swings in performance and sustainability into the future may be difficult to predict.*

Question 18 What would the typical number of firms in the fund be?

- | | | |
|----|---------|-------|
| 1. | < 10 | _____ |
| 2. | 10 – 20 | _____ |
| 3. | 20 – 30 | _____ |
| 4. | 30 – 40 | _____ |
| 5. | > 40 | _____ |

Response: *It is difficult to say with certainty, since each deal will vary in its risk/return profile and the size of the investment. The number of firms in its portfolio will be irrelevant, since BP appoints intermediaries (accountants and advisors) on its behalf to monitor and control activities at managerial and board representation.*

Question 19 What would the make-up structure of the firms in your fund be like, and the reasoning thereof?

1. small, higher risk, unquoted trading companies
2. small quoted trading companies on the AltEx (1st October 2003)
3. combination of both (specify % mix)

Response: *Any type of company provided it has good accounting control and monitoring.*

Question 20 What would the nature of the deal with individual firms be like, ie ratio of debt to equity provided to investee firms and its structure? (equity, debt, dividends and board fees)

Response: *It will depend on each individual deal, and a generic policy will not be enforced.*

Question 21 Would the participation in younger and high tech firms be skewed towards equity financing and re-investment, so reducing the “cash burn”, Yes/ No and reasoning?

Response: *High-tech firms pose a significant risk and may consider of not even going there.*

Question 22 Would the participation in older and more mature firms be skewed towards debt financing and dividends, to provide a return and hedge against risk, Yes/ No and reasoning?

Response: *No. Will evaluate the merits of each mature firm in terms of:*

- *innovation and transformation (are they showing any signs)*
- *ownership/management styles – is there going to be a change, for example from father to son in a family-owned business.*

Section 6: Rates of return

Question 23 What will your likely portfolio consist of:

1. Potential high performers (say, 10 – 20 %) _____
2. Average performers (say, 70 – 80 %) _____
3. Poor performers and/ or will be liquidated (say, 10 – 20 %) _____

Response: *BP targets returns in the region 26% to 49%. Will depend on the firms and the deal they can strike. More than likely target above average performers.*

Question 24 What management fee in % p.a. gross assets would you seek to take?

Response: 1.5%

Question 25 What will the target overall rate of return to the VCT, taking account of equity, debt, dividends, board fees and VCT fees (all elements) range be like in % per annum for the following funds?
(Provide reasoning if possible)

- | | | |
|----|---|-------|
| 1. | Generalist (eg. 25 – 30%) | _____ |
| 2. | Buy-outs (eg. 20 – 25%) | _____ |
| 3. | Specialist [early stage high tech] (eg. 40 – 50%) | _____ |

Response: 26% to 49%

Lower limit – 26% - to cover GP margins

Upper limit – 49% - not to take on too much risk

This range applies to individual deals and based on risk/return profiles.

Question 26 What is the expected time frame in years to achieve the stated returns mentioned in Question 25?

Response: *The projections will be cash flow based. To a large extent will depend on the nature of the deals. Time frame – as short as possible.*

Section 8 Other comments/observations with regard to the rationale and objectives of the VCT scheme.

Response: *The VCT scheme provides incentives, for investors in the form of tax breaks, for firms in the form that they have to comply with the rules, what incentives are there for the VCT companies apart from the management fees they receive? Will there be tax breaks for VCT companies to create willingness to drive the scheme?*

4.2 Responses to additional questions / issues not included in the questionnaire

In addition to the specific questions addressing the framework of VCTs, the following *four issues* were put forth to the respondent:

1. Are there potential high-growth SMEs that are being overlooked?
2. Is there a definite ‘equity gap’ to satisfy the needs of potential SMEs that is not being serviced?
3. Are there sufficient investors who can be attracted to fund this ‘equity gap’?
4. Are there sufficient rewards for the private sector financial institutions (venture capitalists and associated network) to be willing to manage and drive the VCT framework?

The response to each of the four issues is as follows:

Issue 1: Are there potential high-growth SMEs that are being overlooked?

Response:

The response was a positive **Yes**. The reasoning was illustrated via an example, and Business Partners’ investment appraisal rating methodology, as follows:

- 1) Viability
- 2) Management
- 3) Owner’s Equity
- 4) Shareholding (to be acquired by Business Partners)

The small company required funding for R1 million. Although the firm had sound management, the viability of its product and market was untried and untested (in spite

of a proper business plan. The firm was highly geared, its own contribution (equity) was low. Also, its security was very poor, almost nil. Hence, BP cannot fund such a request since it will make BP the major shareholder (BP does not exceed 49% shareholding). Although the ROI is very good, IRR > 40%, the financial risk is too high (the firm could easily suffer financial distress).

Issue 2: Is there a definite ‘equity gap’ to satisfy the needs of potential SMEs that is not being serviced?

Respondent: There exists a huge segment of the market that is ‘untried and untested’

Issue 3: Are there sufficient investors who can be attracted to fund this ‘equity gap’?

Respondent: Yes. There may also exist sufficient foreign investors who may show interest. Foreigners may want to provide assets (equipment and machinery) instead of funds.

Issue 4: Are there sufficient rewards for the private sector financial institutions (venture capitalists and associated network) to be willing to manage and drive the VCT framework?

Respondent: Yes and No.

Arguments for Yes:

- In excess of 30% IRR may be earned,
- Earnings may even be ‘blue sky’, industry terminology of expressing > 100% IRR earned.

Arguments for No:

- Small firms are characterised by liquidations and sequestrations
- Poor management
- Very low levels of education in terms of business management
- Will have to alter their investment philosophy to accommodate the VCT framework, which is highly unlikely.

4.3 Discussion of findings

4.3.1 Findings of the questionnaire response with Business Partners Limited

Section 1: The marketing and the identification of investors, and attractive features of the scheme that will appeal to investors

The respondent has indicated that the launch of the VCT framework should be task of the administrators of the scheme. The marketing and education of investors, highlighting the features and attractiveness of the scheme should be mass marketed. Thus much of the upfront marketing costs will be borne by the administrators. The VCT managers will then continue with the marketing of their individual funds.

Section 2: Marketing and the identification of potential firms (high growth and/or ability to generate high returns) and attractive features that will appeal to firms

The same response/answer as for section 1 was given.

Section 3: Supply of finance

- This is a untried and untested market
- Will depend to a large extent on VCTs investment philosophy, in BP's case, it varies between R150 000 to R15 million

- Companies expectations that VCTs may exercise leniency and relax its investment policy and rules and may become more risk tolerant (but this pure speculation.

Section 4: Management of firms

The scheme will to a **significant extent** improve the strategic and management support. However, it will involve restructuring.

Section 5: Scale and Nature of Deals

- The deals will be individual in nature and assessed on its own merits and funding requirements. The total number of firms in the fund will not be problematic, since outsourced accountants and advisors will monitor and control activities at board level
- The size of the fund will not be an issue since cash flow and roll over of funds will be of more importance
- Accounting reporting and control will be of paramount importance to VCT managers

Section 6: Rates of return

Although Business Partners will be targeting 26% to 49%, they fear that actualised returns may be far less, since small firms to a large extent falsify accounting reports, and at present there is insufficient checks and balances in place by accounting and auditing bodies.

Section 7: General

Although potential high-growth firms in South Africa **are approachable**. UK is a developed country (1st world) and South Africa, a developing country (3rd world), hence South Africa, may experience its own set of unique problems.

Section 8: Other

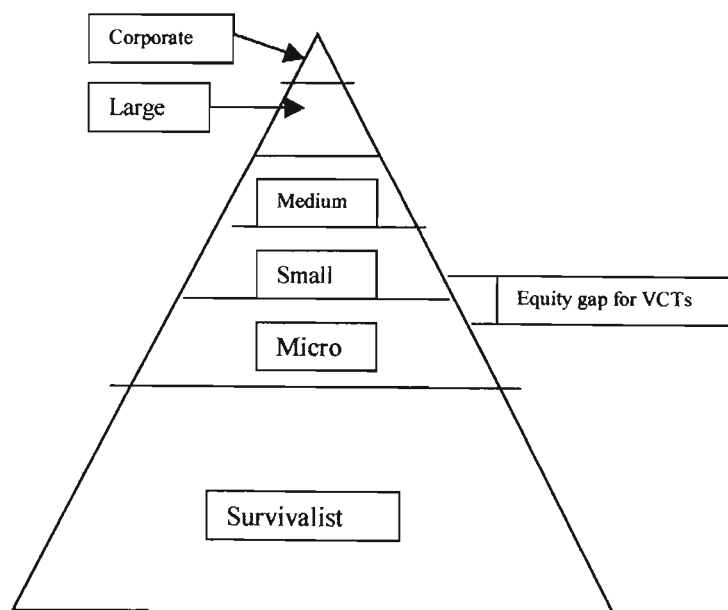
VCT managers are concerned that there are no incentives for them apart from the management fees, to drive the VCT framework. Hence, they may not be willing, since they are profit driven.

Overall Response of Business Partners Limited – East Fund

The respondent has indicated that their investment policy may not allow them to them to become a VCT manager for the following reasons:

- They are to a large extent, profit driven. Managing a VCT fund may not be in the best interests of their shareholders
- The VCT fund will create conflicts in their current investment policy, and the conventional venture capital/equity firm will have to operate with two sets of policy directives.
- The VCT fund will cater for a unique equity gap (see figure 1), comprising an untried and untested segment of the market. This in itself will pose unique and high risks, which a conventional venture capital/equity firm normally tries to stay away from.

Figure 1: Firm size profile



However, the respondent has stated that they may be prepared to start a separate company under the parent company umbrella. The VCT firm, will be structured around a limited partnership basis involving its current investment executives, and accountants and business advisors (which it normally outsource), provided there is already a VCT market in place.

4.3.2 Recommendations of respondent as to ideal VCT manager, suitable for the VCT implementation

The respondent has also indicated that the VCT scheme should be launched and implemented by Khula through its Retail Financial Intermediaries (RFIs), based on the following recommendation. The RFI should partner with The Enterprise Organisation (TEO) or a portion of it and register as a private company with a new mandate exclusively for driving the VCT framework. This new company (privatised RFI) should also consider forming a partnership with an established (accredited and recognised) accounting consulting firm and business advisory firm. It could also consider outsourcing these functions if unable to form a partnership or alliance. The privatised RFI will essentially have a successful network that will be in a position to implement the VCT scheme. The impact will also be enhanced since it will be given sufficient incentives such as profit sharing schemes and state subsidised grants. The recommendation is based on Business Partners own experience and success since it was also an RFI under Khula before being privatised.

4.3.3 Further issues to explore

From the previous sections of discussion, certain issues are emerging, namely, what are the underlying reasons for Business Partners Limited, not being in a position to becoming a VCT manager:

- Could it possibly be that operating costs (costs to evaluate and appraise SMEs, accounting & auditing costs of their investments in SMEs, etc.) is too high?
- Could it be that financing costs and gross profit margins of VCT fund managers are too high (in terms of interest rates) as compared to UK counterparts?

These issues need to be explored further with quantitative assessments, prior to the launching of the VCT scheme.

4.3.4 Targets and benchmarks for the VCT market to strive towards

The implementation of the VCT scheme, if properly launched and marketed by the privatised RFI, could within a short period, receive competition from the private sector accounting firms and business advisors, who would be enticed to become VCT managers, competing for market share. The larger venture capital / private equity firms may also come on board should the market be lucrative.

The aim of launching the VCT scheme in South Africa should be to create as large and diverse as possible a VCT market with the largest possible number of funds. Should this be achieved, the South African VCT introduction would be in a position to show similar gains for SMEs and the economy as a whole as the UK counterparts within a few short years. These gains are demonstrated by means of the following two illustrations:

1. Impact of the schemes on the overall supply of venture capital funds in the UK
2. Generation of wider economic spillovers by the schemes

1. *Impact of the schemes on the overall supply of venture capital funds in the UK*
Table 1 shows that since their introduction, the VCT and EIS schemes combined have accounted for an increasing share of an increasing supply of total private equity in the UK*.

Table 1

The share of EIS and VCT investments in the total supply of private equity in the UK

Year	1) Total supply of private equity in the UK, £ million	2) Amounts invested through EIS and VCT scheme, £ million	3) EIS and VCT investment as share of total private equity (2 as % of 1)
1991	989	-	-
1992	1251	-	-
1993	1231	4	0.3
1994	1668	41	2.5
1995	2140	213	10.0
1996	2806	264	9.4
1997	3066	303	9.9
1998	3775	455	12.1
1999	6189	830	13.5
2000	6371	1490	23.4

Source: PACEC Research Report, page 131

* It should also be cautioned that the term ‘total supply of private equity’ is believed to mean the amount of equity finance provided to unlisted companies from formal venture capital sources, rather than the amount of equity finance provided from all private sources.

2. Generation of wider economic spillovers by the schemes

The econometric analysis of the VCT scheme undertaken by PACEC, on company performance, showed that there was a significant scheme impact on company asset growth. It also showed a range of beneficial effects likely to impact on the economy as a whole. For example, each of the following changes and effects (listed below) were attributed to scheme finance by sizeable minorities of companies in both the EIS and VCT scheme:

- Strengthened company management
- Improved skills of other staff
- Obtained external expertise
- Increased capital expenditure

- Invested more in R & D
- Launched new / improved product(s) / service(s)
- Innovated in other ways
- Improved quality of products / services
- Reduced costs
- Improved efficiency in other ways

Individually and collectively, the changes and effects reported are indicative of increased small company competitiveness.

CHAPTER 5: CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

1. The Venture Capital Schemes (VCS), in theory, appears to be a viable option in creating a competitive small firms economy.
2. The respondent, Business Partners Limited – East Fund (representing the larger venture capital / private equity firms) have indicated that they will not be willing to become a VCT manager and drive the VCS framework, since it requires an adjustment to their investment philosophy. It could also be for the undisclosed reasons mentioned in section 4.3.3.
3. The respondent has indicated that a RFI with a reasonable network of resources, operating as a private company, will be in the best position to drive the VCS framework. It will also be able to attract competition from the smaller venture capital / private equity firms, accounting firms and business advisors, to create a vibrant VCT market (industry).
4. The two other key players in the VCT framework, namely investors and high-growth firms (whose financial requirements lie in a unique equity gap) are available in South Africa.
5. Hence, the introduction of the VCS framework to South Africa is probably a viable option (as per exploratory study), which needs to be studied further.

5.2 Recommendations

1. In this study, it was assumed that the Administrator of the VCS, namely, The South African Revenue Services (SARS), would go along with the policy strategy and adopt the scheme. In a more comprehensive study, cumulative cost of the VCS to the public purse, in terms of tax foregone (excluding possible gains from an increased SME economy), should be investigated and estimated, to give an indication of the optimal size of the VCT market that will meet the requirements to create a competitive SME economy.
2. In a more comprehensive study, the resources and ability of a RFI to launch and implement the VCS, should also be evaluated.
3. In a more comprehensive study (both quantitative and qualitative), the smaller venture capital / private equity firms, accounting firms and business advisors, should be assessed, to what extent they will be able to register and become successful VCT managers, to create a vibrant VCT market (industry).
4. The operating costs, financing costs and gross profit margins of a potential VCT manager should also be evaluated and compared to the UK VCT fund managers.

CHAPTER 6: BIBLIOGRAPHY

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Appendix I

Summary of the Venture Capital Schemes

Overview

This section of the literature review presents a brief outline of the four schemes and the participants of each scheme, together with the rules and regulations of the schemes. The contents of the review are as follows:

1. Introduction
2. History of the Schemes
3. Administration of the VCS Framework
4. Rationale for the Schemes
5. Objectives of the Schemes
6. The VCT scheme
7. The Corporate Venturing Scheme
8. The Enterprise Investment Scheme
9. Development of the VCT market
10. The VCT investment remit
11. Performance of the VCT funds

[The information contained in this Appendix is compiled, using the sources listed below:

- www.ir.gov.uk/manuals
- Allenbridge Group plc – Tax Shelter Report,
www.taxshelter.systematicmarketing.com
- ISIS report – Your guide to investing in Venture Capital Trusts,
www.isisinvestor.com
- ISIS report – A focus on investing in unquoted companies,
www.isisam.com]

1. Introduction

The Venture Capital Schemes consist of the following individual schemes:

- Enterprise Investment Scheme (EIS)
- Venture Capital Trust scheme (VCT)
- Corporate Venturing Scheme (CVS)
- Relief for capital losses (VC loss relief)

These schemes can be grouped together because they have similar aims and have certain legislative features in common.

The central aim of the venture capital schemes is to encourage investment in small unquoted trading companies. Small businesses generally, while often able to obtain modest loans or overdraft facilities, can find larger amounts of capital difficult to raise. The exact range of this '**equity gap**', as it is known, is open to dispute, but the existence of a funding gap of some kind is commonly agreed.

The EIS aims to attract investment from individuals (and, in the case of deferral relief under the scheme, from certain trustees), while the CVS aims to promote investment by companies and thereby to encourage corporate venturing relationships. The VCT scheme encourages indirect investment by individuals, through the medium of a corporate vehicle similar to an investment trust.

2. History of the Scheme

The first initiative to be taken with a view to encouraging investment in small private trading companies was a facility for capital losses on unquoted shares of such companies to be relieved against income tax. This was introduced in 1980. It remained substantially unchanged until 1998, when it was aligned with the provisions of the EIS. It is referred to in this manual as 'VC loss relief'.

In 1981 a scheme called the Business Start-Up Scheme (or Relief for Investment in New Corporate Trades) was introduced. It was superseded in 1983 by the Business Expansion Scheme (BES), which provided relief for investment in both new and existing trading companies. In 1986 BES was extended to give exemption from Capital Gains Tax in cases where BES relief had been given.

BES came to an end at the end of 1993, when it was replaced by EIS. This represented a revision and fine-tuning of BES, and added to the income tax relief on subscriptions and CGT exemption the facility of a CGT deferral relief, which was available for chargeable gains reinvested in shares attracting the income tax relief. In 1998, when there was a major revision of EIS, this deferral relief became available whether or not income tax relief had been obtained on the new shares. In this way it effectively replaced a set of CGT provisions known as Reinvestment Relief, which was then abolished.

In 1995 the Venture Capital Trust scheme was introduced. This provided a range of reliefs for an individual investing in a Venture Capital Trust, which is a company investing its funds mainly in small unquoted trading companies.

Finally, in 2000, reliefs somewhat similar to those provided under the EIS were made available to companies through the Corporate Venturing Scheme, which was introduced for a ten-year period as part of an initiative to promote corporate venturing activity.

3. Administration of VCS Framework

The Venture Capital Schemes (VCS) Framework consists of the VCT, CVS, EIS, and VC loss relief schemes. The framework is administrated by Inland Revenue's Savings and Pensions Schemes (SPS). For the purpose of this thesis, only the VCT and CVS will be covered in detail, the EIS and VC loss relief, will only be referred to, since they are incorporated to a certain extent within the VCT and CVS schemes. The guideline rules and policies, are formulated by the Board of Inland Revenue. Qualification and acceptance by the different parties of each scheme is subject to the approval of the SPS.

The VCT consist of the following parties, each subjected to its own set of rules:

- VCT company,
- Qualifying holdings, and
- Investors

The CVS consist of the investor company (corporate) and investee company (qualifying holding).

The EIS scheme is an intermediate between the VCT and CVS. Its investors, (normally in the form of ‘business angels’) would prefer to invest directly into a qualifying holding, and avoid paying management fees to a VCT company.

4. Rationale for the Schemes

The rationale for the schemes is that smaller, unquoted companies find it difficult to raise external equity finance for one or more of the following reasons:

2. Information costs.

The costs to an investor of obtaining the information needed to appraise the risks and expected returns from an investment tend to be high, relative to the size of investment, in the case of smaller companies.

2. Asymmetric Information and principal / agent problems.

A business owner is likely to be better placed than prospective external venture capitalists to assess the prospects for his/her business. The latter might wish to compensate for this by seeking higher returns and exercising a degree of control over how the business is run. However, entrepreneurs may be reluctant to dilute their control by bringing in external equity. As a result, profitable investment and growth opportunities may be forgone.

3. Inexperienced management.

Entrepreneurs, scientists, engineers etc. who wish to exploit their ideas commercially may lack managerial skills, making external investors reluctant to put in funds. The EIS allows for the possibility of investors taking a managerial role in a company, following their investment. Similarly, a VCT’s managers may have more influence than an individual investor could have over how a company receiving funds is run.

5. Objectives of the Schemes

Both the VCT and EIS schemes have similar broad objectives:

1. The **immediate objective** of the schemes is that the tax incentives provided by the EIS and the VCT scheme should improve the post-tax returns for investors, thereby encouraging them to invest more in the companies covered by the schemes (i.e. the schemes should increase the supply of finance).
2. The **intermediate objective** of the schemes is that the companies should then be enabled to use the funds to improve their performance.
3. The **ultimate objective** is that the UK economy should benefit by having a more competitive small firms economy.

6. The VCT scheme

The Venture Capital Trust (VCT) scheme was introduced in April 1995 after substantial public consultation. The VCT scheme is designed to encourage individuals to invest indirectly in unquoted small higher risk trading companies through VCTs. VCTs have the advantage of a managed fund, where the selection and monitoring of investments, are undertaken by a professional fund manager. A portfolio of investments enables some reduction in risk. VCTs are listed on the Stock Exchange and provide such trading companies with funds enabling them to develop and grow.

VCT companies

Broadly similar to investment trusts, they are investment companies quoted on the Stock Exchange.

To **qualify as a VCT** a company must meet the following conditions:

- At least 70% of its investments must be in qualifying shares or securities (including loans of at least 5 years) within 3 years;

- At least 30% of the value of its qualifying holdings must be in ordinary shares within 3 years and at least 10% of its holding in each company must be in such shares;
- Its income must be wholly or mainly from shares or securities;
- No holding in any one company may represent more than 15% of its total investments;
- Its ordinary share capital must be quoted on the London Stock Exchange; and
- It must not retain more than 15% of the income that it derives from shares or securities.
- If a VCT makes a further issue of shares, 70% of those funds must be invested in qualifying companies within 3 years of the date of the new fund raising.

Qualifying holdings

- Qualifying holdings are classified as newly issued shares or securities of an unquoted company, which exists wholly or mainly for the purpose of carrying on a qualifying trade in the UK. Exclusions include such trades as property, financial services and commodities.
- The gross assets of the investee company must not exceed £15 million prior to the VCT's investment and £16 million post investment.
- The maximum a VCT can invest in any one company in any tax year is limited to £1 million. Investments in the same company in two different tax years must be at least six months apart.

Investors (VCT relief)

- Subscribers for new ordinary shares in VCTs are entitled to claim income tax relief at 20 per cent on subscriptions up to £100,000 provided the shares are held for at least 3 years (5 years for shares issued prior to 6th April 2000). No income tax is payable on dividends from ordinary shares in VCTs.
- Subscribers for new ordinary shares in VCTs on which they have obtained income tax relief are also able to defer a capital gain, up to £100,000 a year.
- No capital gains tax is payable on disposals by individuals of ordinary shares in VCTs.

Excluded Trades in VCT and EIS

Trades will not currently qualify if excluded activities together amount to a substantial part of the trade. The main excluded activities are

- dealing in land, in commodities or futures or in shares, securities or other financial instruments
- financial activities such as banking, money-lending, insurance, debt-factoring, and hire-purchase financing
- dealing in goods other than in an ordinary trade of retail or wholesale distribution
- leasing or letting assets on hire, except in the case of certain ship-chartering activities
- oil extraction activities, except where for oil exploration leading to oil extraction
- receiving royalties or licence fees, other than, in certain cases, such payments arising from film production, or from research and development
- providing legal or accountancy services
- property development * (also excluded for first six months of EIS)
- farming or market gardening *
- holding, managing, or occupying woodlands, any other forestry activities or timber production *
- operating or managing hotels, guest houses or hostels *
- operating or managing nursing homes or residential care homes *, and
- providing services to another company where the other company's trade is substantially excluded activities.

* Activities excluded since March 1998. Whether excluded activities amount to a substantial part of a company's trade is decided by reference to the relevant facts and circumstances of a particular case, generally they will be substantial if they amount to more than 20 per cent of the trade.

Initially, until November 1994, EIS scheme companies with more than half their assets in land or buildings were ineligible.

Investors for which VCTs are suitable

VCT are suitable for particular types of investors including:

- Those with maturing share options;
- High earners who wish to reclaim 20% income tax;
- Those seeking a growing, high, tax-free income;
- Investors looking to defer capital gains, as a result of the sale of the privately owned business or demutualisation windfall;
- Those who wish to rebalance a portfolio ripe with capital gains;
- Those who have capital gains crystallising 12 months before or after potential potential subscription and who wish to defer their liability; and
- Those looking at inheritance and estate planning, as there is no income or capital gains tax claw back on death.

What should investors look for in a good VCT fund manager

The secret to private equity investment is understanding the key fundamentals that characterise a successful company. Before a good fund management team invests in any company, they get under the skin of the business. That means attending company meetings, appraising business plans and getting to know the company's management style.

- **Track record:** How long have they been managing their private equity portfolio? If they are launching a VCT, is it their first one?
- **Choice of trusts:** Do they offer a range of fund types? For example, is a generalist, AiM or technology based portfolio more suitable to you, given your existing portfolio and attitude to risk?
- **Size and experience of management team:**
Do they have a dedicated private equity team and do they have the necessary specialist back up e.g. researchers, business analysts and legal support?
- **The number of VCTs:** The more the number, the more likely they can invest in larger deals and offer a good spread of investment.
- **The management company's track record and deal flow:** How are their existing private equity funds performing?

- **Deal flow:** Are they currently investing at the rate needed to meet all the qualifying rules for a VCT?
- **The costs involved:** What are the running costs? Remember to assess the possible cost of any performance fees as well as issue costs and annual management fees.
- **Shareholder friendly policies:** Does the fund have a buy-back policy in case you need to sell?
- **Investor relations:** How often will you receive an update on the progress of your investment and how will your questions be dealt with?

7. The Corporate Venturing Scheme (CVS)

The Corporate Venturing Scheme ('CVS') provides a range of tax reliefs for companies, which subscribe for shares in other companies, known as qualifying issuing companies. The latter are companies, which are unquoted at the time the shares are issued and which carry on or are preparing to carry on certain types of trading activities, and satisfy certain requirements. Many of the conditions, which they have to meet, are identical with the conditions to be met under the Enterprise Investment Scheme ('EIS'), and there are a number of cross-references to the guidance.

8. The Enterprise Investment Scheme (EIS)

The Enterprise Investment Scheme (EIS) was introduced in 1994 to encourage individuals to invest in small higher-risk trading companies as a means to help alleviate the problems faced by such companies in raising equity finance. The scheme provides income tax relief for new equity investment by external investors and business angels in qualifying unquoted companies, and capital gains tax exemption on disposal of shares. In April 1998 capital gains tax reinvestment relief was merged with EIS to create a new unified scheme so that individuals and some trustees can defer the capital gains tax arising on any chargeable gain by investing the gain in qualifying companies.

Qualifying companies

- EIS companies must be unquoted at the time the shares are issued to investors. Throughout a period of at least three years, the company must exist for the purpose of a qualifying trade and must not be under the control of any other company. The money raised by the issue of shares must be employed in a qualifying business activity within certain time limits.
- Qualifying business activities comprise not only trades but also research and development, which is intended to lead to a qualifying trade. Some trading activities are excluded. These include dealing in land or shares; money-lending, insurance and other financial activities; dealing in goods, other than ordinary wholesale and retail trades; leasing or letting assets on hire, except certain ship-chartering activities; and receiving royalties or licence fees, other than those attributable, broadly, to intangible assets created by the company. From March 1998 certain property-backed activities were excluded. These are farming and market gardening, forestry, property development and operating or managing hotels, guesthouses, nursing or residential care homes.
- Participation is limited to companies with gross assets of no more than £15 million immediately before raising funds under the scheme and no more than £16 million immediately afterwards.

EIS Reliefs

- Investors can obtain income tax relief at 20 per cent on investments up to £150,000 in any tax year. The upper limit for relief was increased from £100,000 a year to this in 1998-99. There is no limit on the investment qualifying for deferral of liability to capital gains tax.
- The reliefs are available only for investment in new ordinary shares in qualifying companies. Investors must hold their shares for at least 3 years (5 years for shares issued prior to 6th April 2000) to retain their income tax relief in full, unless the company is wound up for genuine commercial reasons.
- A gain arising from the disposal of shares for which EIS income tax relief was obtained and retained is exempt from capital gains tax (CGT).

Business Angels

The term “business angel” is used here to describe an investor who becomes a paid director on or after the date of buying shares in a company. To qualify for income tax relief, such an investor must not previously have been connected with the company or involved in its trade, and must not own more than 30 per cent of the company's shares.

9. Development of the VCT market

Since 1995 when the first VCT was launched, around 60 have come to the market and have raised almost £1.4 billion between them. And, over the past three tax years (to 5.4.01) the amount of funds raised each year has almost tripled.

(source: PricewaterhouseCoopers, Allenbridge 31.7.01).

Investment at an early stage in young, high-growth companies is where real returns can be seen. Normally, access to such companies is restricted to venture capitalists, or wealthy individuals known as 'business angels', who invest directly in an entrepreneur's business or through a scheme such as an EIS. These people supply young companies with cash to start them off on the route to a stock market quotation.

VCTs are one of the best ways for you, as a private investor, to access this part of the market while at the same time reducing the risks of investment. They allow you to benefit from the skills of professional managers, to invest in a portfolio of stocks rather than gambling on one or two, plus give you an enhanced return through the generous tax breaks on offer. From slow beginnings, the popularity of VCTs as a more mainstream investment is increasing. Many VCT launches are over subscribed because of the surge of investors becoming aware of their attractions.

10. The VCT investment remit

VCTs can invest in both unquoted and AiM companies. Trusts tend to fall into one of three focus areas; generalist, AiM or technology. There are advantages to each, but a balanced portfolio would cover all three.

(a) Generalist

Generalist funds concentrate mainly on investment in unquoted companies and are akin to the wider venture capital industry.

The UK venture capital industry has shown sizeable growth in recent years. The amount invested in 1995 in the UK grew from £2.1 billion to £6.4 billion in the year to 31.12.00

(source: British Venture Capital Association (BVCA)/PricewaterhouseCoopers).

Over ten years to 31.12.00, the net annual investment return for the BVCA membership (about 95% of all investors) averaged 20.4%. This compares to the FTSE All-Share Index returns of 15.4% a year over the same period and 13.6% a year achieved by mixed pension funds (source: WM company).

In the year to 30.9.00, the number of unquoted transactions backed by VCTs was estimated to be 150 (source: PricewaterhouseCoopers) and represented about one in eight of all venture capital backed deals in the UK by number. These transactions enable VCT investors to build up a selected portfolio within the VCT of faster growth companies. This would be very difficult otherwise, especially as the typical venture capitalist will only wish to back three in every 100 opportunities.

Unquoted companies are usually valued following the BVCA valuation guidelines as there is no ready ability to sell unquoted company shareholdings. This typically results in cautious valuations in the early years of an unquoted portfolio until the shareholdings are either sold to a trade buyer or floated on a recognised stock exchange. This can result in a 'J-curve' growth in net asset value per share which is flat at first, followed by an upward swing.

(b) Alternative Investment Market (AiM)

AiM is a natural home for VCT monies as it is host to a wide range of dynamic growth companies, many of which fit the rules for VCT investing. There are few VCTs which concentrate solely on AiM, however. Being a regulated market, AiM imposes disciplines on its member companies and allows for a greater degree of liquidity and transparency than many unquoted investments which constitute the majority of holdings within conventional VCTs. In fact, AiM stocks are sometimes

tagged as venture capital with a quote. With AiM companies there is also a greater potential to sell a holding, though it can be an illiquid market.

The AiM market was launched by the London Stock Exchange in June 1995 with the objective of providing young and growing companies with the means of accessing equity capital to facilitate their expansion. From the initial ten quoted companies, it has shown itself to be a very important source of capital to growing small British companies, now comprising 587 companies with a market capitalisation of £12.4 billion (at 31.7.01). £6.9 billion has been raised by the companies on AiM, since launch and they are using this capital to finance their development and growth plans. Private investors usually find it difficult to subscribe for these fund raisings as they are normally done by way of institutional placings rather than public offers.

83 companies, which started on AiM, capitalised at £8.4 billion, have now progressed to the Official List (at 31.8.01) and around 121 Companies have joined AiM so far in 2001. (Figures sourced from London Stock Exchange 14.9.01.)

AiM comprises a diversity of businesses by sector and size of company but investment typically gives you significant exposure to technology and technology-enabled businesses including biotech, healthcare, computer software and quoted internet companies.

AiM listed companies are particularly attractive because they are young and entrepreneurial with plans for growth and a requirement for capital to develop. This makes AiM an exciting market for the growth investor. Around 30 to 35% of the companies are typically owned by their directors, meaning the directors have a vested interest in creating capital value for the business.

Table 1-1

AiM sector split

Sector	%
Resources	9.7
Industries	5.3
Consumer goods	12.5
Services	39.7
Financials	19.8
Technology	13.0
	100.0

Source: London Stock Exchange 31.07.01

(c) Technology

Technology-focused funds are at the more risky end of VCT investment. They do have the potential for very high returns, but this should be balanced with the volatility inherent in the market. If you are after technology exposure, it may, however, be wiser to invest in a spread of investments such as that available with a VCT rather than selecting a single stock or two.

11. Performance of VCT funds

Performance of VCT funds has varied depending on the sectors they have chosen to invest in. Also, when looking at the performance of a VCT, you need to remember that it will take a couple of years for the managers to fully invest the funds and for true performance to show through. Performance tends to be flat at first, as most investment is in fixed-interest securities and some investments may fail. It is then usually characterised by an upward swing as investments start to mature (the ‘J-curve’). Significant trading in the shares is not likely to start until after the three year lock-in is over.

11.1 Performance of UK private equity funds (excluding) VCTs

The table below highlights the impressive performance of UK private equity funds. The superior performance story explains why the UK private equity industry continues to attract record levels of funds from both foreign and UK institutional investors. UK pension funds alone committed £1.6 billion to private equity in 2001, almost twice as much as in the previous year.

Table I-2
Overall performance by investment stage

	Number Of funds	5-years (% pa)	10-years (% pa)
Early stage	58	10.8	11.3
Development	53	11.2	15.6
Mid MBO	61	10.2	13.9
Large MBO	53	16.0	18.4
Generalist	50	24.2	20.0
Total / average	275	15.7	17.4
FTSE All Share		7.3	11.6
FT/S&P World (ex UK)		9.6	11.0
FT/S&P Europe (ex UK)		10.8	13.4

Source: British Venture Capital Association. Figures are to 31.12.01. The table above highlights the performance of 'independent' UK private equity funds – funds raised from external investors for investment at the venture capital (early stage and development) and private equity (MBO) stages, but excluding development capital investment trusts (VCITs) and venture capital trusts (VCTs).

8.1 Performance of UK VCTs

The following tables of VCT performance are taken from the Allenbridge Group plc – Tax Shelter Report (as at 27 March 2003). The following disclosures are to be noted :-

1. Table of Internal Rates of Return (IRR) for current VCTs based on latest published Net Asset Values (NAV). Figures only relate to investors who purchased the first issue of shares.
2. We are publishing these tables as a contribution from an independent source to the debate on how VCT fund managers have performed. To this end we compare the amount invested in a share against the distribution stream plus the latest net asset value. Dividends up to the end of the 1999/00 tax year are gross. As we are measuring fund manager performance the tax breaks are not relevant. However, because of the issues mentioned in the note following the table, we do not believe that conclusions can yet be drawn from the data to judge the performance of fund managers.
3. Allenbridge believe that the only way to compare funds properly is to incorporate the time value of money through a discounting technique such as the Internal Rate of Return. Adding dividends paid to Net Asset Value does not do the job.
4. There is only a limited value in this table as you cannot compare AIM funds with general funds nor can a new fund be compared to one that has been running a few years. In general, any fund that holds AIM stocks will look good . compared to one whose unquoted holdings are valued conservatively according to British Venture Capital Association guidelines.
5. As Allenbridge repeat frequently in Tax Shelter Report, the share price is no indicator of value as there is virtually no market for second hand VCT shares- purchasers do not receive full tax reliefs and sellers lose their tax reliefs if they sell within the first five years.
6. There are many timing and investment valuation issues which inhibit direct comparison of rates of return between VCTs: AIM stocks can be valued at mid-market or at a discount to reflect illiquidity; unquoted investments are valued according to guidelines that are open to interpretation; most VCTs have immature portfolios; VCTs have net asset values declared on different dates.

Table I-3

GENERALIST FUNDS STARTED IN TAX YEARS 95/96 AND 96/97							
Venture Capital Trust	Funds Raised (£m)	Net Asset Value (pence)	Issue Price (pence)	Total Return (Net Asset Value plus dividends) (pence)	First Trading day	Date of last published NAV figure	Total Return Internal Rate of Return (%)
Close Brothers VCT Plc C Shares	15.50	106.80	100	140.40	17/03/98	30/09/02	8.8
Close Brothers VCT Plc Ord Shares	24.20	106.80	100	151.90	04/04/96	30/09/02	7.7
Oxford Tech. VCT plc	4.90	119.00	100	120.40	04/04/97	31/08/02	3.5
Enterprise VCT plc A shares	6.50	87.90	100	120.60	13/01/97	31/12/02	3.4
Baronsmead VCT plc	10.80	86.90	100	121.20	13/11/95	31/12/02	3.1
Northern Venture Trust plc	43.30	80.10	100	106.90	01/11/95	30/09/02	1.1
Quester VCT plc	32.10	63.60	100	105.10	04/04/96	31/12/02	0.9
Close Brothers Protected Plc	27.90	79.00	100	96.30	04/04/97	28/02/03	(0.7)
Elderstreet Millenium VCT	19.10	68.00	100	91.50	04/04/96	31/08/02	(1.5)
Murray VCT plc	26.60	55.60	100	84.10	28/09/95	31/08/08	(2.8)
British Small Cos VCT plc	16.20	64.30	100	82.70	04/04/96	31/12/02	(3.1)
Murray VCT2 plc	37.20	60.70	100	83.00	08/04/97	31/08/02	(3.8)
Advent VCT	31.50	56.60	100	63.80	04/04/96	28/02/03	(6.8)
Guinness Flight VCT plc	32.90	75.50	100	76.70	05/04/96	31/08/02	(4.1) ⁽¹⁾

Source: Allenbridge Tax Shelter Report

Table I-4

GENERALIST FUNDS STARTED IN TAX YEARS 97/98 AND 98/99							
Venture Capital Trust	Funds Raised (£m)	Net Asset Value (pence)	Issue Price (pence)	Total Return (Net Asset Value plus dividends) (pence)	First trading day	Date of last published NAV figure	Total Return Internal Rate of Return (%)
Foresight Tech. VCT plc	10.90	97.90	100	200.90	17/11/97	30/09/02	22.2
Baronsmead 2 VCT plc	45.20	95.20	100	108.40	02/04/98	31/12/02	1.8
Downing Protected Healthcare VCT	9.80	79.50	100	101.20	19/05/97	30/06/02	0.3
Close Brothers Development Plc	14.60	80.30	100	95.00	26/01/99	31/12/02	(1.4)
Murray VCT3 plc	40.00	77.10	100	93.80	08/04/98	31/08/02	(1.6)
Elderstreet Downing VCT plc	15.10	59.90	100	84.40	21/05/98	31/12/02	(4.1)
Quester VCT 2 plc	45.80	57.50	100	84.10	17/03/98	31/01/03	(4.1)
Advent 2 VCT	35.00	53.70	100	73.70	16/03/98	31/12/02	(7.1)

Source: Allenbridge Tax Shelter Report

Table I-5

AIM BASED STARTED IN TAX YEARS 95/96 AND 96/97							
Venture Capital Trust	Funds Raised (£m)	Net Asset Value (pence)	Issue Price (pence)	Total Return (Net Asset Value plus dividends) (pence)	First trading day	Date of last published NAV figure	Total Return Internal Rate of Return (%)
Pennine AIM VCT plc	4.60	99.20	100	154.30	04/04/96	31/12/02	7.8
Capital for Companies VCT plc	10.40	72.70	100	102.70	15/04/96	31/12/02	0.5
Legg Mason AIM Distribution Trust plc	17.60	48.70	100	95.60	03/05/96	31/01/03	(0.9)

Source: Allenbridge Tax Shelter Report

Table I-6

AIM BASED STARTED IN TAX YEARS 97/98 AND 98/99							
Venture Capital Trust	Funds Raised (£m)	Net Asset Value (pence)	Issue Price (pence)	Total Return (Net Asset Value plus dividends) (pence)	First trading day	Date of last published NAV figure	Total Return Internal Rate of Return (%)
Close Brothers AIM VCT plc	10.10	59.00	100	111.30	30/04/98	31/01/03	3.0
Pennine AIM VCT II plc	4.60	69.00	100	105.50	01/05/97	31/12/02	1.1
Pennine Downing AIM VCT plc	10.20	69.00	100	76.50	21/05/98	31/01/03	(5.8)
BWD Aim VCT plc	23.50	63.80	100	71.30	25/06/98	28/02/03	(7.2)
AIM VCT plc	17.00	48.20	100	69.10	09/12/98	24/03/03	(9.6)
Singer & Friedlander AIM VCT plc	16.50	29.30	100	61.70	24/11/98	27/02/03	(14.7)

Source: Allenbridge Tax Shelter Report

Table I-7

GENERALIST AND HYBRID LAUNCHED IN TAX YEAR 99/00							
Venture Capital Trust	Funds Raised (£m)	Net Asset Value (pence)	Issue Price (pence)	Total Return (Net Asset Value plus dividends) (pence)	First trading day	Date of last published NAV figure	Total Return Internal Rate of Return (%)
Northern 2 VCT plc	24.30	94.50	100	102.70	21/04/99	31/01/03	0.7
Foresight Tech. VCT plc C Shares	0.90	73.70	100	80.00	02/11/99	30/09/02	(7.5)
TriVen VCT plc	19.10	67.60	100	72.90	06/04/99	31/10/02	(8.7)
Talisman	5.30	12.70	19	12.70	04/04/00	30/09/02	(9.2)
British Smaller Tech. Cos. VCT plc	14.00	63.30	100	64.20	06/04/99	30/09/02	(12.0)
Downing Classic VCT plc	6.70	57.70	100	59.90	13/05/99	31/10/02	(13.8)
Qvester VCT 3 plc	48.00	56.00	100	57.80	16/02/00	31/01/03	(17.2)

Source: Allenbridge Tax Shelter Report

Table I-8

GENERALIST AND HYBRID LAUNCHED IN TAX YEARS 00/01⁽²⁾							
Venture Capital Trust	Funds Raised (£m)	Net Asset Value (pence)	Issue Price (pence)	Total Return (Net Asset Value plus dividends) (pence)	First trading day	Date of last published NAV figure	Total Return Internal Rate of Return (%)
Oxford Tech 2 VCT plc	6.00	140.00	100	142.00	05/04/00	31/08/02	
Baronsmead 3 VCT	33.00	94.90	100	100.00	30/01/01	31/12/02	
Murray VCT4 plc	38.30	88.20	100	94.50	11/04/00	31/08/02	
ProVen	22.00	79.10	100	84.97	10/04/00	31/08/02	
Sitka	7.60	88.60	100	89.60	26/03/01	30/10/02	
Qvester VCT 4 plc	53.00	78.50	100	8.40	10/11/00	31/01/03	
Trivest	41.70	76.20	100	79.20	15/11/00	31/12/02	
Close Technology and General	13.20	73.00	100	77.00	17/01/01	28/02/03	
Matrix e-Ventures	13.10	69.30	100	71.60	11/07/00	31/10/02	
Downing Classic 3 VCT	21.90	74.90	100	77.90	04/04/01	31/10/02	
Downing Classic 2 VCT plc	11.00	57.70	100	59.80	10/04/00	31/10/02	
Pennine Downing Ethical	10.70	52.10	100	53.40	10/04/00	30/09/02	
i-Net VCT plc	10.70	52.30	100	53.80	18/07/00	31/10/02	
e-Technology	13.60	66.20	100	66.20	30/06/00	30/09/01	

Source: Allenbridge Tax Shelter Report

Table I-9

AIM BASED LAUNCHED IN TAX YEARS 00/01⁽²⁾							
Venture Capital Trust	Funds Raised (£m)	Net Asset Value (pence)	Issue Price (pence)	Total Return (Net Asset Value plus dividends) (pence)	First trading day	Date of last published NAV figure	Total Return Internal Rate of Return (%)
AIM VCT 2 plc	41.80	75.20	100	77.40	04/12/00	24/03/03	
Close Brothers AIM VCT C shares plc	16.00	71.00	100	74.30	11/08/00	31/01/03	
Singer & Friedlander AIM 3 VCT plc	33.00	74.00	100	75.70	30/01/01	20/03/03	
Artemis AIM	33.00	78.40	100	79.30	20/02/01	31/07/02	
Singer & Friedlander AIM2 VCT plc	22.00	52.10	100	54.00	04/04/00	20/03/03	
Northern AIM	22.00	53.70	100	54.40	11/01/01	28/02/03	

Source: Allenbridge Tax Shelter Report

Table I-10

GENERALIST FUNDS LAUNCHED IN TAX YEARS 01/02							
Venture Capital Trust	Funds Raised (£m)	Net Asset Value (pence)	Issue Price (pence)	Total Return (Net Asset Value plus dividends) (pence)	First trading day	Date of last published NAV figure	Total Return Internal Rate of Return (%)
Aberdeen Growth	24.40	60.90	100	62.00	10/04/01	31/01/03	
Aberdeen Growth Opportunities	10.00	93.20	100	93.20	12/12/01	30/11/02	
Baronsmead 4	18.40	94.10	100	95.10	20/12/02	30/11/03	
BioScience	7.00	93.70	100	94.50	19/04/02	31/12/02	
British Smaller Tech. Companies 2	6.80	92.50	100	92.50	10/04/01	30/06/02	
Electra Kingsway	15.40	93.30	100	94.10	25/01/02	30/09/02	
Leisure and Media	8.90	93.50	100	94.30	08/06/01	31/12/02	
Northern 3	13.90	95.50	100	96.10	17/12/01	31/12/02	
Oxford Technology 3	4.00	96.00	100	96.00	04/04/02	31/08/02	
Quester VCT 5	18.40	92.60	100	92.60	24/12/01	31/01/03	
ProVen Media	5.60	90.40	100	92.80	31/05/01	31/08/02	

Source: Allenbridge Tax Shelter Report

Table I-11

AIM BASED FUNDS LAUNCHED IN TAX YEARS 01/02							
Venture Capital Trust	Funds Raised (£m)	Net Asset Value (pence)	Issue Price (pence)	Total Return (Net Asset Value plus dividends) (pence)	First trading day	Date of last published NAV figure	Total Return Internal Rate of Return (%)
LeggMason Investors	8.90	45.70	100	47.30	30/04/01	31/01/03	
Pennine Downing AIM 2	12.50	67.00	100	68.00	31/05/01	31/01/03	
Teather & Greenwood AIM	2.75	96.80	100	96.80	27/03/02	31/12/02	
Unicorn AIM	35.00	83.10	100	83.60	05/11/01	28/02/03	

Source: Allenbridge Tax Shelter Report

Notes:

(1) no recent NAV

(2) Internal rates of return on these recent VCTs are not shown as they convey little meaning
VCTs are ranked alphabetically

Appendix II

South Africa's SMME Support Network

1. Introduction

The 1995 White Paper on National Strategy for the Development and Promotion of Small Business in SA has been the first major effort by the South African government to design a policy framework particularly targeting the entire spectrum of small enterprise sector.

The overall objective of the strategy was to create an enabling environment for SMME growth in the country as a way of addressing basic inequalities in the economy. The Act legalized the establishment of new institutions, an affirmative procurement reform, and the formation of an advisory board to review SMME's legal regulatory environment.

2. THE DEVELOPMENT OF INSTITUTIONS TO FACILITATE SMME GROWTH

In response to the challenges set out in the White Paper, a four-pronged new institutional network at national level were established to drive the National Small Business Strategy:

- The Centre for Small Business Promotion (CSBP) of the DTI
- National Small Business Council (NSBC)
- Ntsika Enterprise Promotion Agency (Ntsika or NEPA)
- Khula Enterprise Finance.

3. Description Of South Africa's SMME Support Network

3.1.1 Ntsika or NEPA

Ntsika was initiated by the DTI to implement the national SMME strategy. It provides non-financial support to SMME's via a range of programmes that are accessible through a network of retail service providers classified as:

- Local Business Service Centers: For assistance in business administration and general information.

- Tender Advice Centers: To provide assistance and training to SMME's on government tendering processes and inform about current tenders.
- Manufacturing Advice Centers: Provides industry specific assessments and link SMME's to highly specialized service providers.

Technical colleges were founded for the purpose of implementing the Technopreneur Programme for potential SMME entrepreneur to improve their technical skills.

3.2 Khula Enterprise Finance Ltd

Khula has initiated, since its establishment in 1996, a number of loan schemes to increase access to finance for SMME's through Retail Financial Intermediaries (RFIs), which are SMME departments of commercial banks or accredited NGOs. RFIs apply their own minimum lending criteria (the most basic is the provision of a business plan) as the responsibility of risk assessment lies entirely with the RFIs. The scheme can be grouped as follows:

- 3.2.1 Business Loan Scheme: Out of a total of R400 million, loans to the value of R1 million to R100 million are forwarded to RFI's to capacitate them to increase their willingness to provide loans to SMME's.
- 3.2.2 Guarantee Schemes: Guarantees are underwritten by Khula to reduce the risk of lending to SMMEs without sufficient collateral.
- 3.2.3 Equity Funds: Through the internet-based Emerging Enterprise Zone (EEZ) as part of the JSE, SMMEs are expected to gain access to equity funding (up to R250 000, constituting less than 45% of the total equity and to re-capitalise within five years) from private investors with whom Khula might partner. Unclear business plans or problems to determine the willingness to repay have been two of the reasons for rejections, only a minority of SMMEs has access to the Internet.

In addition, Khula Institutional Support Services Ltd offers seed loans to organizations that aim to become RFIs. Khula also runs a capacity building programme for existing and potential RFI Staff.

3.3 DTI and its institutions.

A number of DTI Incentive Schemes were designed exclusively for (registered) SMME industrialists and include:

- Standard Leased Factory Building Scheme, of the Industrial Development Corporation (IDC), which makes general purpose factory buildings available for lease to SMMEs
- Small/Medium Manufacturing Development Programme (SMEDP), which consists of tax-exempt establishment grant as a percentage of the investment for the first two years and a Skills Support Programme (SSP) if the business has an approved training programme.
 - Economic Empowerment Scheme, for the expansion or establishment project of PDI SMME entrepreneurs to which the IDC contributes the majority of capital outlay.
 - Venture Capital Schemes, with which the IDC co-finances viable product ventures.
 - Normal Finance Scheme, which provides for low-interest IDC administrated finance during expansion.
 - Import Finance Scheme, which consists of credit and guarantee facilities for importing capital goods and services.
 - Short-Term Export Finance guarantee Facility, through which the credit Guarantee Insurance Corporation (CGIC) can provide pre- and –post shipment export finance guarantee for SMMEs; and
 - Export Marketing and Investment Assistance Schemes (EMIA), which provides funding for primary market reseach, outward selling and inward buying trade missions and assistance to take part in exhibitions.

3.4 Provincial SMME Desks

The provincial SMME Desks were established to ensure provincial representation of SMME interest as well as contribute to implementation of national strategy. Their main task is to link national or sectoral programmes with local or regional implementation bodies and establish a comprehensive SMME database on which national policy changes can be based.

Appendix III

Factors in the growth of micro-enterprises: Developing a framework and exploring the implications

by Lew Perren, 1996, PhD Thesis – University of Brighton

(The summary of this review has been adapted from the
Journal of Small Business and Enterprise Development,
Volume 6, Number 4 and Volume 7, Number 1)

Factors in the growth of micro-enterprises: Developing a framework and exploring the implications

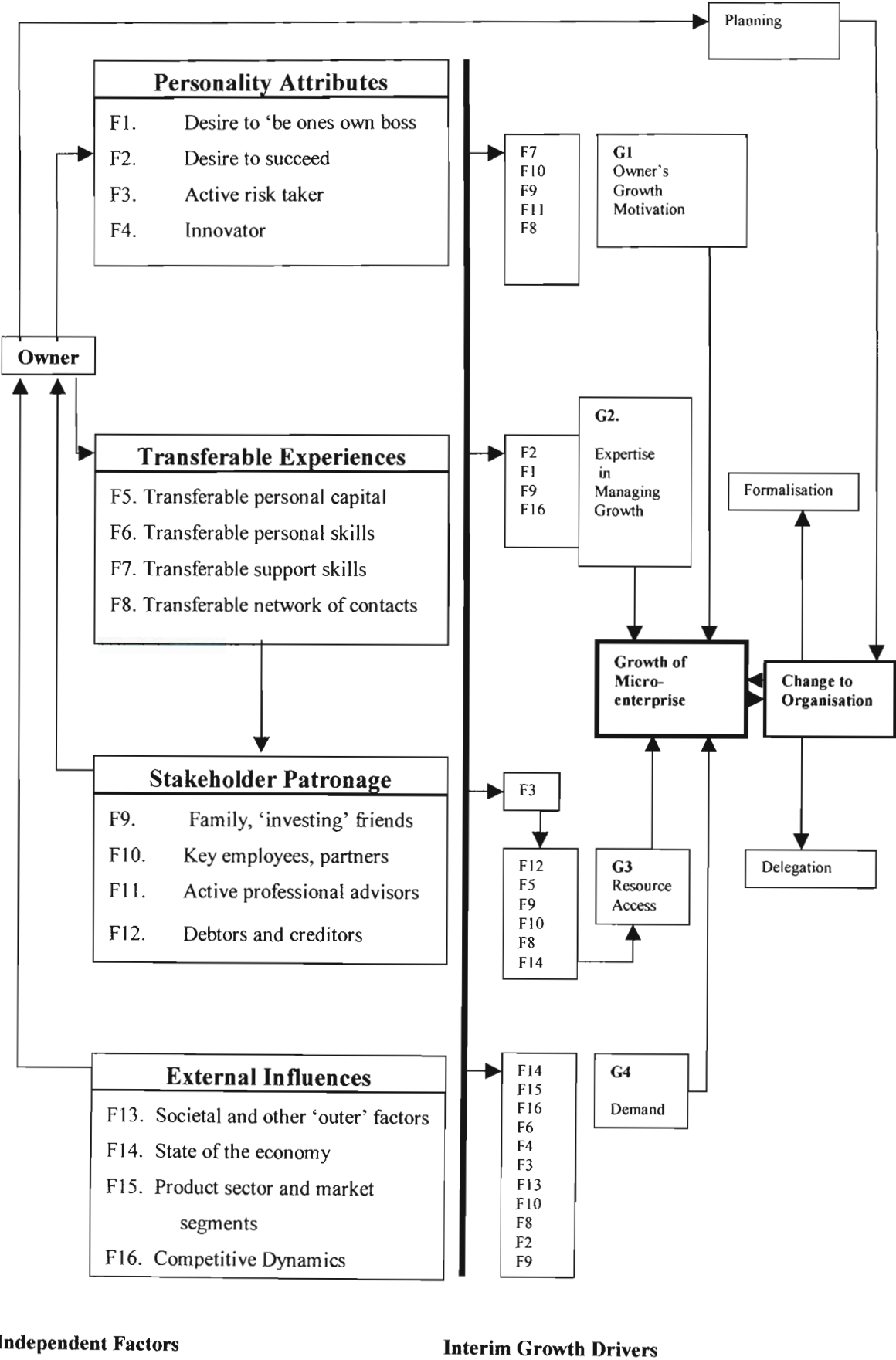
The research examines the micro-enterprises pursuing gradual growth. The research findings develop an empirically verified framework (Figure 1) that explains how growth is influenced by a myriad of interacting factors. This leads to a discussion of the policy implications of the framework and explores the managerial implications of the framework. Also the research can be applied to small firms to pursue gradual growth.

MANAGERIAL AND POLICY IMPLICATIONS

- Four interim growth drivers influence micro-enterprise development: owner's growth motivation, expertise in managing growth, resource access and demand.
- The interim growth drivers are in turn influenced by a myriad of independent factors.
- Growth beyond the micro-enterprise phase requires the combined influence of the independent factors to be positive on all four interim growth drivers.
- There is the possibility of compensation, the phenomenon where, a deficit in one factor's influence against an interim growth driver can be counterbalanced by another.
- The framework provides micro-enterprise owner-managers and their advisers with a checklist of potential compensating factors for each of the interim growth drivers. This should provide an agenda for stimulating growth beyond the micro-enterprise phase.
- Micro-enterprise development has been shown to be a process of slow incremental iterative adaptation to emerging situations, rather than a sequence of radical clear steps or decision points.
- Micro-enterprises need timely and tailored support, rather than any form of standard supply-side policies, which will be wasteful and not address real needs. What is needed is support that is owner-manager centred, rather than adviser-centred.

- The diagnostic toolkit provides micro-enterprise owner-managers and their advisers with a systematic way of exploring the influences on the interim growth drivers and highlighting ways of compensating deficits in particular factors.
- Adopting a Socratic questioning approach helps unleash owner-managers' intimate knowledge about their businesses and empowers them to think creatively about growth opportunities.
- Owner-manager centred approaches like this should be encouraged, as they can help develop diagnostic skills and self-awareness. They may also reduce the risk of over dependence on external advisers.

Figure III-1: Diagrammatic summary of the empirically verified framework



Appendix IV

National Competitive Advantage: Porter's Diamond

Michael Porter, Harvard Business Review, March-April 1990, page 77

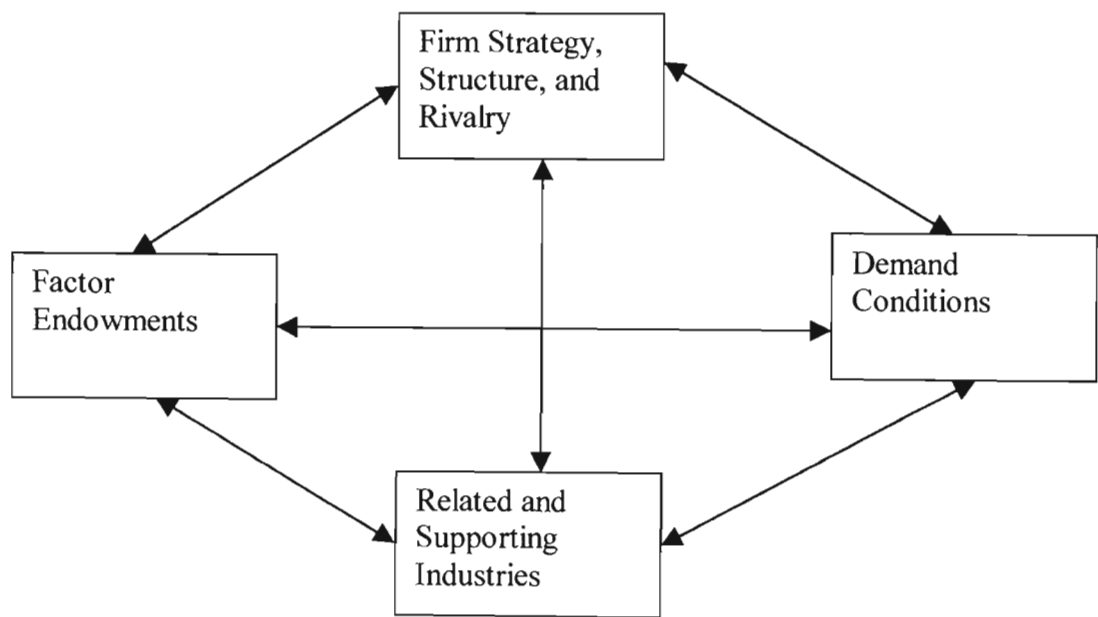
(This summary is taken from International Business-Competing
in the Global Marketplace, 3rd Edition, 2002, Charles W. Hill)

National Competitive Advantage: Porter's Diamond

Although this thesis was written with an international focus, it does however have implications for SMEs pursuing growth. Such SMEs need to place themselves in context of the big picture and see how they fit in, if they are to aim for the top of success ladder. Also, government is a major player in this theory. Furthermore, this theory is a reasonable starting point for Khula and TEO to assess potential high-growth SMEs.

The theory essentially examines why a nation achieves success international success in a particular industry. Porter's thesis is that four broad attributes of a nation shape the environment in which local firms compete, and the attributes promote or impede the creation of a competitive advantage. These four attributes are Factor endowments, Demand conditions, Related and supporting industries, and Firm strategy, structure, and domestic rivalry, which constitutes the *diamond*.

Figure IV-1: Determinants of Porter's Diamond



Porter maintains that two additional variables can influence the national diamond in important ways: chance and government. Chance events, such as major innovations, create discontinuities that can unfreeze or reshape industry structure and provide the opportunity for one nation's firms to supplant another's. Government, by its choice of

policies, can detract or improve national advantage. For example, regulation can alter home demand conditions, antitrust policies can influence the intensity of rivalry within an industry, and government investments in education can change factor endowments.

Porter's argument is that the degree to which an industry (enterprise) will achieve success is a function of the combined impact of Factor endowments, Demand conditions, Related and supporting industries, and Firm strategy, structure, and domestic rivalry.

Appendix V

Secondary data analysis of SMEs

This section attempts to provide some insights with regard to the following two issues:

- Are there high-growth SMEs that are being overlooked by suppliers of finance?
- Is there an equity gap to service the needs of SMEs?

It is discussed in-depth in the Trade and Industrial Policy Strategies (TIPS) draft report “The Economics of SMMEs in South Africa”, February 2002, Cassim et al, Pages 12-32, 72-83 and downloadable from the website www.tips.org.za.

The following information, presented in brief, is intended to shed some light:

1. Sectoral dynamics – sectors with high company creations
2. Evidence of untapped potential in rural areas
3. Angel finance and Venture Capital as sources of SME finance
4. SMMEs low level of investment as a symptom of a financing problem

1. *Sectoral dynamics – sectors with high company creations*

Two additional sources, GEM (2001) and Stats SA 2000 are used to draw inferences on the sectoral dynamics – in the last five years and in 2000, which sectors witnessed the most enterprise creation? In which sectors does entrepreneurship appear to be sustainable?

• **Sectors with high company creations in the last 5-10 years**

According to both sources, two sectors emerge as having had a strong creation activity, namely the **financial and business services** and **trade/hotels and restaurants**. This is not surprising as these are known to be popular start-ups activities. In the former case, though, this dynamic creation activity seems to be compensated by a fairly high “attrition rate”¹, almost 11 per cent of new registrations in 1999.

The **manufacturing** sector is fairly dynamic, as GEM results suggest (high share among new firms in particular). Nevertheless, according to registration statistics, the sector’s creation activity is rather ‘average’ relative to its size in the formal economy. What is more, the sector appears to have the highest attrition (11.3 per cent).

• **Sectors with high company creations in 2000**

Looking at most recent creations (in 2000), the above-mentioned three sectors remain significant. In addition, the sector of “**social and personal services**” emerges both from GEM results (very high share of start-ups but not of new firms) and from the Registrar’s data as a sector where creations have accelerated in 2000.

• **Contradictory results**

For three sectors, the two sources apparently yield contrary results. Apart from possible measuring weaknesses, other explanations are also sought for this discrepancy.

Construction: The Registrar suggests that in the last 10 years, the construction sector has had the second-most vibrant registration activity, albeit with a slight slow-down in 1999, while the GEM findings suggest that there are rather few new firms in that sector. While its overall ‘attrition profile’ is average (9.7 per cent), it is very dramatic among private companies (46.3 per cent).

This could possibly be attributed to a discrepancy between the formal and informal sector, a high “infant mortality” rate leading to a much smaller number of living young companies than were created, and/or the re-registration of proprietary companies (Ptys) as close corporations (CCs), and the phenomenon of dormant companies.²

Transport and communication: This sector consists of among others, activities such as “telecommunications” or “tour operators/ travel agencies”, which are known to be popular start-up activities - and also activities such as taxi driving. While GEM found a very high share of start-ups but not of new firms in that sector, the registration activity seems to have slightly slowed down in 1999-2000, especially for CCs. This may arise from a difference in the delimitation of the sectors or by the fact that while the communication and tourism sectors are beginning to be saturated, which shows up as a high infant mortality. This may have reduced the attractiveness of the sector for start-ups.

Agriculture, Fishing and Hunting: The primary sector shows an intriguing pattern when comparing registrations in 2000 to the registration activity in 1990-99. Undoubtedly, there has been a great acceleration in the registrations of CCs in 1999-2000. However, GEM does not corroborate this, as they found very few new firms in that sector. The hypothesis of a rather “old sector” is also confirmed by the low rate of attrition. It is difficult to correctly interpret these results without a study of the structural changes in agriculture as a whole. This would require knowing what proportion of agricultural businesses is registered as CCs or Private companies. In any case, the land reform process seems to be slowly generating some emerging farming businesses.

Notes:

1. The ratio of deregistrations to registrations, which we call an “**attrition rate**”, should not be seen as a proxy for a “mortality rate”, which would be the ratio of deaths to the entire sector’s population which is typically much lower.
2. Examples of these are Black Economic Empowerment companies, which are registered for the purpose of winning government tenders, while in reality they are merely fronts for older white-owned firms. This trend has received widespread publicly and criticism.

2. *Evidence of untapped potential in rural areas*

One limitation of the GEM methodology is that the business creation potential is self-assessed, i.e., respondents are asked whether they believe that there are opportunities and that they would have the skills necessary to start a business. However, the results are intriguing, and suggestive of a huge untapped business potential in rural areas - especially among black people.

Table V-1: Untapped potential of “opportunity entrepreneurship”

	White	Indian	Coloured	Black	Metro*	Small Town	Rural	Total
"Potential opportunity entrepreneurs"*	7.0%	6.2%	8.1%	5.8%	6.3%	5.4%	6.0%	6.1%
Actual opportunity entrepreneurs	8.1%	6.2%	6.1%	2.6%	6.3%	3.8%	0.7%	3.7%
Untapped potential	-1.1%	0.0%	2.0%	3.2%	0.0%	1.6%	5.3%	2.4%
No of adults	-38,350	0	49,364	657,139	0	87,008	583,420	665,490

Source: GEM 2001, combined with OHS data. Note - all percentage figures are percentages of the adult population within the category.

Table V-1 shows that among urban and White and Indian populations, there is little or no potential for more entrepreneurship opportunity. On the other hand, it seems that, with the appropriate support (including probably (finance, infrastructure and mentoring), there could be a considerable increase in entrepreneurship in rural areas and among coloured and black people. This suggests that government policy should really endeavour to stimulate small business activity among those population groups.

The second caveat is that the “potential opportunity entrepreneurs” are self-assessed. It is possible that, with their lack of exposure and business experience, rural and black South Africans over-estimate both the opportunities present on the market, and their own ability to start a business.

3. *Angel finance and Venture Capital as sources of SME finance*

Business angel finance and venture capital are often viewed as an alternative to bank finance, especially for young “high-risk high return” companies, whose available collateral or equity resources are too low to qualify for a bank loan.

As far as Business Angels are concerned, most recent statistics¹ suggest that in the last three years, approximately 1.1 per cent of South Africans have privately invested into firms that were not theirs. This is less than in most developed countries, but it suggests that the business angel culture is far from being insignificant. The Global Entrepreneurship Monitor evaluates the total amount of angel investment over the last three years at approximately R1 billion.

While there are very divergent estimations, KPMG’s “2000 Private Equity Survey” seems to indicate that compared with the size of the economy. South Africa has one of the most vibrant venture capital and private equity markets, with more than R33 billion under management (Table V-2).

Table V-2

Relative size of international private equity markets

	Value of private equity investments (US \$ billion)	As a% of GDP
USA	400.0	4.9%
UK	27.6	2.3%
Israel	10.4	12.1%
SA	4.3	4.2%
Netherlands	4.2	1.3%

Source: KPMG and the South African Venture Capital and Private Equity Association, “2000 Private Equity Survey”, April 2001

The venture capital/private equity sector, hence, is not small in South Africa. But, considering that “private equity” includes all equity investments in non-listed companies, the size of the sector is not necessarily an indicator of the importance of equity as a source of finance for SMMEs. Although very little evidence is available in this area, there is a strong presumption that only a small portion is directed to SMMEs (presumably less than R5 billion). Especially, black SMMEs apparently received no more than R700 million of equity investment (Karungu *et al.*, 2000).

¹ Global Entrepreneurship Monitor (GEM), South African Executive Report (2001: 32-33)

² Karungu, Dr. P., T. Nyandoro and Dr. M. Stettler, Venture Capital as a Source of Economic Empowerment in South Africa, March 2000

KNC and Associates² have surveyed 213 black businesses, most of them being very small to small enterprises with a focus on the services sector. Firms were asked whether they had applied for venture capital funding and if so, whether they were successful. The results point at a lot of unsatisfied demand in the very low layers of the size range (Table V-3).

Table V-3
Firms' application for venture capital by size

Size of firms (total assets) (R million)	Number of firms	Applied for venture capital funding		Received venture capital funding	
		Number	In % of firms surveyed	Number	In % of firms which applied
less than 0.5 m	120	18	15%	1	5.5%
0.5-2 million	38	7	18%	1	14%
2-5 million	9	2	22%	1	(50%), but not significant
Above 5 m	11	7	64%	3	43%

Source: Karungu *etal.* (2000)

4. *SMMEs low level of investment as a symptom of a financing problem*

Capital investments in new machinery and equipment were undertaken by 60 per cent of the SMMEs sampled by the World Bank, in both 1998 and 1999. Nevertheless, when accounting for a 10 per cent cut-off for depreciation, only 38 per cent of all SMMEs reported net investment increases in 1998, and 32 per cent in 1999.

The SMME survey asked firms which had planned, but not undertaken new investments for their reasons. While 39 per cent of the sample SMMEs considered new investments in 1998, one-third did not realise their plans. The main reasons provided not implementing planned investment in 1998 are shown in Table V-4.

Table V-4

Reasons for firms not undertaking planned investment in 1998, by percentage

	Size 1	Size 2	Size 3	Black	Asian/ Coloured	White
Lack of access to capital	26	26	14	59	32	16
Interest rates too high	7	11	16	6	7	10
Insufficient demand	28	28	37	16	32	30
No need/desire	18	16	16	12	11	21
Insufficient business experience	14	12	2	6	12	10
Business costs too high	1	1	2	0	2	1
High labour costs	1	1	3	0	0	2
Other	5	6	9	0	4	9

Source: Chandra et al (2001)

On average, poor business conditions pre-empt the need for capital investment and seem to be a far more critical explanation than limited access to capital markets or high costs of credit. Nevertheless, limited access to capital markets played a very significant role, and especially prevented micro and black-run SMMEs from expanding. In addition, there are good reasons to believe that these results understate the role of financing constraints in low investment levels.

Appendix VI

SAVCA's Full member association with SMEs

Table VI-1: SAVCA's Full member association with SMEs

No	Name	Size of Fund (R m)	Funds invested to date at cost (R m)	Individuals as a source of funds (Y/N)	Minimum Investment (R millions)	Average current investment size (R millions)	Industry Exclusions	Industry Preference
1	African Harvest Capital	-	-	N	1	-	Mining, agriculture, property	Technology, media, telecoms, service industries
2	Aquila Growth Ltd	-	250	Y	0	28	Mining, high working capital and capex intensive industries	Gaming, tourism, IT, media, FMCG, retail, telecoms, electronics
3	BoE Investment Partners	-	264	N	0.5	10	Hotels, commodities, agriculture	IT, sport and leisure, telecoms, financial services
4	Business Partners - Central	310	268	Y	0.15	1.1	Agriculture and on-lending	None
5	Business Partners - East	324	324	Y	0.15	0.55	Agriculture and on-lending	None
6	Business Partners - South	290	220	Y	0.15	0.7	Agriculture and on-lending	None
7	Business Partners – West	300	221	Y	0.15	0.409	Agriculture and on-lending	None
8	Business Partners – Ventures I	100	34	Y	1	3.1	Agriculture and on-lending	None
9	Cycad Financial Holdings Ltd	107	163	Y	1	12	Property, mining, agriculture	IT
10	Gensec Bank – Archway Venture Partners Trust	110	96	N	0.5	8	All except IT & related industries	IT & related industries
11	Gensec Bank – Archway Technology Venture	160	19	N	0.5	8	All except IT, telecoms and media	IT, telecoms and media
12	Gensec Bank – Biotechnology Fund	80	-	N	1	-	All except Biotechnology	Biotechnology
13	Global Capital	-	-	Y	0.5	-	Property, construction, mining	None
14	Greenfields Venture Capital	-	-	N	0.15	-	-	Property, liquor, gambling, tobacco

No	Name	Size of Fund (R m)	Funds invested to date at cost (R m)	Individuals as a source of funds (Y/N)	Minimum Investment (R millions)	Average current investment size (R millions)	Industry Exclusions	Industry Preference
15	HBD Venture Capital	70	17	Y	0.25	5	None	Any industry
16	Horizon Equity Partners – MCA Investments	US\$20 million	-	N	2	10	Property, agriculture, armaments	IT, e-comm, telecoms, electronics, life sciences, mining technology, specialist engineering products
17	Horizon Equity Partners – Technology VC Fund	150	120	N	2	10	Property, agriculture, armaments	IT, e-comm, telecoms, electronics, life sciences, mining technology, specialist engineering products
18-22	Industrial Development Corporation of SA (IDC)	612	27.5	N	2	-	None	Technology, empowerment
23	Lireas Holdings	-	40.6	N	0.1	1	All except Financial services	Financial Services
24	NEF Venture Fund	200	-	N	0.25	-	None	None
25	NewFarmers Development Co.	51.4	58	Y	1	5	All except agribusiness	Agribusiness
26	PointBreak (Pty) Ltd	-	-	-	0	2	None	High growth industries
27	Rock-IT Private Equity	120	-	Y	-	-	All except IT and telecoms	IT and telecoms
28	Venfin Limited	-	-	N	-	400	Non-technology	Technology
29	Venture Capital Managers	83	73	N	0.5	3	Building, armaments, tobacco	Manufacture and technology
30	Viking Investments and Asset Management	160	-	Y	0.05	-	Agriculture	None

Source : SAVCA Directory 2002

Appendix VII

SAVCA's Associate member association with SMEs

Table VII-1

No	Name	Type of firm	Core Services
1	Andersen Axis	Corporate finance	
2	Audax Ideas Management Consulting	Business & corporate strategy	<ul style="list-style-type: none"> • Consulting on business strategy projects • Facilitating executive education programmes • Advising businesses on VC financing
3	Cape Chamber of Commerce & Industry	Chamber of Commerce	Provides extensive networking activities to businesses
4	Cinergi Group	Financial Services Group	<p>Cinergi Asset Managers – provides advisory service to small and medium sized VC/private equity funds</p> <p>Cinergi Corporate Finance – provides advisory services to small & medium sized companies and entrepreneurs to raise capital to finance growth and expansion, MBO's or MBI's</p>
5	Chrysalis Biotechnology Holdings Ltd	Industry specific investment firm	Providing equity capital, strategic and operational support to biotechnology operating companies
6	Deloitte & Touche	Multi-disciplinary professional services firm	The Entrepreneur Services and Corporate Finance divisions provide clients (SMEs & investors) with Multi-disciplinary professional services
7	Development Bank of Southern Africa	Development Finance Institution	Provides finance and technical assistance for infrastructure in the Southern African region
8	Eccles Associates Inc	Financial Services	<p>Provides consulting and corporate finances services</p> <p>Specialises in raising capital (debt & equity) for fast growing businesses</p>

9	European Private Equity & Venture Capital Association (EVCA)	Trade Association	<p>Lobbying and campaigning organisation and by providing a wide range of information services</p> <p>Creating extensive network opportunities through the organisation of conferences, workshops, working committees and other discussion forums</p>
10	Firm Capital	Private equity and venture capital advisors	<p>Advises management and business owners on the development of their business including the opportunities to access capital</p> <p>Engineer innovative empowerment structures in the pursuit of growth and capital</p>
11	Fisher Hoffman PKF (Jhb) Inc	Accountants and auditors	Provides personal relationships with clients (SMEs)
12	Go Capital	Capital raising/ Deal-making/ strategy	<p>Working with management teams to raise capital. Activities include:</p> <ul style="list-style-type: none"> • Strategy analysis and development • Financial modelling and analysis • Fundraising strategy development • Investor networking • Roadshow support and presentation • Deal structuring and process support
13	Grant Thornton Kessel Feinstein	Accountants, auditors and business advisors	Adding value to clients businesses (entrepreneurial and fast growing)
14	JPMorgan	Investment bankers	Is the firm's principal vehicle for private equity investing and provides equity and mezzanine finance to companies around the world

15	Khula Enterprise Finance Limited	Wholesale financier	Creating access to equity finance for SMEs owned primarily by PDIs where there exists a possibility of a positive ROI coupled with job creation. Deal sizes are between R250k and R2500k
16	KPMG	Accountants, auditors and business advisors	Services for companies seeking finance include: <ul style="list-style-type: none"> • Fund raising • Advising MBO teams • Preparation of business plans
17	Omega Investment Research (Pty) Limited	Venture capital solutions provider	Offering input to aspiring high growth companies via formal and informal relationships broadly encompassing the following services: <ul style="list-style-type: none"> • Research, information and guidance • Project appraisals • Business plan guidance • Strategic planning • Due diligence and capital raising • Project management and corporate advisory services • Technology partnering and development • Networking and added value
18	PricewaterhouseCoopers	Corporate finance and private equity advisors	Offer clients comprehensive specialist solutions for their corporate finance requirements

19	Technovent		<p>Special areas of interest (to the entrepreneur and the venture capitalist) include incubation of technological innovative companies.</p> <p>Entrepreneurs are selected, trained and mentored</p> <p>Shares risk through equity, long-term loans and short-term loan investment</p>
20	The Corner House (Pty) Limited	Corporate advisor services	Corporate advisor services
21	The Janus Corporation (Pty) Limited	Investment banking	<p>Dollar based closed ended fund that invests (R3 – 25 million) in:</p> <ul style="list-style-type: none"> • Tourism • Management and financial services • Innovative internet or e-commerce • Health • Retail
22	The JSE Securities Exchange SA	Securities exchange	Provides an orderly market for dealing in securities. Will launch AltEx in Oct 2003 – listing of SMEs
23	Webber Wentzel Bowens	Attorneys	Provides specialised legal services to the private equity industry

Source: SAVCA Directory 2002

Appendix VIII

Evaluating the impact of business introduction services – Informal Venture Capital

Harrison, R. Mason, C. 1996.

Evaluating the impact of business introduction services – Informal Venture Capital
(Synopsis)

A significant element in the underdevelopment of the VC market is the existence of inefficiencies, which limit its potential role in financing SMEs. Most informal investors want to invest more, but cannot find sufficient investment opportunities, which meet their investment criteria; entrepreneurs seeking capital also experience difficulty in identifying potential informal investors. In the absence of effective channels for investors and entrepreneurs to make contact with each other, and in view of the considerable time to search for and appraise investment opportunities, combined with the fact that for most investors it is a spare-time activity, investors generally adopt an *ad hoc*, unscientific and passive approach, relying heavily on friends and business associates for referrals. Equally, informal investors comprise an unorganised, fragmented and, because of their desire for anonymity, largely invisible market which makes them very difficult to identify by entrepreneurs seeking private sources of venture capital.

Although market inefficiency is characteristic of all countries, there is evidence to suggest that its severity is even greater outside the USA. A comparison of the informal venture capital market in the USA and the UK (Harrison and Mason, 1992a) indicates that the inefficiencies which characterise the market in the UK are compounded as a result of three factors: first, less effective information networks leading to lower-quality information on investment opportunities and more redundant information; second, generally less experienced and less sophisticated investors; and third, the limited involvement of UK informal investors in investment syndicates.

These three factors are in turn reflected in the significantly higher deal flow received by UK informal investors and their lower investment rate compared to their US equivalents, and the higher proportions of UK informal investors who are unable to find enough deals and are dissatisfied with existing channels of communication with businesses seeking finance.

The establishment of business introduction services, to provide such channels of communication, represents one effective way of overcoming the sources of inefficiency in the informal venture market represented by the invisibility of informal

investors, the fragmented nature of the market and the high search costs for businesses seeking investors and investors seeking investment opportunities. Such services will enable entrepreneurs to bring their investment proposals to the attention of a number of private investors simultaneously, and provides investors with a convenient means of identifying and examining a range of investment proposals while retaining their anonymity until they are ready to enter negotiations with an entrepreneur.

However, five groups of economic benefits arising from the establishment of effective well-resourced business introduction services can be identified. First, these services facilitate introductions and matches between investors and entrepreneurs, which raise the overall level of informal investment activity. Second, these services provide firms, and to a lesser extent investors, with business advice, counselling and signposting services which are of value in their own right, even where investments are not made. Third, as most informal investors are hands-on investors, investments facilitated by these services bring access to a potentially wide range of other investor inputs such as know-how, contacts, advice and consultancy. Fourth, the secondary effects, or collateral benefits, of investments facilitated by business introduction services including the firm's ability to raise additional equity or loan finance on the strength of the initial investment, may be significant, and in many cases may outweigh the direct investment. Fifth, the operation of a business introduction service, by mobilising what would otherwise be fragmented and invisible sources of risk capital to make them accessible to small businesses, contributes to awareness raising amongst investors, businesses and professional and support networks of informal venture capital issues. Taking all of these value-added impacts into account, the evidence collected in this volume confirms that business introduction services are a worthwhile and beneficial experiment.