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Venture Capital and Section 12J in South Africa

10 September 2019

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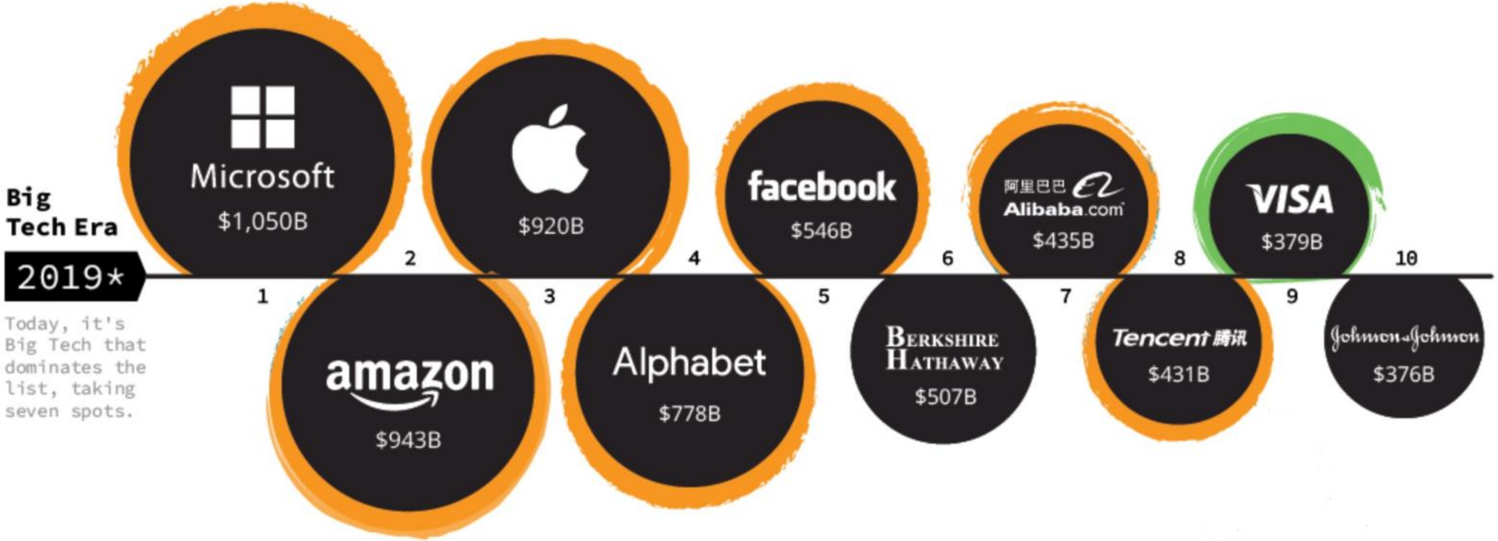
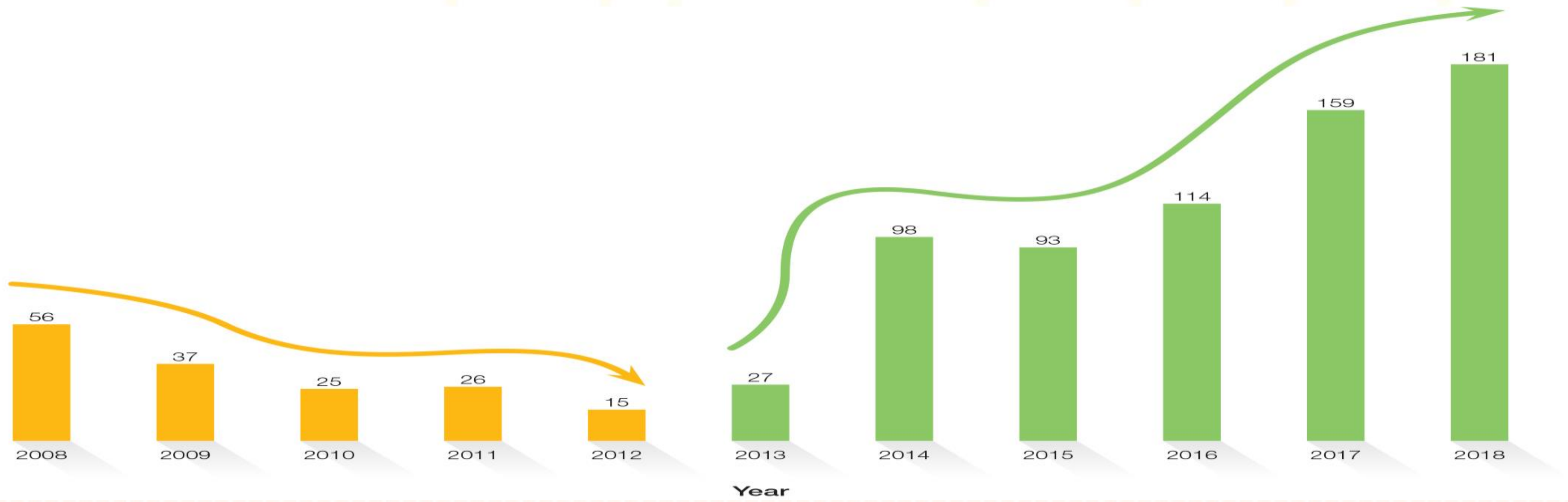
Why is Venture Capital key for growth?



Source: https://www.visualcapitalist.com/a-visual-history-of-the-largest-companies-by-market-cap-1999-today/

State of VC in South Africa



*Number of investments recorded over the years 2008 – 2018**

*SAVCA data

Towards an economic strategy for South Africa

We identify several cross-cutting interventions that would help lower barriers to entry across a number of sectors: (i) competition policy in new regulations; (ii) **development finance, venture capital, and patient capital**; and (iii) government support. “ Page 30

Box 7: The importance of high-growth firms

There is growing awareness that there is a subset of firms in the economy—high-growth firms (HGFs)—that contribute a disproportionately large proportion to net employment growth. These firms also contribute disproportionately to innovation and productivity growth. HGFs are broadly defined as the fastest growing firms in the economy and have been found to be responsible for a disproportionate contribution to net employment growth in developed countries (Shane 2009). HGFs are the most productive and innovative firms in their industries (Li and Rama 2013) and consistently create a disproportionately large share of new jobs at any given point in time across different countries.

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S12J and Early Stage Investment

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- VC funds that were previously unable to raise viable funds were able to do so with the added benefit of the S12J incentive. **This is significant and the success of government intervention should be highlighted.**
- Individual investors were unable to reconcile the risk profile of investing into the SMME space with the expected return of such an investment. The incentive has provided a viable investment proposition for investment into SMMEs.

Policy Certainty

- Investors are committing capital for the long term (“patient capital”)
- Policy certainty plays a significant role in their investment decision making process
- Continual adjustments to the legislation creates an unstable policy environment to raise capital and investor distrust in Governments commitment to the success of the incentive

Concerns with the 2019 TLAB proposal

- We expect **a reduction in the number of fund managers** who are able to raise adequate capital **to invest into SMEs in a sustainable manner;**
- SAVCA view R200m as minimum for a sustainable fund size;
- With a R2.5m cap, 80 investors are required - this represents a significant increase in operational capability and cost to administer;
- Most venture capital funds require an anchor investor to allow traction to raise funds. This anchor investor would typically invest >R2.5m;
- Proposal will result in current structures being non-compliance ("connected person" test);
- Capital will flow offshore instead of being invested in local SMME's.

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SAVCA Alternative Proposal

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- SAVCA views the investment cap as **a broad-brush intervention** which is **unlikely to achieve Treasury's policy objectives**.
- We **do not believe a cap should be included in the legislation**.
- We understand from further engagement with National Treasury that the concern is largely in relation to the **impact this incentive has on the fiscus.** With this key driver in mind, SAVCA would like to suggest the following :

    1) Increase the cap to **R10m**; and

    2) Introduction of an **accelerated allowance for the amount invested above the cap**, spread over three years (i.e. 33% year 1; 33% year 2 and 33% year 3).

SAVCA Alternative Proposal example

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Proposed Allowance table

Utilising a cap and an accelerated allowance over and above the cap

Cap amount	10 000 000
- Year 1	100%
Accelerated allowance	
- Year 1	33%
- Year 2	33%
- Year 3	33%

Examples

	Investor 1	Investor 2	Investor 3	Investor 4
Total investment into VCC	5 000 000	8 000 000	15 000 000	50 000 000
Year 1				
Upfront allowance	5 000 000	8 000 000	10 000 000	10 000 000
Accelerated allowance	-	-	1 666 667	13 333 333
Year 2				
Accelerated allowance	-	-	1 666 667	13 333 333
Year 3				
Accelerated allowance	-	-	1 666 667	13 333 333
Total allowances	5 000 000	8 000 000	15 000 000	50 000 000

SAVCA Alternative Proposal

Another alternative proposal would be:

- categorise the underlying types of businesses within the “qualifying companies” and to potentially create a cap per category (if so required).
- This categorisation could be done based on the investment mandate of the fund, or class of shares depending on the VCC.
- This would require National Treasury to refine and prioritise their objective in relation to the incentive and the impact they are looking to create.
- We understand that this may not be achievable in the short term, and thus could be considered more longer term, when the policy is reconsidered as part of the sunset clause deliberations in June 2021