SAVCA
SOUTHERN AFRICAN VENTURE CAPITAL AND PRIVATE EQUITY ASSOCIATION

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Attention: *Hon. J Maswanganyi* (Chairperson of Standing committee on Finance) & Mr Y. Carrim (Chairperson *of Select Committee on Finance)*

Dear Honourable Maswanganyi and Honourable Carrim

RE: SAVCA RESPONSE TO THE DRAFT TAXATION LAWS AMENDMENT BILL

Introduction

We refer to the Draft Taxation Laws Amendment Bill (the "**Draft Bill**") published by the Department of National Treasury on 21 July 2019.

The Southern African Venture Capital and Private Equity Association ("**SAVCA**") wishes to submit comments and proposals for consideration, relating to proposed amendments to the Income Tax Act 58 of 1962, ("**the Proposed Amendments**").

SAVCA respectfully requests that it be **granted an opportunity to make oral representations at the Public Hearings on 10 September 2019** in relation to the impact of the proposed R2.5million cap on investment into Venture Capital Company's ("**VCC**") on the venture capital industry in South Africa. In SAVCA's view, the incentive has proven itself highly effective and beneficial (as outlined below) and we are concerned to see the loss of momentum and risk to the incentive created by the Proposed Amendments.

SAVCA is the industry association and public policy advocate for venture capital and private equity ("**VCPE**") in Southern Africa, with circa 130 venture capital and private equity fund managers registered as SAVCA members, managing approximately R175bn in assets under management.

TLAB Proposal

The deduction as a result of the purchase of shares in a VCC is limited to R2.5 million per annum per VCC shareholder.

Reason

Despite recent anti-abuse measures introduced, National Treasury is of the view that taxpayers are benefitting from excessive tax deductions through abusive VCC structures which erode the tax base.

Comment

SAVCA believes that the VCC incentive has positively contributed to South Africa in directing much-needed capital and skills to SMEs to stimulate economic growth, job creation/retention and innovation. Against the backdrop of low growth rates and increasing unemployment in South Africa, we are convinced that this incentive will demonstrate significant social and economic benefit, and much needed jobs – it just needs time to be proven out and studies are currently underway to highlight the impact to date. Numerous fund managers that had not previously been able to raise sustainable funds focused on the venture capital space have, as a result of the incentive, successfully concluded capital raising and highly promising investments. SAVCA believes targeted legislation and policy certainty, will continue to bolster investment in this space without disruption to VCCs operating in support of the intended purpose and tenets of the legislation.

Investment into high-growth SMEs in South Africa is key to fostering economic growth and innovation and is imperative to tackle challenges of poverty, inequality, unemployment and vulnerability of small companies. And yet, entrepreneurs and small businesses in South Africa suffer from a severe lack of access to capital and professional investors, with most institutional investors favouring less risky investments in larger companies. Supporting the growth of the venture capital industry will lead to an increase in capital available to be invested in promising high growth companies which would also benefit from the additional networks and skills within the venture capital manager to support its growth. SAVCA has seen positive growth with more professional investors supporting the SME sector. One of the impeding factors towards SME growth is the availability of professional business mentors and advisors, often providing valuable support to emerging SMEs. The VCC tax incentive has been critical in introducing more professionals supporting the emerging SME sector.

SAVCA supports National Treasury's objective to reduce any potential abuse in relation to the VCC incentive. We also understand National Treasury's concerns based on the significant uptake and quantum of investment into VCC's over the past few years and the direct impact on South Africa's constrained tax base. We do not however agree with the reintroduction of a maximum limit or cap for investment into VCC's as a means of achieving a reduction in potential abuse. We are of the view that this will be a major setback for the industry and the companies currently able to attract such investment.

Why the Proposal will be Problematic:

We expect the R2.5 million deduction limit to reduce the volume of capital flowing into this sector. However, of greater significance, is that ***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***. A number of fund managers that rely on support of larger investors to ensure the financial viability of the fund, will be negatively impacted. Not only would this pose a risk to the growth of this young industry, but ultimately a risk to the investors themselves, as the longevity of the fund manager is critical to ensure that capital is invested in a sustainable and value-adding manner. With fewer fund managers, there is a risk that many SMEs will no longer able to tap into the VCC market for capital, and more importantly skills and support, to grow their businesses.

The cap is expected to have the unintended consequence of affecting true venture capital and growth investors the hardest by a broad-brush intervention. As stated in the accompanying Explanatory Memorandum, the cap was calculated as an average investment size over the last 4 years. On initial consideration the cap would appear logical, as R2.5million is a reasonable deduction when considering there are only circa 120,000 tax payers registered with SARS, and earning over R1.5 million per year.

On a more thorough review of the VCC investment landscape, there are a number of reasons the R2.5 million cap will reduce National Treasury's ability to meet its stated objective in relation to the incentive:

Firstly, investment strategies targeting true SMEs require higher volume of capital investments to achieve sustainability objectives, and will thus necessitate a much higher number of investors to achieve the same outcome. This is cumbersome to manage, difficult to achieve from a capital raising perspective given limited marketing budgets of small fund managers, and may result in the VCC having to register as a public company due to the number of investors required to achieve scale and fund their investment strategy. Implementing the R2.5 million cap is tantamount to reducing the asset size limit of the underlying investments, as any investment into larger SME's (still small and medium in size viz a vis the broader SME market) will be too difficult to fund whilst still meeting the VCC requirements.

Secondly, implementing the R2.5 million cap is directing the VCC capital raising squarely into the more retail part of the market, which has more onerous compliance requirements in order to meet the "Treat Your Customers Fairly" desired outcomes as set out in the Twin Peaks regulatory framework. Given the risks inherent in private equity and venture capital investing, sophisticated high net worth investors, better equipped to thoroughly interrogate and evaluate the risk and return profile of an investment proposal, should not be precluded from investing in VCCs due to the quantum they are able to invest. A number of VCCs limit their target market and have a minimum investment by investors of R1 million, seeking to attract sophisticated high net worth investors. Fund managers that have opted for this more narrow approach will now be severely thwarted in their plans and will either need to opt for a costly retail fundraising strategy or opt out completely of investing in this part of the market – a loss for the SMEs that would otherwise be funded.

Third and most important, smaller fund sizes affect the overall sustainability of the fund manager. A minimum sustainable fund size for a very small fund manager team is estimated at R200 million, where the annual management fee (average 2%) would provide R4 million in working capital – which would be able to just cover basic salaries, operating costs and infrastructure. Under the proposed cap, a fund manager would need to raise this amount from at least 80 investors – this is simply too difficult for small fund managers to do with limited resources and they are likely to withdraw from the market. For those fund managers who have raised less than R200 million to date, this represents a risk to existing investors where the fund manager is not able to be financially viable through the investment period.

Fourth, the fundraising environment for 'true venture capitalist' is such that an initial investor(s) would often invest a significant amount into a VCC. This initial investment assists the fund manager to raise additional capital and increase the number of investors over a period of time to achieve a financially viable fund whilst still meeting the section's requirement for no VCC shareholder to hold more than 20% of the shares in a VCC. This is also common practice in the industry internationally, where the initial investor is termed an "anchor investor". Without a significant anchor investor, a number of venture capital funds would not have been able to raise sufficient capital and the fund would have failed before it could be successfully launched.

Fifth, it may also pose risks to VCCs that are part way through their capital raising and investment programmes, where an inability to raise further meaningful capital means they will not be able to achieve targeted investor composition after 3 years where an existing anchor investor is not diluted to below 20% and remains a connected person (again making irrelevant the previous provisions allowing time for anchor investors to generate momentum for a fund). It may also mean that the single asset limit of 20% cannot be complied with over the 3 year period if additional capital cannot be raised and invested.

Finally, the VCC incentive has played a critically important role in encouraging high net worth investors to invest their capital in South Africa, rather than offshore. There is a significant risk that the cap on the investment deduction would result in more capital being invested offshore as the risk return benefits of investing locally in SMEs do not add up without the incentive.

International Benchmarks

When comparing the South African VCC incentive to other international incentive programs with similar stated objectives, both in Australia and the United Kingdom, we note that the Australian incentive, Venture Capital Limited Partnerships, has no maximum deduction threshold for investments and the UK Venture Capital Trust regime ("VCT") has a similar maximum deductible investment amount, which is set at GBP 200,000 (R3 million at prevailing exchange rates). Apart from the increased monetary value attributed to the cap, we note that UK VCTs also offer capital gains relief on the sale of shares, as well as Income tax relief on dividends. The South African proposed legislation includes only the deduction restriction without the corresponding incentive benefits. The UK has established itself as an investor friendly investment jurisdiction, with a strong retail customer base and a significantly higher amount of high net worth individuals as potential investors. Additionally, UK corporates regularly invest into the SME ecosystem which is not common place in South Africa. We also highlight that the need to attract capital to SMEs for job creation, job preservation and growth is higher in developing economies and in difficult market conditions such as those we are currently experiencing. We therefore need to do more than the developed markets to support South Africa's entrepreneurial ecosystem, and thus SAVCA firmly believes that no cap should be introduced into the South African legislation.

According to PitchBook's 2018 Annual Private Fund Strategies Report and PitchBook Data[1], the median fund size of North American and European venture capital funds was $100 million. Across a sample of seven prominent funds in these regions, representing over $50 billion in assets under management, the minimum investment ticket size by any one investor was in excess of $45 million[1]. South Africa's nascent venture capital industry has shown impressive growth in recent years, supported by the VCC incentive. The proposed cap would severely limit the industry's growth potential and ability to capitalise on South Africa's slight competitive advantage on the continent in this space. SAVCA believes that an introduction of a VCC cap would have the opposite effect, leading to the deterioration of the venture capital industry in South Africa.

[1] PitchBook Data Inc. is a globally recognised research and data technology platform that covers private capital markets include venture capital.

Policy Certainty

The continual adjustments to the VCC legislation, albeit done with the understandable objective of reducing potential abuse, creates an unstable policy environment for VCCs to raise capital. Investors are committing capital for the long term and policy certainty plays a significant role in their investment decision making process. We respectfully request, that the legislation remains in its current form, until a thorough analysis of its benefits and risks is undertaken for National Treasury to determine any changes to policy in the future. The sunset clause in June 2021 represents a key date by which this could be undertaken, although we hope that National Treasury will have sufficient feedback and data to do this sooner than the sunset clause date to allow the industry to make any adjustments if necessary.

We further respectfully request that National Treasury clarify the nature of the perceived abuse and implement a more targeted response to address this, rather than a broad-brush intervention that we believe will disproportionately negatively impact true venture capital and growth investors.

SAVCA Updated Proposal

SAVCA views the investment cap as a broad-brush intervention which is unlikely to achieve the policy's desired outcome. SAVCA would be more supportive of National Treasury addressing directly the types of transactions they consider to be abusive or not in the spirit of 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 alternative proposal:

1) Increase the cap to R5m; **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).

We believe this will alleviate National Treasury's concern regarding exceptionally large upfront deductions (within the current legislation), whilst still allowing the industry to continue to contribute towards economic growth, innovation and job creation.

Another potential solution would be to 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. This is similar to the approach followed in the UK for Venture Capital Trust (VCT), Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS). We note that only the VCT has a cap, whilst the EIS and SEIS do not. 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.

Thank you for considering SAVCA's submission. We are fully supportive of the steps taken by National Treasury to date to encourage investment into this section of the market. We strongly believe that with tighter legislation and increased policy certainty, this investment incentive will provide significant economic and job creation benefits that will showcase the positive results that can be achieved when government and the private sector work together with a common purpose.

Yours sincerely

S Lotz

Head of Regulatory Affairs: Southern African Venture Capital and Private Equity Association

Annexure A

Proposed Allowance table

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

Cap amount	5 000 000
- Year 1	100%
Accelerated allowance	
- Year 1	33%
- Year 2	33%
- Year 3	33%

Examples

	Investor 1	Investor 2	Investor 3	Investor 4	Investor 5
Total investment into VCC	5 000 000	8 000 000	15 000 000	50 000 000	100 000 000
Year 1					
Upfront allowance	5 000 000	5 000 000	5 000 000	5 000 000	5 000 000
Accelerated allowance	-	1 000 000	3 333 333	15 000 000	31 666 667
Year 2					
Accelerated allowance	-	1 000 000	3 333 333	15 000 000	31 666 667
Year 3					
Accelerated allowance	-	1 000 000	3 333 333	15 000 000	31 666 667
Total allowances	5 000 000	8 000 000	15 000 000	50 000 000	100 000 000