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Epilogue: A South African Perspective

Saville Aaron Mallach

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By
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Introduction

A small venture capital industry already exists in South Africa. More than twenty domestic funds are currently listed on the Johannesburg Stock Exchange.[1] A number of private and government-sponsored foreign funds also operate in the region. The situation therefore, at first glance, appears positive for the development of a large and successful traditional venture capital industry in a developing country which has only recently emerged from a lengthy period of economic isolation.

When account is taken of the economic strength of the Johannesburg Stock Exchange (JSE), the sophistication of the financial instruments which are traded, the level of financial, legal, and accounting expertise available, the relatively advanced banking and legal systems which are in place, and the free market economic policies of the South African Government, the outlook for the development of a large and successful traditional venture capital industry cannot appear brighter.

Because many of the impediments which characteristically hinder the development of traditional venture capital industries in developing countries are absent, one might be excused for assuming that the probabilities for success in South Africa in this respect are good. But such an assumption does not take account of certain fundamental obstacles which currently prevent the development of a venture capital industry in the traditional sense. These obstacles necessitate that for the medium term South Africa's venture capital industry should not endeavor to follow a traditional venture capital model. It should instead focus its resources on the promotion of the country's small, micro and informal business sectors, which will permit the industry to achieve maximum long term success.

The fundamental obstacles hindering the development of a traditional venture capital industry in South Africa can be traced to its social, political and economic policies which, until very recently, have centered around the doctrine of 'apartheid.' It is not intended that this paper will cover in any great detail

1. Samuel Foster, *South Africa: Ripe for Venture Capital*, VENTURE CAP. J., July 1, 1995, *available in* 1995 WL 22871995. In July 1995 there were 15 companies listed on the Johannesburg Stock Exchange's Development Capital Market, and 5 companies registered on the Venture Capital Market.

South Africa's political transformation and development, which was very well documented and analyzed by Professor Zahralddin.[2] However, any analysis of the development of South Africa's venture capital industry is not possible without taking into account the context within which it is occurring. In the case of South Africa, political and economic factors cannot be separately considered.

The economic consequences of these pre-Mandela Government policies, as they impact upon the ability of the venture capital industry to develop and flourish, has resulted in limited access to equity capital and loan financing for most of South Africa's population. The Government controls approximately thirty percent of South Africa's total assets. Nearly eighty percent of the assets held by the private industry sector are controlled, directly or indirectly, by South Africa's five largest conglomerates.[3] Cartels and monopolies are widespread, and not per se illegal.[4] Moreover, these conglomerates have a well-established tradition of using their financial leverage to resist competition at all costs, even from other large established corporations.

Therefore, the fact that the Johannesburg Stock Exchange is the tenth largest exchange in the world, with a market capitalization of $218 billion,[5] has done little for small businesses wishing to gain a foothold in the South African market. This position has been exacerbated by deficient standards of education, and extremely high levels of unemployment and illiteracy.

In the past, South Africa's black population was denied access to capital, and black businesses were denied entry into the marketplace. This situation was intentionally created by the previous government in order to keep control of the country's economy in the hands of the white population. An important method used to preserve this situation was the maintenance of separate educational systems which operated on a racially segregated basis with huge disparities in the levels of education provided. The founders of 'apartheid' created such an educational system in order to restrict the black population to unskilled manual labor positions. Other obvious consequences aside, this resulted in the effective estrangement of approximately eighty percent of the country's forty-two million people from full and active participation in its economy.

The international perception of South Africa as an emerging market with good prospects for growth and development is not wholly inaccurate. But the policies of 'apartheid' have resulted in a shortage among the majority of the country's population of the resources necessary for entrepreneurial development. The effect has been to exclude the majority from full participation in the economy. Two important factors in this respect are access to finance and training for South Africa's black population.

2. *See generally,* Rafael X. Zahralddin-Aravena, *Development in South Africa and Venture Capital: The Challenges and Opportunities for the Enterprise Fund for Southern Africa*, 15 BERK. J. INT'L L. __ (forthcoming).

3. Donald G. McNeil Jr., *Keeping Corporate Score*, N.Y. TIMES, Mar. 2, 1996, at 31.

4. *Id.*

5. Foster, *supra* note 1.

Because of the thirty percent unemployment rate,[6] and the huge need for basic necessities such as housing, sanitation, and medical assistance, the development of a large-scale venture capital industry in South Africa offers the opportunity to address these issues. This can be achieved while simultaneously facilitating black empowerment in the private sector, training black entrepreneurs, and uplifting the small, micro and informal business sectors. Despite adverse conditions, the informal sector is estimated to represent up to forty percent of current GDP,[7] and account for approximately 4 million jobs (as opposed to the 7.7 million jobs provided by the formal sector).[8] However, potential remains for further expanding the role and contribution of the informal, micro and small business sectors. This paper will address many of the difficulties currently prevalent in South Africa. It will seek to identify methods in which the venture capital industry can be structured and channeled so as to assist in facilitating access to finance, training, and participation in the private sector for South Africa's black population, so as to further develop the small, micro and informal sectors of the economy.

TARGET MARKET FOR A SUCCESSFUL VENTURE CAPITAL INDUSTRY

The reality is that the five aforementioned conglomerates will not readily 'unbundle' their cross-holdings, and will not permit their stranglehold over the economy to be reduced without offering strong resistance. Antitrust law is only in the fledgling stages of development in South Africa, and is not enforced with any effectiveness. The Government is committed to reversing this position. However, because of the complexities involved in doing so, and because of the need for South Africa to maintain a strong and stable economy in order to gain foreign investment, it is unrealistic to predict that the status quo will be reversed on anything but a gradual basis.

It is submitted that while a large-scale venture capital industry in the traditional sense is a desirable long term objective, this is not a realistic short term aspiration. "Some South African business leaders . . . suggest the country still is not well suited for traditional venture capital. Buyout and expansion financings are more likely investment targets."[9] "[T]he action in South Africa now is in leveraged buyouts of established businesses. South Africa has a very conservative economy that is not willing to invest in entrepreneurs who do not have track records."[10]

The absence of a large-scale traditional venture capital industry in South Africa has been attributed to the effects of economic sanctions, and to the " . . .

6. Drusilla Menaker, *Leveling This Playing Field Will Take Some Bulldozer*, BUS. WK. Oct. 2, 1995, Pretoria, *available in* 1995 WL 10403510.

7. Michael H. Morris & Leyland F. Pitt, *Informal Sector Activity as Entrepreneurship: Insights from a South African Township*, 33 J. SMALL BUS. MGMT. 78, January 1, 1995 *available in* 1995 WL 8966837.

8. *Id.*

9. Foster, *supra* note 1.

10. *Id.* (*quoting* Martin Keyset, General Manager of Corporate Finance, Rand Merchant Bank).

exodus of skilled managerial talent that occurred during apartheid."[11] These factors render entry into the high-end of the market difficult at this stage. When one takes into account the untapped and, as yet, undeveloped potential of South Africa's informal, micro and small business sectors, the best prospects for a successful South African venture capital industry in the medium term rest with these sectors of the market. It is among the small and micro-sized enterprises that the limited capital available can best be utilized with the greatest overall effect. Moreover, it is in this sphere that opportunities abound as new industries are created to fill gaps which existed in the marketplace under apartheid.

The National Strategy for the Development and Promotion of Small Business in South Africa, produced by the Department of Trade and Industry, is the first attempt by the Government of National Unity to ". . . create an enabling environment for small enterprises [in South Africa]."[12]

> Since the elections of April 1994 the issues of economic empowerment and growth have been placed high on the agenda of the Government of National Unity of South Africa. With millions of South Africans unemployed and underemployed, the government has no option but to give its full attention to the fundamental task of job creation, and generating sustainable and equitable economic growth.
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> Small, medium and micro-enterprises (SMMEs) represent an important vehicle to address the challenges of job creation, economic growth and equity in our country. Throughout the world one finds that SMMEs are playing a critical role in absorbing labor, penetrating new markets and generally expanding economies in creative and innovative ways.[13]

The potential for the development of SMME's becomes apparent when one considers that "while South Africa is by far the largest national economy on the [African] continent, its small and medium-scale sectors compare unfavorably with those of other countries in the region."[14] This indicates that the venture capital industry's best prospects for success lie in targeting the low-end of the market spectrum. The crucial importance of the SMME sector to the development of South Africa's economy has not escaped the attention of the Government. However, it must be emphasized that the above statements are merely policy objectives. What is required is that these objectives be transformed into reality with practical and positive effect. It is in this respect that a venture capital industry, structured to meet the particular needs of South Africa's political and economic circumstances, can be employed as a vehicle to achieve many of these objectives.

The Government is committed to expanding the country's wealth and infrastructure so as to reach all of its people. This includes the provision of housing, sanitation, electricity, education, health care and basic necessities. It is submitted

11. *Id.*

12. National Strategy for the Development and Promotion of Small Business in South Africa, White Paper of the Department of Trade and Industry, Feb. 1995, at 15, para. 3.11 [hereinafter White Paper].

13. *Id.* at 5.

14. Julian Samboma, *South Africa: Small Business Can Boost Jobs and Growth*, INTER PRESS SERVICE, Aug. 4, 1994, *available in* 1994 WL 2579409.

that by targeting these industries, the informal, micro and small business sectors are more likely to attract the financial and influential support of the Government.

Market Conditions and Investment Climate

For 1995 South Africa had a GDP of $12,500 billion representing a growth of 3.3 percent from the previous year, and a per capita income of $2,800. Inflation was at 8.6 percent, and interest rates were approximately 14.25 percent.[15] Economic indicators therefore appear to be positive. South Africa's fiscal policy has been accused of imposing excessive tax rates to compensate for inadequate tax enforcement and collection capabilities, which has also limited its ability to spread its tax base so as to create a more equitable distribution of tax liability. The corporate rate of taxation is 35 percent, with a secondary tax being imposed on the distributed profits of companies, in the hands of the distributing company, at a rate of 12.5 percent.[16] All entities that do not enjoy limited liability are taxed as individuals at increasing rates of up to 45 percent, partnership profits and the proceeds from trusts being taxed in the hands of the recipient. There are no capital taxes, and non-residents pay no tax on interest received. Favorable rapid deductions, exemptions, and limited tax incentives serve to create some stimulus for investment.

Economic conditions are fairly stable but fail to expose the extreme level of poverty and unemployment prevalent in the country. The country's currency, the 'Rand', has experienced a dramatic decrease in value since February 1996. Exchange controls are still in force, but have been gradually relaxed since the abolition of the dual currency system in March 1995.

Some level of political instability remains, and increased criminal activity has become a cause for major concern. However, the political situation continues to improve and is not considered to be an impenetrable obstacle to continued investment in the economy. The emphasis has moved to investigating ways in which the levels of poverty and unemployment can be reduced, and Black empowerment and participation in the economy facilitated. Foreign investment is encouraged. There are no restrictions on foreign investment except in a few essential and protected industries such as banking and insurance. Repatriation of profits is permitted by non-residents, but is subject to exchange control regulations in order to avoid abuse.

South Africa's infrastructure is fairly developed with reliable transportation, communications and energy networks already in place. Moreover, the legal, accounting and banking systems are fairly advanced for a developing country, and are respected as such. Reliable advice is readily obtainable, although professional fees are fairly expensive for clients paying in domestic currency.

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15. Central Statistical Service (CSS) of South Africa (using CPI for inflation and the benchmark government bond for interest).

16. Budget of the Republic of South Africa, Mar. 1996, presented by the then Minister of Finance, Dr. Chris Liebenberg.

All of these factors tend to create the impression of promise and prosperity. As previously mentioned, however, this must be viewed in the context of other factors in order to appreciate that these advantages do not necessarily operate to the benefit of the majority of the country's population. The objective is to create mechanisms which will allow full and active participation by the country's impoverished majority in its economy. It has already been submitted that this can be most effectively achieved by targeting the informal, micro and small business sectors. In order to do so it is necessary to evaluate the particular aspects of the market which require revision in order to accomplish these objectives.

OBSTACLES TO BE ADDRESSED

The primary obstacles rendering participation by the informal, micro and small business sectors in the economy difficult include an anti-competitive economic structure without effective competition laws; overly burdensome minimum requirements for listing on the JSE; inadequate sources of equity and loan financing; inadequate entrepreneurial and management skills and training; difficulties in gaining access to technology; and a lack of access to adequate information and counseling. In addition, investors wishing to support the development of a venture capital industry which emphasizes the informal, micro and small business sectors also face additional concerns ensuring effective exit mechanisms, and obtaining some form of security for their investments. The challenge is to implement effective mechanisms which will permit the informal, micro and small business sectors to take advantage of current economic opportunities. This requires that these impediments be removed so as to render this possible. The remainder of this article will examine possible solutions to these concerns.

ANTI-COMPETITIVE ECONOMIC SYSTEM

South Africa's anti-competitive economic structure, characterized by the monopolistic control of the economy explained in the introduction, places most of South Africa's economic power in the hands of its larger corporations, especially the five 'titans' of the market. Because of ineffective competition laws and insufficient antitrust laws, monopolies are able to flourish and to extend their influence on a vertical basis in a manner similar to the 'Keiretsu' system found in Japan. The larger corporations tend to operate in very diverse industries, which enables them to target new markets as soon as their potential is exposed by smaller operators, who are then forced out of these markets. This makes traditional venture capital investment very risky because such practices have been used even against other influential corporations. It also makes it very difficult for micro and small enterprises to expand in an industry whose potential they have exposed.

The Government embarked upon an initiative, called the Reconstruction and Development Program (RDP), to ensure the rapid economic and social upliftment of South Africa's impoverished black community. The RDP is aimed, inter alia, at reversing the economic distortions created by the factors briefly outlined above.[17] It has addressed both high and low-end market factors. With respect to South Africa's Competition policy it has stated that:

> The South African economy must be opened to greater ownership participation by a greater number of its people. The Government will introduce strict anti-trust legislation to create a more competitive and dynamic business environment. The central objectives of such legislation are systematically to discourage the system of pyramids where it leads to overconcentration of economic power and interlocking directorships.[18]
>
> Objectives of this policy are to remove or reduce the distorting effects of excessive economic concentration, collusive practices, and the abuse of economic power by enterprises in a dominant position. In addition, the policy will ensure that participation of efficient small and medium sized enterprises in the economy is not jeopardized by anti-competitive structures and conduct.[19]

While these objectives are admirable and reflect a clear intention on the part of the Government to address present concerns, in the eighteen month period after publication of the RDP paper no substantial amendments were introduced. The solution is simply to amend existing laws so as to bring them into conformity with international competition law, and then to ensure that these laws are implemented as amended. Particular attention must be given to methodologies which will ensure that the existing forms of control are broken without negatively affecting economic stability in the process. This process will necessarily be a gradual one. However, the introduction of specific time periods into the legislative amendment process will ensure that realistic deadlines are achieved.

Coupled with a simultaneous privatization process of the thirty percent of South Africa's assets which fall under the control of the Government, this will not only create 'spin-off' opportunities, but will also increase liquidity on the JSE. It will, in addition, serve to encourage a broader base of investors to participate on the JSE, as will be discussed in the following subsection.

Obstacles to Listing on the JSE

In 1995 the listing requirements for entry onto the JSE venture capital board were made simpler to encourage the participation of small and medium sized black owned enterprises.[20] The minimum capital requirement was reduced from R2 million to R500, 000[21] subject to the condition that the venture must be

17. White Paper on Reconstruction and Development, Ministry in the Office of the President, November 15, 1994, Cape Town, WPJ/1994, ISBNO 621 15777 5, at 10, para. 1.4.8 [hereinafter RDP].

18. *Id.* at 30, para. 3.8.1.

19. *Id.* para. 3.8.2.

20. Mark Suzman, *Johannesburg to Relax Market Access Restrictions: Committee Urges Increased Black Participation in Stockbroking Community*, FIN. TIMES, May 4, 1994, *available in* 1994 WL 12655804.

21. The US Dollar/SA Rand rate of exchange as of December 1997 was approximately $1 to R4,80.

viable, with rapid growth projections and reasonable returns.[22] Although this must be regarded as a positive step, it is still very difficult for small businesses to raise the R500, 000 required to obtain a JSE listing. Given the difficulties in obtaining financing which will be dealt with in the next subsection, the present position still excludes many small businesses with excellent growth prospects from market participation.

It is submitted that these obstacles could be reduced by introducing a mini-exchange where small companies with good market potential can list and sell stock. Alternatively, the potential also exists for the development of markets for the sale of unlisted securities. Aside from providing additional sources of finance and additional opportunity for Black empowerment, this would also serve to increase liquidity in the market, and would increase the present dwindling number of individual investors who regularly trade on the market from the present 250, 000 (which represents less than one percent of the country's population).[23]

Sources of Finance

Probably the biggest problem confronting the growth and development of the SMME sector is the lack of access to equity and loan financing. Equity financing is limited because of the absence of an established venture capital industry; a reluctance to invest in start-up and small companies with no track record and no proven entrepreneurial and management skills; and the generally conservative and risk-averse style of entrepreneurship which prevails within South Africa's business community. This makes participation by the SMME sector especially difficult because South Africa displays the typical developing country need for equity capital rather than long term debt. Long term debt, although available, is very difficult for this sector to obtain because of an inability to provide adequate security, and accurate and reliable business and accounting information.

Present sources of finance include both government-backed and private interests. Private sources of finance have tended to follow the larger corporations and the few more traditional venture capital funds which exist. The South African Government-backed initiatives, such as the SBDC, SBDA, and NSBC (to be dealt with later), as well as foreign programs targeting Southern Africa such as that of the USAID and OPIC, are devoting most of their attention to a handful of small successful businesses. The reality is that there is not nearly sufficient government-backed funds to make any significant impact on the market except for identifying a few isolated cases as examples of what can be achieved.

Private commercial banks, although more than adequately capitalized, have traditionally tended to be of little assistance to the SMME sector because of an

22. *South Africa Special Report. Winning Against All Odds. Roy Anderson, President of the JSE, is Setting the Pace for Change*, Bus. Age, Jan. 1, 1995, (author not identified) *available in* 1995 WL 12733245.

23. *Johannesburg Stock Exchange: Enticing the Small Investor*, S. Africa Bus. Intelligence, May 23, 1994, *available in* 1994 WL 8221041.

unwillingness to provide loan financing without complete securitization for such loans. In the past, commercial banks preferred to make less risky, more traditional loans because of a readily available clientele able to offer adequate security. There is some indication of a change in attitude prompted to a large degree by the realization of the long term economic potential of the SMME sector. Commercial banks have accordingly begun to investigate possibilities for financing these sectors without demanding that customary security requirements be met. Many innovative financing schemes have been introduced to assist particular types of SMME clients.[24] However, the banks appear to exercise these initiatives on a discretionary basis. Moreover, the banks are demonstrating a willingness to make smaller loans despite their high and often unrecoverable administrative costs in order to gain a foothold in the market in anticipation of its long term development and success. The Department of Trade and Industry (DTI) is presently investigating ways in which the government can cooperate with the commercial banks in order to offer catalytic support, with a Small Business Finance Act being one of the options under consideration.[25]

Very few SMME businesses can afford loan financing, nor are they able to raise equity capital. Therefore the primary impetus for the development of this sector will have to come from government-backed initiatives. It is submitted that the proposed Small Business Finance Act should investigate ways in which the Government can assist commercial banks by assuming some of the risk associated with such loans in the form of government-backed guarantees. The Government can look to outside assistance from international institutions and approved NGO's to spread its exposure. It is argued that this constitutes a far more effective utilization of the limited financial resources available than any program which targets a mere handful of young companies. The ability to reach a much broader base of recipients will have a far more meaningful impact on economic growth and unemployment.

The DTI has also proposed the creation of 'private-sector-driven' equity funds to address the equity needs of SMME's.[26] The public sector will assist in capitalizing some of these funds targeted at disempowered entrepreneurs with viable business propositions via SMME-focused financing institutions.[27] No specific details pertaining to the operation of the model have been provided. It is submitted that the model should be based on the US SBIC program, but that it should be tailored to take account of the inherent limitations prevailing in South Africa's economy. This will, of necessity, require a greater number of much smaller investments. It is suggested that large domestic corporations, as well as foreign corporations and institutions, be approached to establish a finance trust which will supplement the government's limited ability to capitalize such funds.

24. White Paper, *supra* note 12, at 30, para. 4.5.1.
25. *Id.*
26. *Id.* at 31, para. 4.5.4.
27. *Id.*

ENTREPRENEURIAL SKILLS, MAGEMENT AND TRAINING

The point has already been made that the lack of entrepreneurial, managerial and training skills, and conversely of suitably qualified entrepreneurs and managers, has resulted in the underdevelopment of the SMME sector. This has in turn resulted in the sector's inability to contribute adequately to the economy, which has impaired growth and created devastating unemployment and poverty. Targeting a small group of potential growth companies does little to address these concerns. It is accordingly submitted that most of the available funds should be directed towards the immediate provision of public programs designed to provide entrepreneurial and managerial skills.

The curriculum for such programs should be structured to meet the varied needs of South Africa's people. Courses should cover the basic skills necessary to successfully establish and run a 'survivalist' informal business operation, and should also include the teaching of advanced management skills geared towards the corporate environment. While the former is designed to target the unemployed population, the latter is directed at managers and entrepreneurs with successful SMME experience in order to ensure that human resource capabilities are in place for the expansion of these businesses, and possible listing on the JSE. Where possible, teaching should be supplemented with practical exposure to the targeted environment. The programs should seek the cooperation of successful businesses and corporations who are willing to assist in attaining these objectives. Training skills should be offered free of charge at locations easily accessible to the targeted audiences without travel costs being incurred in cases where the audience is not in a position to afford them.

Emphasis should not only be placed on public programs, since financial constraints will place inherent limitations on their ability to provide much more than basic skills to the informal sector. Universities, technical teaching institutions, and schools should offer courses which focus on the provision of skills necessary to achieve the aforementioned economic objectives at every level. At present, primary education tends to overlook these areas, while tertiary education is focused primarily on theoretical concepts pertaining to the more developed end of the market spectrum. Many graduates unable to secure positions in the high-end market then find that they are unable to apply the skills which they have learned on any other level. Attempts should therefore be made to bring teaching objectives into conformity with South Africa's economic realities. There should also be a much stronger emphasis on the provision of practical, as opposed to theoretical, skills.

The training of managers will not only provide the leadership necessary in order to expand the scope of activities of SMME enterprises thus ensuring Black economic empowerment, but will also create a platform for the development of a large-scale venture capital industry in the traditional sense in South Africa. This is important to compensate for the massive 'brain-drain' which has depleted the country's supply of top entrepreneurial and managerial talent, and to reestablish the confidence of investors in the quality of the country's entrepreneurial and management capabilities.

Although private enterprise should be called upon to provide financial and other resources necessary to support such a program, most of the funding will have to come from the Government, NGO's and international institutions. The RDP has included access to training in its proposals in respect of the development of the SMME sector,[28] while the DTI has accepted part of the financial responsibility associated with attaining these objectives.

STRUCTURING THE MOST VIABLE INVESTMENT VEHICLE

South African law permits a business to operate in the form of a public or private company, partnership, sole proprietorship, trading trust, or close corporation. The close corporation resembles a company in that it has limited liability and is taxed at corporate rates, but its membership is limited to ten persons and it has simplified accounting, incorporation, and procedural requirements.

Taking into account taxation factors, the ideal investment vehicle depends on profitability and the need for limited liability, which may be useful in an uncertain economic and political climate. Assuming that the business will produce annual profits in excess of R100, 000 (approximately $20,800) per shareholder, partner or member, the most viable vehicle would be some form of corporate entity subject to corporate rates of taxation. This is because the maximum marginal rate of taxation for individuals is 45 percent on all amounts in excess of R100,000, while the corporate rate of tax is a flat 35 percent. As previously indicated, a Secondary Tax on Companies (STC) of 12.5 percent is levied on all profits distributed by corporate entities. This tax is levied in the hands of the company declaring the dividend in order to encourage companies to retain and reinvest profits, and is accordingly not a tax on dividends in the traditional sense. This assists venture capital investments where the declaration of dividends is unlikely in the early stages.

Foreign investors should be aware that many countries, including until recently the United States, do not recognize the STC as a tax on dividends and it accordingly is not creditable under international tax credit arrangements. This may lead to double taxation when the distributed sums are taxed as dividends in the home country without any credit having been received for the STC paid in South Africa. This can be averted by using a branch office as opposed to a subsidiary. Although branch offices are theoretically liable for the STC, it has never been applied against them due to inefficient tax collection capabilities. Branch offices are, however, unlikely vehicles for venture capital.

Interest paid to non-residents is not subject to South African taxation, although it will probably be taxed as such in the home country. Foreign investors may utilize favorable double tax agreements which specify a low rate of taxation on interest in the home country to take advantage of this situation by opting for loan rather than equity financing. Thin capitalization rules were amended in 1995 to prevent abuse. However, most 'policing' is effected through the operation of exchange control regulations.

28. RDP, *supra* note 17, at para. 3.10.2.

POSSIBILITIES FOR EXIT

The venture capitalist relies upon a well planned exit strategy in order to make an investment. In South Africa's case, the vehicle for such an exit exists in the form of the well structured and established JSE, but is hampered by other extraneous considerations which impact upon this ability in the context of the submissions made during the course of this paper. The two primary obstacles appear to be exchange control regulations, and the previously mentioned excessive listing requirements which may render it impossible for the SMME sector to list on the JSE.

Although the repatriation of profits is permitted subject to exchange control regulations, the sale of an interest in a listed company coupled with an attempt to transfer the proceeds of the sale outside of South Africa's territory would require the approval of the Reserve (central) Bank. Such a transaction is likely to be closely scrutinized in order to ensure that no interest in the transferred funds has been acquired by local investors, and time delays are thus very likely.

If the investor failed to succeed in having the company listed, a private purchaser would have to be found, thus further complicating and delaying exit. Moreover, even if a listing were possible, trading on the JSE is dominated by major corporations and, as previously indicated, a small number of influential private investors. It may therefore be difficult to sell the stock. Market liquidity cannot be relied upon with any degree of assurance. "The opportunities to exit private equity in South Africa are far from tested" and "may not be easy".[29]

This reaffirms the argument that government-backed funds should target the training of entrepreneurs and managers rather than actual investments, aside from a handful of strategic and well-deserving projects. The latter is necessary in order to give the government some level of practical experience in the venture capital industry, and to serve as a basis for the refinement of a small business investment act tailored to meet the particular needs of South Africa. The intention is that the development of the small, micro and informal business sectors would spur economic growth, which would in turn allow for greater participation on the JSE by the country's population. This would increase market liquidity, and ultimately facilitate smoother exit possibilities. Moreover, it is highly likely that exchange controls will be phased out over the next few years, which will substantially improve the position for foreign investors.

INTEGRATING THE VARIOUS INITIATIVES TO CREATE EFFECTIVE MECHANISMS FOR THE DEVELOPMENT OF THE SMME SECTOR

The following extract from the RDP provides a firm indication of the current Government's recognition of the dire need for the development of SMME enterprises, and targets the key areas which must be addressed in order to attain this objective.

29. Foster, *supra* note 1.

In line with the objectives of economic policy, growth in employment can be enhanced through government support to small and medium-sized enterprises. *The institutional framework of support for such enterprises will be fundamentally restructured.* The Government will determine appropriate support policies which will be both focused and sectorally differentiated. Such a policy should not be based on hand-outs. Support to this sector will best be decided by the Government, the private sector and NGO's acting in concert.[30]

The Key areas of support to small and medium-sized enterprises will include:

access to advice;
favorable amendments to legislative and regulatory conditions;
access to marketing and procurement;
access to finance;
access to infrastructure and premises;
access to training;
access to appropriate technology; and
encouragement of interfirm linkages.[31]

This indicates government support for the amendments suggested above. However, the South African scenario is complicated by a lack of adequate resources and a plethora of institutions all wishing to achieve similar objectives. As early as 1981, through a joint partnership of the government and the country's mining, banking, and insurance industries, attempts were made to develop a venture capital industry.[32] This led to the formation of the Small Business Development Corporation (SBDC), which was launched to stimulate job growth in the private sector through the promotion and development of small to medium-sized enterprises.[33] The SBDC, which financed more than 50,000 businesses and created approximately 400,000 jobs, now plans to adjust its strategy to focus on small loans to black (and particularly family) owned businesses.[34] However, the SBDC may not be the ideal vehicle for the attainment of such objectives. This is because it is "contaminated by the stigma of its apartheid origins, reflected in its operational practices—including allegations of corruption and nepotism—and its predominantly white board (which has 'blackened' in recent years)."[35] Its past has been fettered by the concentration of its activities on white-owned small to medium sized enterprises, but its new commitment to expanding the promotion of black-owned businesses and affirmative action has created the view that it " . . . could be restructured to bring it in line with the RDP."[36]

In the interim, government programs are being directed at the creation of a new institutional framework with the establishment of the Small Business Development Agency (SBDA), the National Small Business Council (NSBC), a network of Local Service Centers, and a Small Business Desk in each of the

30. RDP, *supra* note 17, at para. 3.10.1. (emphasis added).
31. *Id.* at para 3.10.2.
32. Foster, *supra* note 1.
33. *Id.*
34. *Id.* (referring to comments made by Dr. Ben Vosloo, Managing Director, SBDC Ltd.)
35. B. Davies, *The Development Agency Industry*, S. AFRICA BUS. INTELLIGENCE, September 26, 1994, at 2, *available in* 1994 WL 8221295.
36. *Id.*

nine provincial governments.[37] This has been done largely to avoid the marginalization that was prevalent in the SBDC, but it is serving to create a multiplicity of institutions all striving to achieve similar objectives. An overlap of activities is depleting the limited financial resources available.

For this reason it is argued that the government should be concentrating its efforts on reducing the number of institutions involved in the promotion of the SMME sector, rather than increasing the number. All the aforementioned institutions should be incorporated under the auspices of a single umbrella body which would supervise administration, financing, training and marketing. Through adequate control, the Government should be able to ensure that these bodies target the primary objectives of economic development (especially among the SMME sectors), and Black empowerment.

Private funds, and funds such as the Overseas Private Investment Corporation's (OPIC's) two Africa Growth Funds (worth $25 million and $75 million respectively), should be encouraged to target high-end market investments with substantial Black ownership and control in order to assist in facilitating Black empowerment, while simultaneously ensuring a framework for the development of a traditional venture capital industry.[38]

Domestic and foreign government-backed funds, with assistance from large domestic and foreign corporations, must utilize the limited resources available in the most cost-efficient manner possible to provide a framework for the development and full integration of the SMME sector into the economy as has been proposed. The U.S. Agency for International Development's (AID's) $100 million Southern Africa Enterprise Development Fund (SAEDF) has devoted fifty percent of its funds to South Africa. The fund seeks to reach the lower end of the market with loans ranging from $1,000 to $100,000 by establishing alliances with other financial institutions and organizations that have proven programs which are effectively servicing this business group.

Equity investments, loan guarantees and technical assistance are also envisaged, the overall objective being to expand Black business development and ownership. It is submitted that since the South African Government and the SAEDF share common objectives, they should work closely together especially insofar as the provision of loan financing and technical skills are concerned. The SAEDF should also offer its assistance to the DTI in ensuring the creation of an adequate enabling environment for the promotion of the SMME sectors.

CONCLUSION

When I first began researching this paper, my inclination was to look for ways in which the traditional venture capital industry in South Africa could be further developed. Having reflected upon the obstacles confronting the develop-

37. *The New SA Program for Small Business*, S. AFRICAN BUS. INTELLIGENCE 8, April 7, 1995, *available in* 1995 WL 8280939.
38. OPIC's Africa Growth Funds target not only South Africa, but the entire Sub-Saharan region.

ment of such an industry, and South Africa's present economic and political objectives, it became apparent that while the development of a traditional industry is desirable, the country's immediate concerns and circumstances necessitate that the emphasis be placed on the development of the small, micro and informal market sectors.

Any such analysis is impossible without taking account of South Africa's political history. Professor Zahralddin and I agree that this history has resulted in a unique situation where the commonly accepted venture capital principles and themes pertaining to developing countries do not necessarily apply. On the one hand, an entrepreneurial infrastructure with a developed and established stock market, legal system, manufacturing sector and corporate culture already exists. The situation is therefore unlike that of many former non-market economies. On the other hand, dramatic levels of unemployment, poverty and illiteracy have served to exclude the majority of the population from active participation in the economy.

The realities of the market dictate that any meaningful change will not be presently achieved by targeting the high-end of the market spectrum. The obstacles preventing this are still too daunting. Had no alternatives existed, this would be an appropriate target for venture capital investment. However, given the enormous potential which exists at the low-end of the market, it seems sensible to utilize available funds to expand these sectors. This is not only less costly, thus permitting far-reaching results within the confines of the limited available financial resources, but it also provides an opportunity to simultaneously address many social ills which continue to plague South Africa's development.

The challenge presently facing the Government is the implementation of the proposed solutions to the many obstacles which serve to impede the rapid development of the venture capital industry. The Government will be required to effectively bring the multitude of institutions under the control of a single umbrella body capable of providing the framework to implement the suggestions made during the course of this paper. These objectives already have the support of both the RDP and the DTI. The ultimate challenge lies in the Government's ability to act upon its own recommendations.