The Challenges in Funding of Broad Based Black Economic Empowerment

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This thesis is not confidential. It may be used freely by the Graduate School of Business.

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Last, but not least, I would like to thank my wife, Nokuthula, for her support and encouragement in the past two years.

I certify that except as noted above the thesis is my own work and all references used are accurately reported in footnotes.

Signed:

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Mcebisi Ngubane
The Challenges in Funding of Broad Based Black Economic Empowerment

ABSTRACT
The Broad Based Black Economic Empowerment Act was signed into law in order to promote participation of black people in the South African economy. This has resulted in several deals where equity in companies has been transferred from white to black people. In spite of this, progress has been hampered by the inability of black people to access funds for the deals. This research focuses on why this has been a problem even though there are several funding models and institutions that were set up to assist in financing BEE deals. The research was conducted using interviews with various stakeholders and secondary qualitative data.

It was found that the factors that make it difficult for black investors to access funds are poor planning prior to entering the deal, the economic climate, regulatory requirements, improper funding structures used, poor service from funding institutions and that black people are not creditworthy because they often do not have security or own capital to fund the deal.

KEYWORDS: black economic empowerment, funding institutions, funding models
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## GLOSSARY OF TERMS

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<tr>
<td>BBBEE</td>
<td>Broad based black economic empowerment</td>
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<td>BEE</td>
<td>Black economic empowerment</td>
</tr>
<tr>
<td>DBSA</td>
<td>Development Bank of Southern Africa</td>
</tr>
<tr>
<td>ESOP</td>
<td>Employee share (stock) ownership plan</td>
</tr>
<tr>
<td>FNB</td>
<td>First National Bank</td>
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<tr>
<td>IDC</td>
<td>Industrial Development Corporation</td>
</tr>
<tr>
<td>JSE</td>
<td>Johannesburg Stock Exchange</td>
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<tr>
<td>NEF</td>
<td>National Empowerment Fund</td>
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<tr>
<td>NGO</td>
<td>Non-governmental organisation</td>
</tr>
<tr>
<td>SME</td>
<td>Small and medium enterprises</td>
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<td>SMME</td>
<td>Small, medium and micro enterprises</td>
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<tr>
<td>SPV</td>
<td>Special purpose vehicle</td>
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<td>WAIH</td>
<td>Worldwide Africa Investment Holdings</td>
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1 INTRODUCTION

1.1 Research area and problem

The Broad-Based Black Economic Empowerment (BBBEE) Act was gazetted by the South African government in January 2004. Its aim was to enable meaningful participation of black people in the economy by increasing the number of black people that own, manage and control enterprises (Department of Trade and Industry, 2004). The scope of participation of black people is not limited to individuals but also includes groups such as communities and workers. Also mentioned specifically in the Act is the intention to promote access to finance in order to promote black economic empowerment (Department of Trade and Industry, 2004).

A lot of studies have been conducted in relation to the application of BBBEE with several problems being identified. Among these is the often quoted problem of black economic empowerment (BEE) investors’ lack of capital. The Deutsche Bank estimated that R1.3 trillion will be required to finance empowerment if 25% of the economy were to be transferred (Kingston & Chiume, 2006) to black people. The problem of lack of capital has been mentioned in studies conducted by Burger, Munian & de Groot (2003), Nulliah (2006), Balshaw & Goldberg (2005) and Budhram & Yankey (2004). Industry specific studies about BEE also indicate this problem e.g. in the automotive industry (Horn, 2007) lack of funds is as a result of BEE investors not having collateral required by the banks. The Exxaro BEE case study (in the mining sector) by Fauconnier & Mathur-Helm (2008) shows that the funding of the deal was the main challenge.

There are some funding institutions that have been set up to address the issue of funds. Among these are institutions such as the National Empowerment Fund (NEF), Khula Enterprises and Umsobomvu Youth Fund. An in-depth analysis of these institutions was studied by Bwakira & Khumalo (2004). In their study, Burger, Munian & de Groot (2003) analysed the impact of different funding structures on sustainable BBBEE deals.

In spite of the different funding structures and funding institutions that are in place, it is apparent that accessing funds for BBBEE is still a topical issue. The aim of this research is to identify the problems that are encountered by potential investors in furthering the cause of BBBEE. More specifically it seeks to identify problems that are related to accessing funds for BEE transactions.
1.2 Research questions and scope

BBBEE is not limited to the transfer of equity stakes to new black shareholders. In fact there are seven elements of BBBEE that are used to measure the status of companies (Department of Trade and Industry, 2007a). However the scope of this research will be limited to the BBBEE deals that are characterised by the transfer of equity stakes to black investors, thereby directly addressing the ownership element.

The research will therefore attempt to answer the following questions.

- In spite of all the current funding models in place, are there any challenges that potential investors are facing in accessing funds for BBBEE?
- From the point of view of funding institutions, what causes investors to fail to get access to funds?
- What challenges are faced by the funding institutions themselves in providing funds to BBBEE?
- Are the existing funding structures making it easy for the investors to access funds for BBBEE?

A lot of BEE deals have been approved. In 2007 alone, 153 deals worth R96 billion were made. According to Dada & Thayser (2007), BEE deals have been a dominant feature in mergers and acquisitions in South Africa. However this does not include other forms of empowerment such as small, medium and micro enterprise (SMME) development. As there are no available records of failed deals and declined loans, it is difficult to take into account the point of view of a BEE investor. In fact an investor with a declined application for finance would provide better insight into what the financing problems are.

However funding institutions themselves will have processed both failed and successful applications for funding. They would therefore still be able to give a good picture of what the financing problems are. This research will therefore be looking primarily at the funding institutions’ point of view.

1.3 Research Assumptions

It has been pointed out already that the respondents that were chosen for the interviews did not include BEE investors. Their point of view is therefore not captured in the results. However an assumption is made that funding institutions are able to provide a complete picture as they will have
processed both successful and unsuccessful applications. Interviews and previous research on the impact of these institutions will therefore adequately answer the research questions.

Secondly, there is not a wide range of samples to choose from. The success of gathering data for this research therefore depended largely on the willingness by respondents, especially funding institutions to participate in the research. An example is in the work by Ackermann & Meyer (2007) where only two out of the four commercial banks were willing to participate in the research as interviewees.

1.4 Research Ethics

It is recognised that some respondents in this research may want to remain anonymous. This is even more important based on the example of Ackermann & Meyer’s work (2007), where sensitivity of questions asked may have been the reason why other research subjects declined to be interviewed. According to Bryman & Bell (2007) anonymity potentially raises a problem in that secondary analysis may be difficult if further possible studies are to be conducted for this research. This however should not have an impact on the outcomes of this research.
2 LITERATURE REVIEW

2.1 History of BEE deals

Several BEE deals have been concluded since BEE was first introduced. The table below shows the number of deals and their value, year on year since 1995.

Table 1: Value and number of BBBEE deals from 1995

<table>
<thead>
<tr>
<th>YEAR</th>
<th>NUMBER OF TRANSACTIONS</th>
<th>VALUE (R BN)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>23</td>
<td>12.4</td>
</tr>
<tr>
<td>1996</td>
<td>45</td>
<td>7.0</td>
</tr>
<tr>
<td>1997</td>
<td>52</td>
<td>8.3</td>
</tr>
<tr>
<td>1998</td>
<td>111</td>
<td>21.2</td>
</tr>
<tr>
<td>1999</td>
<td>132</td>
<td>23.1</td>
</tr>
<tr>
<td>2000</td>
<td>126</td>
<td>28.0</td>
</tr>
<tr>
<td>2001</td>
<td>101</td>
<td>25.1</td>
</tr>
<tr>
<td>2002</td>
<td>104</td>
<td>12.4</td>
</tr>
<tr>
<td>2003</td>
<td>189</td>
<td>42.2</td>
</tr>
<tr>
<td>2004</td>
<td>243</td>
<td>49.9</td>
</tr>
<tr>
<td>2005</td>
<td>238</td>
<td>56.2</td>
</tr>
<tr>
<td>2006¹</td>
<td>221</td>
<td>56.0</td>
</tr>
</tbody>
</table>


¹Source: Dada & Thayser (2007)

Work that has been done on BEE does not indicate whether there are any major drivers to BEE deals other than compliance to legislation. Dada & Thayser (2007) indicate that there has been more flexibility to do the deals since the introduction of the Codes of Practice.

2.2 Legislation on BBBEE

2.2.1 Broad-Based Black Economic Empowerment

The Broad-Based Black Economic Empowerment Act was gazetted in January 2004. One of its key objectives is promotion of participation of black people in the economy. This includes
According to Jack (2007), the BBBEE Act only provided an outline for BEE. In essence the Act only served to give powers to the minister to establish a more detailed framework to implement BEE. There was therefore a need to provide a more detailed framework that companies could use to implement BEE. To this effect the government gazetted the Codes of Good Practice, which then expanded on the elements of BEE. The seven elements of BEE are ownership, management control, employment equity, skills development, preferential procurement, enterprise development and socio-economic development (Department of Trade and Industry, 2007a). The ownership element is one of the key factors as evidenced from its weighting of 20 points out of 100 in the BEE scorecard (Department of Trade and Industry, 2007a). Together with Preferential Procurement, it therefore carries the most weight of the seven elements.

According to the Act and the Codes of Good Practice, the Department of Trade and Industry also issued a BBBEE strategy, which among other things, should show a plan for financing BBBEE. The strategy is discussed in more detail below.

2.2.2 Broad-Based Black Economic Strategy

In the 2002/3 year the South African government allocated R2.2 billion for BBBEE initiatives. Some of these funds came from Ntsika, Khula Enterprises, Isibaya Fund, Umsobomvu Youth Fund, Development Bank of South Africa (DBSA) and Land Bank (Department of Trade and Industry, 2003). Among the government interventions, Khula had approved R1.3 billion worth of facilities, 79% of which were to BEE (Department of Trade and Industry, 2003).

The government in its BEE strategy, recognises that some of the BEE deals were highly leveraged, resulting in implemented financing structures being exposed to the tough financial crises such as the 1997 Asia crisis (Department of Trade and Industry, 2003). The government also saw a need to maintain the macroeconomic balance in that high levels of debt need to be avoided while financing BBBEE activity. There is also a need to consider the small, medium and micro-enterprises (SMMEs) when financing strategies are put in place (Department of Trade and Industry, 2003, p.17). The government’s strategy also clearly expresses that the commercial risk of BBBEE activity will remain with the enterprises, entrepreneurs and investors. However, the government sees the need to provide collateral and capital to facilitate BBBEE (Department of Trade and Industry, 2003, p.17). The government lists the following forms of financing:
• Grants and incentives
• State facilitated lending – in particular to small and medium sized enterprises
• Project financing
• Venture capital
• Targeted investments

2.2.3 Financial Sector Charter

The Financial Sector Charter was developed to provide guidelines on how financial institutions should implement BBBEE. Given that financial institutions, by definition in the Charter (Department of Trade and Industry, 2007b, p.6), are a key source of finance, it is important to understand how the South African government aims to facilitate BBBEE through the financial sector. One of the imperatives that were identified in order to promote BEE is for the financial sector to support black entrepreneurs (Department of Trade and Industry, 2007b). On that point, the government acknowledged that credit had not been effectively provided to black businesses. Arya, Bassi & Phiyega (2008) also state that provision of credit to black entrepreneurs has been insufficient.

According to the Financial Sector Charter (Department of Trade and Industry, 2007b) there are forms of interventions that financial sector companies are expected to undertake in order to support BEE. Only interventions that are related to BEE financing are discussed below. Firstly, the financial sector is expected to invest in financial sector BEE companies through joint ventures, debt financing and equity financing. Secondly, companies are expected to establish the total amount of empowerment financing on an annual basis. In addition, the portion of total empowerment financing that was part of BEE transaction financing should be clearly specified. Lastly, the Charter also states that the funding models used should promote full economic interest to the BEE partner and should also promote long term instead of short term ownership.

2.3 Different funding structures & models

The type of funding structure that is used in BEE deals is essential in making sure that the deal itself is sustainable. According to Fauconnier (2006, as quoted in Fauconnier & Mathur-Helm, 2008), many deals have failed because of unsustainable funding. Radebe (2006) makes an example of the Johnnic deal that failed because of an inappropriate funding structure. The problem with this transaction is that it was based on expectations of an increase in share price. Several funding structures have since been developed because of perceived lack of finance from black people (Burger, Munian & de Groot, 2003). Different types of available funding structures and the
examples of companies that have concluded empowerment deals using these structures are discussed below.

2.3.1 Debt Financing
In this type of deal, the empowerment partner raises their own funds, using the issued shares as security. This structure, according to Gounder (2005) needs predictable cash flows, in order to service debt which is supplied by generally risk averse funders. In order to raise debt different institutions can be used. These include commercial banks, insurance companies and pension funds (Balshaw & Goldberg, 2005). As commercial banks are seen as a principal source of debt (Rose, 2002 quoted in Ackermann & Meyer, 2007) their role is discussed in more detail in a later section.

A disadvantage of this structure is that additional security may be required for the empowerment partner to access funds. Secondly, BEE businesses are often not liquid enough to repay the loans. Finnemore, Darroch and Lyne (2004) propose alternative repayment terms that may suit investors with short term liquidity problems in order to assist BEE companies. However these structures were specified for BEE companies that invest in productive assets as opposed to equity acquisitions. The repayments terms recommended in this study therefore may still leave other BEE investors with the task of finding suitable structure to help them repay their loans.

2.3.2 Employee share ownership schemes (ESOPs)
In this type of deal, shares are bought for the employees by using internal cash flows or debt. One of the companies that have used this is Sasol in their Sasol Inzalo BEE transaction where 4% of the company was transferred to the employees and black managers (Sasol Limited, 2008).

Employee share ownership has the advantage of better retention and incentivisation of employees (Balshaw & Goldberg, 2005). Jack (2007) elaborates this point further by stating that since employees will have a vested interest in the business, they will ensure that the business is sustainable. This practice is also done in the United States where companies have been given tax incentives to encourage this (Finnemore, Darroch & Lyne, 2004).

One of the disadvantages of this structure, according to Balshaw & Goldberg (2005), is that there is a cash drain that results from the repurchase of shares from the employees that leave the company. In addition, the shares may be placed at low value, diminishing the value for some shareholders. Lastly, setting up the transaction is considered to be costly. On the contrary, Jack (2007) indicates that the real cost of the BEE deal is the administration cost which is considered to be minor.
Mazibuko & Boshoff (2003) also contradict this view about ESOPs by stating that they are easy and inexpensive to design and implement.

2.3.3 Mergers
Some BEE deals are structured by means of mergers. In such cases a white owned company and a black owned company merge to form a single company. The shareholding structure depends on the relative sizes of the two independent companies that are merging (Jack, 2007). An example of this kind of structure is a BEE deal that took place between Datatec and African Legend Technologies in 2007. In this deal Datatec merged its South African operations with African Legend Technologies to form a new company called African Technology Indigo. Datatec owned 55% of the company while African Legend Technologies would hold the remainder (Datatec, 2006).

The advantage of this type of deal is that synergies between the two merging companies can be exploited to possibly increase profits (Jack, 2007). Its main disadvantage is that although studies show that shareholders of both target and acquiring firms tend to get abnormal returns in the short term, there are no persistent returns for the shareholders in the long term (Wimberly & Negash, 2004).

2.3.4 Deferred shares
This method of financing takes the form of shares being granted to the empowered company. The shares carry full voting rights without economic benefits until the shares are converted to ordinary shares, subject to certain agreed targets being met (Jack, 2007). During the waiting period before full economic rights are granted, the black investors would be paying off the debt that was used to buy the shares. Sanlam used this structure when they entered into an empowerment deal with Patrice Motsepe. According to Jack (2007), this method of financing has an advantage that the empowered company is able to add value and influence the shares. However, the targets that need to be met before the shares are converted to ordinary shared may be too unrealistic (Jack, 2007). In the Alexander Forbes deal for instance, the deferred shares could only be transferred to the empowerment partner after 7 years on condition that earnings would grow by 30% a year (Brinker, 2006). This type of structure was criticized because white owned companies were getting credit for full ownership even though the black shareholders did not enjoy full economic benefits and rights (Tangri & Southall, 2008). To this end, the Codes of Practice (Department of Trade and Industry, 2007a) make a clear distinction between voting rights and economic interest in the scorecard.
2.3.5 Split-up of assets
In share splits, companies divide assets by exchanging shares between sister companies or subsidiaries in the case of holding companies (Balshaw & Goldberg, 2005, p.179). This has an advantage of matching cash flow needs of various assets to the different preferences of individual shareholders. The drawback of this method is the complexity of structuring the deal. It may also result in higher tax liabilities for shareholders as a result of higher valuation of the business.

2.3.6 Equity Financing
This type of financing essentially means that a black business raises funds by selling its assets or even subsidiaries. Worldwide Africa Investment Holdings (WAIH) acquired a 15% stake in CS Holdings (Burger, Munian & de Groot, 2003). The deal, worth R30.5 million (Erasmus, 2001), was financed by selling WAIH’s subsidiary, Argil in exchange for shares in CS Holdings. This type of financing has an advantage that external sources of financing are not required. It also assists in reducing non-strategic assets, thereby helping management to focus on the core business (Balshaw & Goldberg, 2005). The problem with this model is that it is difficult to find black businesses that own unencumbered assets (Gounder, 2005). In some cases where an entire division is to be sold, it may be difficult to separate it from the core business (Balshaw & Goldberg, 2005).

2.3.7 Private Equity Partnerships
In this case financing is sourced from the sale of an equity stake to an investor. This has an advantage of providing cash to the business. The structure is also relatively cheaper. Balshaw & Goldberg (2005) state that this structure has the disadvantage of private investors sometimes requiring too high a return on investment. However it can also be argued that profits and cash flow projections need to be communicated upfront when acquisitions are considered. The investors would therefore not have unrealistic expectations about the returns. Lastly, there is a risk that the investor may eventually acquire control of the business through buying of more shares in the business.

2.3.8 Vendor Financing
Vendor financing involves companies providing loans or guarantees to third party funders. The transaction is structured such that the seller of equity agrees to receive the funds at a later stage. According to Balshaw & Goldberg (2005) this implies that the seller funds part or all of the deal. This financing structure has an advantage of easier access to funds. It is considered to be cheaper for the BEE party. The model was used in the Naspers BEE deal where shares in Media 24 and MultiChoice were sold (Jack, 2007). The disadvantage of this structure is that the company limits its access to additional debt, as capacity is taken up by funding of the deal (Gounder, 2005).
Initially, the Companies Act (South African Government, 1973) prohibited companies from providing financial assistance for the purpose of acquiring shares in the company itself or its holding company. The revised Companies Act (Department of Trade and Industry, 2009) makes provision to offer this assistance subject to the company being able to pass the solvency and liquidity tests after the transaction. This test stipulates that the aggregate assets of the company should exceed its aggregate liabilities. Secondly, the company should be able to repay its debt for a period of 12 months after the transaction comes into effect.

2.3.9 Leveraged buyout structures
In this funding model, a lender (usually a bank), an equity financier and a BEE group form a separate company. The newly formed company buys out the existing company, resulting in a change in the shareholding structure of the existing company. The bank and the equity financier both provide financing to the BEE group to buy shares from the previous shareholders (Jack, 2007).

The involvement of the bank in the transaction brings credibility to the transaction as the financing model is more robust. According to Jack (2007), the bank would not be involved unless it is confident of success. However, the bank’s involvement often results in higher cost of financing.

2.3.10 Special Purpose Vehicles and Consortiums
Special purpose vehicles are used in cases where the investors do not have access to capital. A special purpose vehicle (SPV) is created as an entity that will have equity in the company that is selling its equity in an empowerment deal. The SPV itself is owned by the debt and equity lenders together with the BBBEE investor. The lenders often have a higher interest in the SPV. The lenders borrow money to the SPV in exchange for equity and often preference shares. The SPV uses the cash to buy shares in the seller. When the seller declares dividends, which are paid to the SPV, the SPV in turn pays further dividends to the financier. Ultimately, the SPV later sells its stake in the company, redeems preference shares and repay the original debt. Any profit left is claimed by the BBBEE investors (Jack, 2007).

An example of an SPV financed BEE is the acquisition of 15% of Rainbow Chicken by an SPV that is owned by several institutions. In this case, an SPV called BEECo was formed and it acquired the shares at Rainbow Chicken, at R17.89 per share (Avery, 2008). BEECo itself was owned by Imbewu Consortium (40%), Ikamva Labantu (16.67%), Rainbow Employee Trust (42.66%) and M. Nhlanhla, a Rainbow non-executive director (0.67%). The BEE deal itself was worth R915.6 million (Avery, 2008). A simplified diagram below indicates a typical structure of an SPV that is owned by a consortium, using the Rainbow BEE deal as an example.
2.3.11 Preference Shares

Preference shares are a common feature in a lot of the funding structures that they warrant a separate discussion. By definition, the owners of preference shares are entitled to the company dividends before ordinary shareholders (Firer, Ross, Westerfield & Jordan, 2004). They are often issued by the empowerment company in exchange for cash. These shares often do not carry voting rights. An example of a deal where preference shares were used was between Sanlam and Sancino Projects in 1998 (Dingley, Ngcono, Farlam & Marwell, 2008).

The problem with this funding mechanism is that the ownership of a company effectively changes if the BEE company struggles to pay dividends to the funder. This was the case with the Sanlam / Sancino deal when Sancino failed to pay dividends to Sanlam and redeem the preference shares at the agreed time. Sanlam then exercised their right to vote their preference share as per initial agreement. This meant that effectively Sanlam had 76% ownership of Sancino, thereby making this deal a merger.

Buthelezi (2008) did a study that shows how the use of preference shares may result in net equity value to BEE companies being less than the initial intention of the announced deal under certain scenarios. In cases where the BEE company receives dividends that are less than the dividends
payable to preference shareholders (or even interest payment of a loan), the BEE company ends up in more debt than it initially began with.

2.3.12 Consortia and Syndication
One of the ways that SPVs have been used is in the cases where consortia have been formed. Sometimes a group of investors form a consortium that owns an SPV. The SPV in turn may become a shareholder of a company stake that is being sold in a BEE deal. The idea behind the formation of consortia is to pool resources, in particular money, for the purpose of making an investment. This practice is quite common and is referred to as syndication. According to Bent, Williams & Gilbert (2004), not much research has been done in this field. However in their work, they indicate that the main reasons for syndication are large investments in proportion to available funds, large investments in proportion to average investment size. BEE was also mentioned by companies as a reason for syndication.

The drawback in the practice of syndication is that there is a loss of control (Bent, Williams & Gilbert, 2004), since there is a spread in ownership. In addition, Jack (2007) mentions that large consortia can often lead to complicated group dynamics that result from differences in views, missions and objectives. This problem was experienced when the Exxaro BEE deal was set up (Fauconnier & Mathur-Helm, 2008).

2.3.13 Non-capital financing
As a way to get around the lack of capital finance, some of the funding structures have been created, such that there is less capital required. An example is in the wine industry where black owned businesses only source wine from other cellars. They then blend their own wine, market and sell it under their own brands. Other parts of the value chain such as bottling are outsourced (du Toit, Kruger & Ponte, 2008). These arrangements have resulted in partnerships such as Women in Wine and Boland Cellars. The disadvantage with these partnerships though is that the empowerment companies only control a fraction of the value chain.

Some of the BBBEE deals have been financed through discounted shares as well as shares whose initial price is paid by dividend payouts. An example is the Exxaro deal where the debt that had to be serviced through dividends was minimised to “acceptable levels” (Fauconnier & Mathur-Helm, 2008).
2.3.14 Unfunded structures

In this case the empowerment partner receives shares based on value created in the company. The advantage is that the empowerment partner has influence in the company, thereby creating value, even though it may take a long time before they have economic power (Gounder, 2005).

2.4 The role of government funding institutions

The South African government saw a need to actively promote the financing of BBBEE. This gave birth to several funding institutions that fall under the Department of Trade Industry. In a study done by Schreuder, van Heerden & Khanya (2007), it was concluded that the funding institutions had made a positive contribution towards economic empowerment.

However, some clients, according to this study still perceive some problems that potentially hinder further progress that could be made. The problems that were mentioned include lack of regular feedback, where some investors were not sure whether their applications had been approved. Even in cases where application were approved the process is perceived to be lengthy (Schreuder, van Heerden & Khanya, 2007). This study provides an objective view of the funding institutions as the clients interviewed included those whose applications were granted and those whose applications were declined.

Bwakira & Khumalo (2004) conducted a more detailed study on the impact of funding institutions. Based on this work, a discussion on the funding institutions is presented below.

2.4.1 National Empowerment Fund

The NEF requires investors to put in some of their own capital upfront in order to get commitment from them as they will have their own money in. But Bwakira & Khumalo (2004) argue that this in fact is a hindrance in particular for SMEs. The NEF also requires 12-20% rate of return, which is against its intent of providing finance. Yet they claim to have an appetite for risk compared to conventional banks.

A recent search on the NEF website indicates that its structure is divided into two main focus areas of empowerment. Its Imbewu Fund is focused on promoting new businesses and expansion in the early life of businesses. Its Corporate Fund is specifically designed for BEE capital.

Funding available ranges from R5 million to R100 million. According to their report, NEF had approved transactions worth R932 million by 2008 (National Empowerment Fund, 2008, p.9). On average NEF receives 100 applications per month. It is not yet clear what the average approval rate on these applications is. However, NEF points out that one of the reasons for lack of access to
funding is poor quality of business plans (National Empowerment Fund, 2008, p.15). The NEF therefore provides support by making available an online business planning tool, mentorship and coaching to existing clients.

The NEF also recognised that funding was skewed towards the provinces of Gauteng, Eastern Cape and the Western Cape. In the financial years of 2006/7 and 2007/8 there were no investments at all in the Northern Cape and North West provinces. This, at the time of the report was already being addressed (National Empowerment Fund, 2008, p.26).

NEF has several criteria that they assess in the process of awarding assistance. This includes compliance with relevant laws, black management and operational involvement, risk sharing by entrepreneur, black women empowerment, community involvement, black ownership, job creation and geographic location of the business. Most importantly NEF assesses the viability of the business as a priority (National Empowerment Fund, 2008, p.16).

The NEF strategy also involves leveraging other funding institutions by sharing the risk with entities such as banks and other funding institutions. This has resulted in another R2.069 billion of funds being leveraged by March 2008 (National Empowerment Fund, 2008, p.33).

2.4.2 Industrial Development Corporation

Bwakira & Khumalo (2004) mention that the Industrial Development Corporation (IDC) had become a financier of choice but their process for approval was lengthy. The turnaround time had decreased from 90 days to 50 days. IDC defended this by mentioning that they need to perform a “comprehensive due diligence” as they are using public finds for which they need to be accountable. Bwakira & Khumalo (2004) also mention the need for IDC to focus on rural areas.

The current objectives of IDC include development of SMEs and acceleration of BEE. This is achieved by providing risk capital in partnership with the private sector (Industrial Development Corporation, 2009). In the 2008 financial year, IDC approved funds to the value of R8.5 billion. 75% of these funds were for start-ups and expansions. In terms of actual numbers, over 160 approvals for funding were to SMEs. In support of BEE, 52% of the approvals were to companies that had at least 25% black shareholding (Industrial Development Corporation, 2009).

2.4.3 Khula Enterprises

A detailed impact study of Khula Enterprises was conducted by Makina & Malobola (2004). In this study the role of Khula is summed up in five main objectives. Firstly, it provides access to
micro-loans to historically disadvantaged communities. Secondly, it provides loans to retail finance intermediaries, such as non-governmental organisations (NGOs), which in turn offer financial services to SMMEs. Thirdly, it provides credit guarantees to retail finance institutions and individuals. Fourthly, it provides regional equity funds to emerging entrepreneurs in Limpopo, KwaZulu-Natal and Mpumalanga. Lastly, it provides support services such as management support and development of business plans.

According to Bwakira & Khumalo (2004) Khula had lost its focus and had become more of a lending institution. Nigrini & Schoombee (2002) on the other hand state that it was the initial intention for Khula Enterprises to evolve into a commercial lending enterprise, five years after its formation. However in some cases, the banks were not willing to lend money even though Khula had agreed to be the guarantor for those loans. In essence, the approval of a loan initially rests with the funding institutions (mainly the banks), whereas Khula through its credit guarantee, takes up the risk for the loan. Khula can still decline the loan applications, as according to Nigrini & Schoombee (2002), they declined 7% and 0.7% of loan applications in 1997 and 1999 respectively. Ultimately Khula and the bank share the risks attached to the loan in approximately an 80:20 split.

In the 2008 financial year Khula disbursed R443 million in funds. In the same financial year business loans were awarded to the tune of R264 million. Khula also recognise that banks typically favour large businesses in urban areas in awarding loans. Their strategy is to encourage banks to be accessible to emerging business (Khula Enterprises, 2008). Another problem that has been identified by Khula is the fact that commercial banks have become more conservative to lending to small enterprises as a result of government interventions such as the National Credit Act and high interest rates (Khula Enterprises, 2008). To Khula’s credit, Nigrini & Schoombee (2002) assert that it is spelt out clearly what the expectations are between the banks and Khula, as opposed to countries such as Malaysia and Nigeria, where banks somewhat lack confidence in the government schemes.

Pretorius & Shaw (2004) found that in the cases where Khula, as credit guarantors, have to refund commercial banks in cases where businesses have become insolvent, the process is seen by commercial banks as lengthy. As a result, banks become even more reluctant to issue loans.

2.5 How commercial banks approach financing

According to Rose (2002, quoted in Ackermann & Meyer, 2007) the commercial banks are a key enabler of financial transactions and are a principal source of credit. In spite of this key role that banks should play, they also need to guard against over-extension of credit risk as, according to
Caouette et al (1998, quoted in Ackermann & Meyer, 2007) many banks have failed due to this problem.

According to Ackermann & Meyer (2007), banks typically use a credit scoring system to assess the likelihood of defaulting on payments by using qualitative models. Borrowers are then ranked into different classes (Saunders & Cornett, 2003, quoted in Ackermann & Meyer, 2007). What is apparent from this study is the fact that the qualitative model, referred to as 5C’s (Strischek, 2000, quoted in Ackermann & Meyer 2007) uses the borrowers’ character, capacity, capital, collateral and cyclical aspects of the economy in order to conduct the analysis.

Further, an assessment that focuses on the business itself is made. In order to enable this, banks require all loan applications to have a business plan as well (Pretorius & Shaw, 2004). According to Ackermann & Meyer (2007) the banks require past financial performance records, which are then compared to the projected cash flows. The purpose of this exercise is to assess the need for financing as well as the ability to service the debt. With this approach there is no indication of how a first time investor is assessed as they would have no history to make a comparison.

Lastly, banks require security in order to mitigate the risk of defaulting on payments (Ackermann & Meyer, 2007). The problem with this approach, as pointed out earlier, is the fact that several first time investors do not have the required security or capital (Bwakira & Khumalo, 2004). Booysen & Bouche (2005) sum this up by stating that many black investors are not bankable. In their study, Pretorius & Shaw (2004) found that banks also use Khula Enterprises to provide guarantees to loans as described in the section above. Usually the banks forward applications for finance to Khula after they have approved the application.

The findings from Ackermann & Meyer (2007) indicate that the banks do not have special criteria for lending out to BEE companies. The study also found the following factors that limit BEE companies from obtaining funding:

- little or no own equity
- absence of acceptable security
- lack of management or technical skills
- no or poor credit history
- limited guidelines for funding BEE companies
Nieuwenhuizen & Kroon (2003), recommend that banks should in fact consider financing entrepreneurs in spite of lack of security, as long as they are satisfied that the entrepreneurs have sufficiently met criteria like leadership and skills.

In spite of all the apparent hindrances that result in black investors lacking access to financing, commercial banks have nevertheless financed several BEE transactions. First National Bank (FNB) financed over R240 million empowerment related ownership buy-in transactions in 2007 (First National Bank, 2008). FNB, in partnership with Khula Enterprises also financed new and developing SMEs to the tune of R130 million.

Nedbank had by 2008 provided loans valued to R11 million through Khula Enterprise (Nedbank, 2008). Nedbank’s transaction finance in 2008 amounted to R29.4 million. One of the major BEE deals that Nedbank was in the process of concluding is the deal that involves Mvelaphanda Resources and Northam Platinum. From this transaction, worth R2.7 billion, Mvelaphanda will increase its stake in Northam Platinum to 63% (Nedbank, 2008).

Standard Bank (2008) reported that they had finalised three major BEE deals (Barloworld, PPC and City Lodge) worth over R5.5 billion in 2008. Their empowerment financing had reached R19.7 billion in the same year.

Although ABSA bank does not report the value of its empowerment financing, their sustainability report (2008) indicates that they met their targeted empowerment financing, based on the full scorecard points that are reported.

Other banks as well as investment banks have also contributed to BEE transaction financing as per Charter requirements. An example is Investec Bank which financed transactions to the value of R2.6 billion in 2008 (Investec, 2009). According to Kingston & Chuime (2006) the role of investment banks is often in an advisory capacity, more for the company that is selling equity than the BEE company. This is because of the perceived higher probability of concluding a deal from the seller’s side than from the buyer’s side that faces competition from other bidders.

### 2.6 Other Issues

#### 2.6.1 Taxation

There is a view by Balshaw & Goldberg (2005, p.56) that the government offers tax relief instead of tax incentives. The sheer number of tax laws as well as complexity of same end up impeding
BEE transactions. According to Booysen & Bouche (2005), the tax that results solely from the structure of the BEE deal could in fact be put to better use by funding the deal itself.

2.6.2 Hurdle rates
One of the problems identified by Jack (2007) is that hurdle rates that need to be met before a BEE deal is considered economically viable may be set too high at unrealistic levels. Bwakira & Khumalo (2004) also state this same problem in their critique of the NEF model of financing as it requires a pre-determined rate of return that needs to be met. It is possible that the reason why such rates of return are in place is that people that are tasked with sourcing and approving of funds are given performance and risk targets that are the same as those of a commercial funding institution (Booysen & Bouche, 2005). However it must be stated that the very presence of required rates of return makes business sense as there is a minimum return that compensates for debt and equity investors for bearing risk (Stewart, 1991).

2.6.3 Timing of the deals
Table 1 shows that there has been a consistent increase in the number of concluded BEE deals over time. However, Wolmarans & Sartorius (2009) state that in 1998 there was a decrease in BEE ownership from 7% to 2.2% as a result of the market crisis.

2.7 Conclusions
The study on the commercial banks has some gaps that were identified by Ackermann & Meyer (2007), which this research aims to address. Firstly, the study focused on successful loan applications. Even though the findings of this study can provide some views for this research, there is still a need to understand why some BEE deals may encounter financing problems. Secondly the study also claims that frameworks are in place to incorporate financing of BEE. However these were not yet reflected in the banks’ credit policies. In addition, the Financial Sector Charter was put in place in 2007. There is therefore a possibility that its guidelines may be reflected in the way that banks and other financial institutions approach BEE financing. Thirdly, the study is limited to just the commercial banks. Other financing institutions will be included in this study to give a different perspective. Financing institutions such as the IDC, Khula and NEF have BEE financing as one of their core objectives and their perspective should complement what is seen from the commercial banks.

The literature that has been studied already points to some of the hindrances to BEE financing. These problems are summarised below:
Some business plans have underestimated the required start-up finances. As a result some businesses find themselves having to reapply for additional finance at a later stage (Pretorius & Shaw, 2004).

Some applicants use consultants to compile their business plans. As a result commercial banks often see similar business plans over time. This has a negative impact on the application (Pretorius & Shaw, 2004).

It appears that commercial banks favour certain industries (Pretorius & Shaw, 2004), although it is not clear whether this is a formal criterion used to assess a business plan. This research hopes to clarify this issue, not only with the commercial banks, but also with other financing institutions that will be used in the study.

Pretorius & Shaw (2004) concluded in their study that creditworthiness of the applicant is what ultimately determines whether an application for finance is successful. The main indicator for this is the ability to provide security for the loan, which several papers have been quoted, stating that black investors mostly are unable to do so. However Ackermann & Meyer (2007) had also stated that banks were possibly in the process of incorporating BEE requirements into their credit policies. If BEE financing policies are incorporated into credit policies, this may possibly change this. The interviews will therefore address this issue to check whether credit policies still place emphasis on the applicant’s creditworthiness as opposed to the potential of the business.

Pretorius & Shaw (2004) also found that Khula is consulted once the bank has approved the loan. The banks still place a lot of emphasis on creditworthiness, as a way of minimising their exposure to risk, even though Khula is supposed to bear that risk as they are the ones who give guarantees to loans.

Although there are several types of funding structures that are in place to finance BEE, each of these models has its own pros and cons. Some of the common problems with the models include lack of collateral for debt financing, particularly, that required by commercial banks. Poor business plans have also been cited, even though commercial banks only look at them as a secondary requirement (Ackermann & Meyer, 2007). Models such as consortiums seem to work, even though they pose a problem of different visions and mindsets from the investors.
3 RESEARCH METHODOLOGY

3.1 Research approach and strategy
As previously pointed out, there is a common belief that access to capital is one of the problems that is facing BBBEE deals (Nulliah, 2006; Burger, Munian & de Groot, 2003). It follows from this claim that there is a need to investigate various problems that have been encountered in funding of BBBEE deals. This research will follow a strategy where various ideas will be used to build a theory on why it is a challenge to finance BBBEE deals. The research will therefore be of an inductive nature (Bryman and Bell, 2007).

According to Bryman and Bell (2007, p.23), a constructivist approach asserts that social phenomena are accomplished by social actors. This position was adopted for this research as the current status of BBBEE is constantly changing and is also continually being queried especially in its application. Clearly it is within the influence of the various stakeholders to change this and as a result it became appropriate to take this position on the research.

3.2 Research design, data collection methods and research instruments
The primary research design that was used is a survey research. According to Bryman & Bell (2007), this method predominantly uses structured interviews to collect data. However, semi-structured interviews were used in this case in order to allow the researcher to ask further questions to follow up on some issues that arose during the course of the interview.

The questions that were used in the interviews were a combination of existing questions from previous work and additional questions that were compiled based on additional required information. The use of existing questions is common practice, and this in fact has an advantage that the questions will have been piloted. According to Bryman & Bell (2007), existing questions also help in drawing comparisons with previous research.

Some qualitative secondary data was also used for analysis. The source of the additional data includes studies of funding mechanisms, funding institutions as well as some case studies in application of BEE. There were also some lessons drawn from the studies that have been made about financing business in general, as opposed to BEE companies.
3.3 Research criteria

According to Bryman and Bell (2007), cross-sectional design is typically replicable. This is because procedures such as choosing respondents and interview questions can be easily documented. However, time factor can also be a key in this research as with time factors such as legislation may change the way that BBBEE deals are conducted and as a result other challenges may arise, while some of those that will be identified in this research may become non-issues.

According to Bryman and Bell (2007, p.58), internal validity is usually weak because causal directions are difficult to determine. This research though is more focussed in finding out the actual challenges that are encountered without necessarily trying to find the direction of relationships. Lastly external validity may become questionable (Bryman and Bell, 2007, p.58) as non-random sampling will be used.

3.4 Data analysis method

According to Bryman and Bell (2007) grounded theory is the most common framework for analysing qualitative data. This was used in this research, where primarily data was coded. As a first step, interview responses were analysed to look for issues that are of significance to the research. Once this step was completed, all the issues that arose were grouped into different categories. The different categories are then discussed in the following section and in some cases examples from the literature are used to explain further.

The method of coding was used by Fauconnier & Mathur-Helm (2008) in their study of the Exxaro BEE deal. The key aspect of coding in this research was to allow coding to emerge from the data, rather than using pre-conceived codes as is required in quantitative research (Bryman & Bell, 2007).

3.5 Sampling

Some degree of sampling in this research involved making choices about whom to interview. It is important to note that the interviewees offered opinions based on personal experience. Therefore identification all the relevant stakeholders meant that several perspectives were put on the table. Nulliah (2006) identified investors, BEE authorities and government officials in his research on BEE. The same types of stakeholders were used in this research. However as this research is specifically focussed on finance issues, further stakeholders were identified. These include representatives from financing institutions - both commercial and government.
The sampling strategy that was used is convenience sampling. This method, contrary to probability sampling was chosen because the sample space could be accurately identified; interviews depended on willingness and availability of respondents. This method can certainly introduce bias, making it difficult to generalise the findings of this research (Bryman & Bell, 2007).

At a high level the sample also needed to represent different key stakeholders that have participated in the structuring of BEE deals. These are people or organisations that provided insight in terms of what makes the financing aspect of the deal to work. The following stakeholders were identified for this research.

**Commercial banks.** They have been identified by Rose (2002, quoted in Ackermann & Meyer, 2007) as key lenders of money.

**Third party funders.** Although commercial banks are in essence third party funders, other lenders will also be interviewed. This includes merchant bankers, government funding institutions such as IDC and NEF, insurance companies and pension funds.

**Transaction advisors.** According to Jack (2007), these are the people that advise on how to make the BEE deal work. Their roles include advising on share buybacks, compliance with bodies such as the Johannesburg Stock Exchange (JSE) and determining the value and number of shares to be issued.

**Tax advisors.** Tax advisors assess the tax implications of the deal and advise on how the deal needs to be structured (Jack, 2007). According to Booysen & Bouche (2005) the structure of the BEE deal has an impact on the tax bill for both the black investor and the seller. A tax advisor will be able to shed light on how this impacts the financing of BEE deals.

Other financial services institutions such as Sanlam and Investec.

**Auditors.** The role of auditors is to examine and assess the financial effects of the transaction. They also ensure that the relevant accounting policies are adhered to in compiling the financial statements (Jack, 2007).

Academics have also been identified as stakeholders. They are included as people who may have done some research, particularly in the area of financing businesses.
4 RESULTS

4.1 Interview responses
In total, 8 interviewees responded. Of these, 3 were from the commercial banks, another three were academics and the other two were transaction advisors. In spite of a response rate of 42% (8 out of 18), the analysis of data indicated that common themes emerged from all the respondents. In particular 2 out of the 4 major banks in South Africa were represented. This is a similar response as in the study by Ackermann & Meyer (2007).

4.2 Summary of interview results
Below is a summary of the data that was collected from the interviews. The names of the respondents are withheld in order to protect their identity. Their role as stakeholders in financing BEE is indicated in order to put their responses into perspective.

4.2.1 Interview 1
_Type of stakeholder: Academic_
According to this respondent, the challenges in funding BEE are not unique to BEE but are applicable across all businesses. The main problems are that applicants do not know how to write acceptable and good quality business plans. In their business plans, the ideas put forward are not any different from other business ideas. This leads to copycat ideas to the extent that some people use templates without thinking their ideas through. The business ideas often have poorly thought out assumptions and marketing plans.

The other problem that was pointed out is that BEE investors do not know where to look for funding. There are no central places where people can easily get information. In some cases where information is available, it is often outdated. An example of this is that some of the now defunct funding institutions such as Ntsika Enterprises and Umsobomvu Youth Fund are still listed in some websites as though they are still in existence. In the existing funding institutions there is a problem that some of the employees are incompetent and inefficient. For an example when people make phone calls to these institutions, they go unanswered.

Legislation according to this respondent is seen to have played a positive role in making the accessibility of funds easier as there are plenty of funding institutions available.
In order to make BEE deals more successful they need to be based on viable business plans. Secondly the deal itself must be economically viable. There is also a need to have good mentors to assist BEE investors when they are given funds in order to help them improve their business skills.

4.2.2 Interview 2

Type of stakeholder: Academic

According to this respondent the failure to access funds by BEE investors is just a symptom of other underlying problems. This is not only an occurrence in BEE, but also in SMEs.

In the case of SMEs these can relate to overoptimistic market expectations, incorrect costing, poor management or any of a wide range of other factors that (negatively) influence the cash flow of a small enterprise.

Applying this to BEE deals, the simple answer is that many envisaged deals are poorly perceived or negotiated, superficially planned and not thoroughly costed. When banks or other potential financiers analyse their financing risks, they become cautious because their perception of the risks differs. The challenge is to address the other (“non-financial”) issues rather than to just ease the conditions of financial institutions.

This respondent was not well acquainted with different funding structures. However the respondent believes that a lot more attention needs to be given to staff becoming shareholders, mergers and acquisitions between BEE corporations and “white” firms as well as other (non-financial) ways in which blacks can get a stake in ownership and/or management.

The fact that financial institutions are currently more cautious to finance BEE deals may actually be a blessing since it dampens the over-optimism of deal funding of the recent past (where debt is to be funded by ongoing profits).

In some simple cases straightforward bank finance may be suitable, but in most cases the funding requirements will be far more complex and, therefore, financing processes and packages will have to be adapted and negotiated. It would seem unwise to expect simplistic “funding models” to be found and implemented in a mechanical way. At the same time, financial institutions should be expected to gradually pick up more experience in the planning and funding of deals.
4.2.3 Interview 3

*Type of stakeholder: Academic*

The challenges in funding BEE are that the structure of the deals requires BEE companies to take on long term debt which becomes a challenge to repay. Secondly it is difficult to structure the deal such that there are as many beneficiaries as possible. Lastly the current economic climate has made it difficult to get access to funding. This problem is not limited to BEE deals only, but applies to any business.

The problem with the funding structures is that a lot of them rely on dividends from preference shares for income. These dividends are then used to repay the debt. If companies cannot make profits, no dividends are paid out and as a result the BEE investors cannot repay their debts. The required interest on the debt in such cases results in investors getting into more debt as it accumulates interest.

Secondly, when the deals were set up they were based on certain market prices. The expectation is that the share price would increase. However the economic downturn has had an opposite effect where the shares are worth less than the buying price. In the meantime the debt has to be repaid on the original price. In some cases this results in BEE companies being technically bankrupt.

Legislation is seen as having created an enabling environment for BEE deals to be done. For instance the IDC gives loans at preferential interest rates. Legislation has also made it a strategic imperative to enter into a BEE deal as opposed to an add-on to the empowered company.

In order to make BEE deals more sustainable there needs to be a trend to make them more broad based. This way several groups will not require a lot of funds to enter into the deal as individuals. Small savers will be able to afford entering into the deals without taking on too much debt.

When deals are being evaluated there needs to be more focus on budgeting. Working capital and allowance for contingency needs to be built into the budget in addition to the funds that are required for equity. This is normal practice for running a business.
4.2.4 Interview 4
*Type of stakeholder: Transaction Advisor*

One of the challenges in funding BEE is the current economic crisis. This specific reason is not unique to South Africa as the economic crisis is a global problem. As a result of this problem banks are unable to give access to funds (to everyone, and not just BEE investors). Even if they do give access to funds this still comes at a high price.

The second challenge is that when BEE investors buy shares, it is at a certain price. If the share price decreases the value of their equity decreases. In spite of the loss of value, the investors still need to repay the original debt which was at the original share price.

One of the problems with the current funding structures is that initially businesses were not allowed by law to fund deals through debt. Subsequently new law was enacted to allow this subject to certain conditions. These conditions require companies to meet solvency and liquidity tests. Some companies cannot meet these requirements and as a result cannot fund deals from their own funds.

Stumbling blocks that BEE investors need to watch out for are the interest rates that they are offered in financing the deals as these may potentially make repayments high. They also need to ensure that they remain liquid so that they may be able to repay the loans. Lastly, BEE investors need to ensure that they can provide security for the loans that they require. In some cases they can pledge the shares themselves as security.

4.2.5 Interview 5
*Type of stakeholder: Transaction advisor*

The challenges in funding BEE deals stem from the fact that BEE companies often lack collateral or security for the loans that they require to fund the deals. Most structures are then linked to the share price of the equity being bought with the expectation that it will increase. Even if this does not materialise the bank as a funding institution can still call on the loan to be repaid.

The other problem is that interest rates that are charged on the loans are high. Often the interest on the loan needs to be repaid from dividends coming from share ownership. Often these dividends are not high enough to cover the interest payment and this does not include the capital that still needs to be repaid. This problem also becomes worse if profits decrease because that in turn decreases dividend payments.
The problem with the funding structures is that the asset cover ratio is too low. This means that the shares that are purchased need to be worth more than the funds requested. This is not the case and sometimes the share price decreases, making this ratio even less.

In order to make funding structures more sustainable they need to move away from loan type arrangements. An example of a practical solution offered by this respondent is that a BEE investor can buy a smaller number of shares for cash. The investor can then use dividend proceeds to buy more shares in cash over a longer time period. The BEE investor will also get full voting rights over these shares as they will not owe anything on them. This may be a problem in that it takes a long time to comply with the ownership element targets of BEE. However if there is debt owed on the shares, the BEE investor does not have economic rights in any case, so alternative scenarios have the same effect.

There are no major obstacles that BEE investors should look out for, but they should do due diligence on loan deals. A lot of applications for loans get rejected so investors usually take whatever deal is offered by financial institutions.

4.2.6 Interview 6
Type of stakeholder: Funding institution (investment bank)

There is no indication from this funding institution on how many loan applications are received or on the proportion of these that get rejected. This is because of the various entry points of applications where for instance large deals are processed through a Capital Markets division while smaller deals are processed through the Private Bank divisions.

The main reasons why applications for funding BEE deals are rejected is that applicants lack or do not have sufficient security to back up the loans. This, according to the respondent is the main challenge that is encountered when funding BEE transactions or BEE partners themselves.

The process that is followed when an application is received involves analysing the proposal with the parties. It is then discussed by various credit parties for approval. The funding application is only approved to the extent that it is economically viable. This is done through evaluating the business plan which is primarily what is assessed. However for individuals, credit history and security to back up the loans remain important factors. Factors such as industry and location are not
necessarily an issue that can hinder access to funding, but it is the growth profile of the company and the industry.

This organisation structures BEE deals such that most of the funding will come from the company so that BEE partners will have to use limited funds. The respondent believes that funding structures should rely less on vendor financing, but more on additional company assistance. In this way there will be less reliance on company performance to make the deal sustainable.

4.2.7 Interview 7
Type of stakeholder: Funding institution (Commercial bank)

In this institution there is no record of the number of application for BEE funds that is kept. However a large portion of these applications are turned down. The main reasons for rejecting the applications are lack of credible business plans, inappropriate structuring of the transaction and/or the consortium, lack of own funds by applicants and uncertainty of ability to conclude the transaction. The other challenge is that there is uncertainty on the markets due to its volatility.

This institution does not focus much on the credit history of the applicant unless it has had a previous negative experience with the applicant. Instead the bank focuses on the underlying investment that will generate cash flow for the BEE investor.

From this institution there is no preferred funding structure as there is acknowledgement that each existing structure has its own advantages and disadvantages. The institution itself has invested in a number of BEE companies. There are also focus areas that have been set up to assist in financing BEE and in advising BEE groups.

The factors identified in this interview that can contribute to more sustainable funding structures are increased equity applied to the transaction and longer time periods required to settle the debts. The longer time periods for settling debts are problematic though because that implies longer time to earn points for economic interest as per Codes of Practice.

BEE investors should be aware of obstacles such as lack of equity, lock-up periods, level of gearing, operational risk, interim cash flows and exit mechanisms when entering into a BEE deal. Lastly BEE investors should look out for factors such as history and nature of the business, ability to provide security, management, support from the target company, time period of the transaction,
debt repayment, structure of the investment and legal rights of the BEE company before entering into a deal.

4.2.8 Interview 8
Type of stakeholder: Funding institution (Commercial bank)

In this institution there is no indication of the number of applications for funding BEE deals that have been received due to the differing nature of the deals. Some funding issues pertain to lending to black companies, while in some cases a BEE deal may mean a white owned company buying into a black company. However the majority of applications are rejected. The main reason for rejecting applications is that the “risk versus reward balance” is skewed by the scarcity of equity by black investors. In essence the less equity as a percentage of total funding required the BEE investor has, the less likelihood that the application for funding will be approved.

The three main challenges that are encountered when financing BEE deals are the availability of equity by BEE investors, the appropriateness of the company being bought and the price at which the target company or part thereof is bought.

The entire process of assessing an application involves looking at the pricing of the deal. Secondly a study of the target company is done. This looks at factors such as operational history, growth strategy, sector analysis and the management team. This institution also gives access to funds based on credit history of the applicant. If the deal is considered to be good, preliminary approval is given after which any concerns regarding the deal are addressed. The deal is then taken through a committee for final approval.

Government legislation is not seen to impact the ease or difficulty in lending. However Financial Sector Charter is seen in the sense that it creates a need to provide funding for BEE. The National Credit Act is seen as an enabler for banks to conduct a thorough analysis of the deal before approval. The institution sees itself as a body that finances the deal against credit history as opposed to business plans. This is because its concern is more about how the loan will be repaid as opposed to how good the deal or business idea looks.

In order to ensure that deals are more sustainable, BEE investors need to conduct a thorough analysis of the companies that they want to buy into. This includes looking at the growth prospects of the company and the strength of the management team. Factors such as the sector in which the company operates are only important to the point that a good company to invest in should be a
growing company in a growing sector. BEE investors also need to ensure that the debt can be repaid. They also need to provide some of their own capital and ensure that they can repay the debt.

4.3 Summary of identified problems

The data that was collected is essentially a list of problems that have been identified to be the causes of lack of financing for BEE. The problems that were identified are listed in Table 2 below.

<table>
<thead>
<tr>
<th>NO.</th>
<th>PROBLEM</th>
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<tbody>
<tr>
<td>1</td>
<td>Lack of quality and acceptable business plan</td>
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<tr>
<td>2</td>
<td>Poorly thought out assumptions</td>
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<td>3</td>
<td>Lack of information on sources and requirements for funding</td>
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<tr>
<td>4</td>
<td>Incompetence and inefficiency from funding institutions</td>
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<tr>
<td>5</td>
<td>Economic crisis</td>
</tr>
<tr>
<td>6</td>
<td>Funding of deals at high share prices</td>
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<tr>
<td>7</td>
<td>Failure to meet solvency and liquidity tests</td>
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<tr>
<td>8</td>
<td>Lack of equity from BEE investors</td>
</tr>
<tr>
<td>9</td>
<td>Buying into poor investments</td>
</tr>
<tr>
<td>10</td>
<td>Inappropriate pricing of companies / deals</td>
</tr>
<tr>
<td>11</td>
<td>Inadequate / poor credit record</td>
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<tr>
<td>12</td>
<td>Preference shares do not carry voting rights</td>
</tr>
<tr>
<td>13</td>
<td>Lack of security or collateral to cover the loans</td>
</tr>
<tr>
<td>14</td>
<td>Insufficient dividends to cover interest payments on loans</td>
</tr>
<tr>
<td>15</td>
<td>Inadequate asset cover ratio against loans</td>
</tr>
<tr>
<td>16</td>
<td>Over-optimistic market expectations</td>
</tr>
<tr>
<td>17</td>
<td>Poor management skills by BEE investors</td>
</tr>
<tr>
<td>18</td>
<td>Poorly negotiated deals</td>
</tr>
<tr>
<td>19</td>
<td>Difference in risk perceptions on the deal</td>
</tr>
<tr>
<td>20</td>
<td>High interest rates on loans</td>
</tr>
<tr>
<td>21</td>
<td>Inappropriate structure of the transaction</td>
</tr>
<tr>
<td>22</td>
<td>Uncertainty due to market volatility</td>
</tr>
<tr>
<td>23</td>
<td>Decrease in share price due to economic climate</td>
</tr>
<tr>
<td>24</td>
<td>Poor history and growth prospects of company and industry</td>
</tr>
<tr>
<td>25</td>
<td>Profits and dividends have decreased</td>
</tr>
<tr>
<td>26</td>
<td>Dependence of transaction on share price</td>
</tr>
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The problems listed in Table 2 were then grouped into categories as shown in Table 3 below.

<table>
<thead>
<tr>
<th>NO.</th>
<th>CATEGORY</th>
<th>PROBLEMS IDENTIFIED</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Poor business planning</td>
<td>Lack of quality and acceptable business plan</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Poorly thought out assumptions</td>
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<tr>
<td></td>
<td></td>
<td>Lack of information on sources and requirements for funding</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Poor history and growth prospects of company and industry</td>
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<td></td>
<td></td>
<td>Inappropriate pricing of companies / deals</td>
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<td></td>
<td></td>
<td>Buying into poor investments</td>
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<td></td>
<td></td>
<td>Over-optimistic market expectations</td>
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<td></td>
<td></td>
<td>Poor management skills by BEE investors</td>
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<td></td>
<td></td>
<td>Poorly negotiated deals</td>
</tr>
<tr>
<td>2</td>
<td>Economic climate</td>
<td>Economic crisis</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Decrease in share price due to economic climate</td>
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<td></td>
<td>Uncertainty due to market volatility</td>
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<tr>
<td></td>
<td></td>
<td>Profits and dividends have decreased</td>
</tr>
<tr>
<td>3</td>
<td>Regulatory requirements</td>
<td>Failure to meet solvency and liquidity tests</td>
</tr>
<tr>
<td>4</td>
<td>Structure of BEE deal</td>
<td>Insufficient dividends to cover interest payments on loans</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Preference shares do not carry voting rights</td>
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<td>High interest rates on loans</td>
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<td></td>
<td>Dependence of transaction on share price</td>
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<tr>
<td></td>
<td></td>
<td>Inappropriate structure of the transaction</td>
</tr>
<tr>
<td></td>
<td></td>
<td>BEE companies struggle to repay long term loans</td>
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<tr>
<td></td>
<td></td>
<td>Funding of deals at high share prices</td>
</tr>
<tr>
<td>5</td>
<td>Creditworthiness BEE investor</td>
<td>Lack of equity from BEE investors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Lack of security or collateral to cover the loans</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Inadequate asset cover ratio against loans</td>
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<td></td>
<td></td>
<td>Inadequate / poor credit record</td>
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<tr>
<td></td>
<td></td>
<td>Difference in risk perceptions on the deal</td>
</tr>
<tr>
<td>6</td>
<td>Inadequate service from BEE</td>
<td>Incompetence and inefficiency from funding institutions</td>
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<td></td>
<td>investor from funding</td>
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<td></td>
<td>institutions</td>
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5 DISCUSSION

5.1 Creditworthiness of BEE investors

Business capital is made up of the owner’s equity and debt. One of the issues that have come out of the data collected is that BEE investors often lack both of these. This problem was mentioned by all the respondents from the financing institutions as well as one of the transaction advisors. According to one of the respondents, for institutions to be able to give finance for a BEE deal, the investor also needs to add some of their own capital. This exposes the BEE investor to risk as well and therefore makes them more diligent in conducting business as some of their money is at risk. According to Nulliah (2006) there is a perception that some investors are actually unwilling to add their own capital because of this risk even though they would like to get the rewards. Lack of adequate capital has resulted in commercial banks rejecting feasible applications for funds (Pretorius & Shaw, 2004). The lack of investors’ own capital then further creates a problem of highly leveraged businesses. It is apparent that one of the funding institutions avoids creation of a highly leveraged business as the respondent stated that if the BEE investor has less capital, the chances of a successful loan application are diminished.

The second part of this problem relates to the fact that a loan application needs to be backed up by collateral that the funding institution can claim in the event of default of payment. One of the respondents from the financing institutions stated that the asset cover ratio on the loan needs to be adequate, meaning that the asset pledged as security needs to cover the loan itself. The problem is that BEE investors often do not have sufficient, or in some cases not any, security at all. This problem has also been confirmed by Nigrini & Schoombie (2002) by stating that sometimes the collateral that is pledged to secure a loan is of less value to the bank when a forced sale is made. In essence the bank, as the institution that holds the security actually takes on additional risk by accepting collateral for the loan. The issue of lack of capital and security in South Africa can be attributed to the low levels of savings in the country. Kotzé & Smit (2008) found that the entrepreneurial levels in South Africa are the lowest when compared to other developing countries. The study also showed that this can be linked to the low levels of savings in addition to high debt levels. According to the study an average South African saves only 1% to 2% of their disposable income, while using 62.1% of disposable income on debt repayments. The low levels of saving mean that BEE investors often cannot raise enough capital of their own in order to start their businesses. The same conclusion can therefore be relevant when it comes to BEE financing as BEE investors struggle to finance the empowerment deals.
The third part of the creditworthiness problem is related to the actual credit history of the applicant. All three respondents from the funding institutions gave different answers about the role of credit history in assessing a loan. One of the respondents stated that the institution funds against credit history of the applicant. The second respondent stated that credit history is assessed if the application is by an individual but it is the business plan that plays a key role. The last respondent stated that credit history is checked if only the institution has had negative experiences with the applicant. This institution places more focus on the asset as it will generate cash flows. The study by Ackermann & Meyer (2007) states that commercial banks require BEE companies to disclose their historical financial performance as part of the process to assess the loan application. It is stated that even on a BEE company level, poor or no credit history can limit the success of a loan application. From this, it is clear that credit history can determine whether a loan can be granted to a BEE deal. Although this depends on the funding institution, it is clear that in some cases a distinction is made between a BEE company and an individual.

5.2 Poor business planning

It emerged from the interviews that a BEE investor needs to do a lot of upfront planning before embarking on a BEE deal. This practice is applicable to any other business. Some of the aspects that need to be studied are past financial performance, ability to assume debt, growth forecasts and quality of management. All of the respondents interviewed mentioned at least one problem that points to poor planning prior to setting up the deal.

One of the academics that were interviewed noted that the major challenge in funding BEE is that applicants cannot write good quality business plans. A respondent from a commercial bank also mentioned a business plan as a key element that determines the success of an application for financing a BEE deal. It was noted that the problem of poor business plans is not limited to just BEE, but it is a problem also in non-BEE businesses. However, a study by Radipere & van Scheers (2005) indicates that only 2% of small business owners surveyed in South Africa felt that they did not have adequate skills to write business plans. Interviews in this research reveal that in certain instances the business plans often have poorly thought out assumptions. Some of these assumptions are based on over-expectations on how well the market would perform. This problem was specifically stated by the academics and the transaction advisors that were interviewed. In the study by Pretorius & Shaw (2004) the view from the commercial banks is that in the business plans, the required funds are often underestimated, resulting in businesses reapplying for additional funds.

The skills required by BEE investors to ensure they can access finance for the deals is not limited to the skills of writing a business plan. It is also extended to the general management skills that they
possess. Lack of management skills was also cited as the reason why some investors fail to get funds for their businesses. The lack of management skills has also been mentioned as a cause of failure of small businesses in South Africa (Radinere & van Scheers, 2005). One of the respondents stated that it the BEE company has to have a good track record as a way of showing that they have good management. Ackermann & Meyer (2007) showed that the banks certainly look at the quality of management when they assess applications for funds.

Secondly, poor business planning has resulted in some BEE investors trying to make acquisitions in poor investments. This was a view that was expressed by an academic and a respondent from a financial institution. This problem is evident from the improper price of the target company being bought. It may also be as a result of a poorly negotiated deal which one academic stated as a problem. If a funding institution is of the view that the investment is not good enough, it may result in failure to access funds. It may also happen that a BEE investor tries to buy into a company that has poor growth prospects. This may also extend to the entire sector within which the company operates.

From the interviews it emerged that funding institutions may only favour certain sectors simply because they believe that there are more growth prospects. Makina & Malobola (2004) found in their study that the retail industry was the biggest beneficiary of all products and support services from Khula Enterprise from 1996 to 2001. An example is in their credit guarantee scheme for individuals where 34.5% of the beneficiaries were from the retail sector, followed by 14.7% in the manufacturing sector. The rest of the sectors each comprised less than 10% of the beneficiaries.

Thirdly, there is a problem that BEE investors do not know where to find information about sources of funding. As one of the academics pointed out, this problem is exacerbated by the fact that there are no central sources of information that are easily accessible for investors. In some cases the available information is outdated. This problem is also related to the problem of lack of quality service that is described in Section 5.6.

5.3 Economic climate

One of the identified problems that have contributed to the difficulty in accessing funds for BEE is that the accessibility of funds is related to the economic climate. This view was shared by three respondents that represent the academics, funding institutions and the transaction advisors. According to one of the respondents this means that banks are less willing to issue out credit to businesses because of the current economic climate. This problem is not applicable in the context of South Africa only but also applies globally.
This problem is also related to the issue that the economic climate at the time that several deals were put in place was favourable. There was therefore an expectation that the economy was going to grow further resulting in increased share prices. A similar trend has been observed before where according to Wolmarans & Sartorius (2009), the economic crisis of 1998 saw a reduction in BEE ownership decreasing from 7% to 2.2%. The reason given for this decrease is that the BEE deals had been highly leveraged and the share prices of these companies eventually decreased. Tangri & Southall (2008) make the same statement, adding that at the time of the 1998 crisis, the interest rates were also rising.

Secondly, there is an expectation that there would be a steady flow of dividend with which BEE investors would be able to pay off the debt. However the problem with this structure is that an economic downturn can result in dividends being reduced as companies try to preserve cash. In spite of this, BEE companies are still expected to pay the interest on the loans that were made.

5.4 Regulatory requirements

There were differing opinions on the impact of government regulations on the ease of access to funds. Four of the respondents indicated that the government has actually created an enabling environment for vendors to provide access to funds. One of the respondents from a funding institution felt that legislation has had no impact on the ease of accessing funds for BEE. This in essence means that the legislation does not have a negative impact on the ease of accessing funds.

South African law initially had some requirements that proved to be stumbling blocks in making the process of accessing funds easier. Initially, the Companies Act (1973) did not allow companies to provide loans to buy shares in the same company. However a new Companies Act (2009) allows the company to do so subject to satisfying the solvency and liquidity tests as described in Section 2.3.8. The problem that still inhibits access to funds for BEE is that some companies are still unable to pass the required liquidity and solvency tests in order to assist BEE companies financially.

According to a respondent from a commercial bank, the National Credit Act has made companies to be more thorough in assessing the creditworthiness of an applicant that seeks funds. According to a respondent from a commercial bank the act does not impact on the ease or difficulty in securing a loan.

The Financial Sector Charter has created a need to fund BEE. It does not mean that the institutions will fund unrealistic deals. The charter does not impact the ease of providing funds. The results
from Ackermann & Meyer (2007) also support this as they found that commercial banks did not have separate credit policies to cater for BEE. They further added that lending was based on sound lending principles that do not discriminate against any person in any basis. This also supports the view that the National Credit Act simply reinforces the requirements for banks to conduct a thorough check prior to lending.

5.5 Funding structure of the deal

The data that was collected indicates that the funding structure of the BEE deal is one of the key reasons why access to BEE funding remains a challenge. Seven of the eight respondents mentioned issues that are related to the funding structure as problems to accessing BEE funds. The case study of the Exxaro BEE deal (Fauconnier & Mathur-Helm, 2008) bears testimony to this as this was the main challenge that was found in implementing the deal. Other literature also points out several disadvantages of the funding structures that are available. It appears that none of the structures is perfect, but there are some problems that were commonly highlighted from both literature and interviews.

Firstly, long term loans as a source of finance have a problem that BEE business struggle to repay them. One of the reasons for this is that interest rates on the loans are usually high, as one transaction advisor stated. According to Finnemore, Darroch & Lyne (2004), this is more prevalent in the early stages of operation of companies. In addition, in the cases where the company relies on dividends to repay the loans, liquidity becomes a problem especially once profits fall due to factors such as economic crises. As the profits decrease, so do the dividends that are paid out to the BEE companies. If this problem continues unabated, BEE companies may end up being insolvent. At times the shares in the target company end up in the financier’s possession as these are generally pledged as collateral. This then defeats the whole point of empowerment.

Secondly, preference shares appear to be a popular form of financing. The problem with preference shares as pointed out in Section 2.3.11, is that they do not carry voting rights. If they are issued to the BEE company or investor, the empowered company can therefore not have any points on voting rights in the BEE scorecard. In some cases the BEE companies rely on the dividend proceeds from ownership of preference shares to repay the debts. In some cases the dividends are not enough to cover the loans.

Thirdly, according to four of the respondents, most BEE transactions are structured in a way that they depend on the increase in share price for them to be sustainable. As one respondent stated it, the deals are based on over-optimistic expectations. Some of the deals were actually completed
when share prices were high because of a good economic climate at the time. Failure to meet these expectations has caused some of the deals to fail as some share prices have decreased contrary to expectations.

5.6 Service from funding institutions

One of the problems that were apparent from the respondents is the fact that the funding institutions sometimes do not give sufficient information about the sources of funding. In fact this problem contributes to one of the issues that are discussed in Section 5.1, in that BEE investors struggle to find information on BEE funding. This problem has been mentioned (Nigrini & Schoombie, 2002) as one of those that is not necessarily limited to black businesses, but also extends to other small and medium enterprises. Netswera (2001) found that small business operators in Johannesburg rank access to information as the most important support system that is necessary to ensure the success of their businesses.

Secondly, one of the academics pointed out that BEE investors sometimes receive poor service from the funding institutions. This problem is evident from examples such as complaints about unanswered calls. Other examples include concerns about lengthy approval processes at IDC (Bwakira & Khumalo, 2004) and long times to process claims at Khula Enterprises (Pretorius & Shaw, 2004). As a result, some commercial funding institutions may be unwilling to issue out loans.
6 CONCLUSIONS

Although there are several challenges that make it difficult to access funds for BEE, there are a number of recommendations that emerged from the interviews and literature.

6.1 Recommendations

There is a need for black investors to improve their management skills. The study Radipere & van Scheers (2005) shows that even the small business owners believe that the lack of managerial skills can be a cause of business failure. One of the respondents pointed out that BEE investors do need skills and expertise to ensure sustainability of the BEE deal especially if the empowerment company runs the business. Another respondent added that in order to improve the sustainability of the funding structures, there needs to be good mentors that may assist BEE investors in ensuring the success of the BEE deals. Such structures are already available with the likes of the Khula Enterprise’s Thuso Mentorship Programme. Ackermann & Meyer (2007) also state that commercial banks make use of mentors as a way of mitigating the credit risk that they are exposed to when they lend to BEE companies. However BEE investors themselves have a responsibility to make sure that they make use of such programmes as Makina & Malobola (2004) found that mentorship schemes are not fully utilised in rural areas.

BEE investors also need to conduct due diligence studying the companies that they want to buy. This means conducting thorough business plans with realistic expectations and clearly thought out assumptions. Part of the plan needs to make provision for cash flows that will ensure that BEE companies are able to repay their debts. From the interviews it is clear that BEE investors need to study the business that they want to buy into as well as the industry it operates in. These are just two of the factors that would go into a comprehensive business plan that they need to compile. This will ensure that the deals that they enter into are economically viable.

It is clear that in order for an application for funding to be approved, the financing structure needs to be sustainable. For this to happen there needs to be a shift from structures that are too reliant on debt. The South African government in its BEE strategy had already pointed this out, even though it still appears to be a problem. As one respondent stated, the structure needs to be such that the BEE company has sufficient liquidity. To achieve this, structures such as those mentioned by Kingston & Chi une (2006) need to be considered where the BEE party invests in a cash generating asset as opposed to a listed equity. One of the respondents recommends that empowerment deals need to be more broad-based. If this happens even more people will be able to afford the funds for the deal.
This will then reduce the need for more debt to finance the deal. Another proposal from a
commercial bank respondent is to buy a smaller number of shares using cash. An investor can then
use dividend proceeds to buy more shares, again in cash. This method takes a longer time, but it has
an advantage of independence from debt.

There needs to be focus on educating the South African public about personal finances. According
to Kotze & Smit (2008) this will assist in helping South Africans manage their finances more
effectively and be able to save up enough capital to finance their businesses. The same can apply to
BEE financing as this problem is apparent to all types of businesses.

Funding institutions and other organisations that offer business support to BEE investors need to be
more visible as it has been shown that access to information is actually a stumbling block towards
good planning for small business. The same is applicable to BEE investors. The study by Netswera
(2001) has already indicated that this form of support in some cases is perceived to be even more
important than financial assistance.

6.2 Limitations of the research
The magnitude of this research can be wide as there are several BBBEE deals that have been put in
place. According to Thayser (2005, quoted in NULLiah, 2006) there were 238 BEE deals concluded
in 2005. Each of these deals may have had its own unique challenges when the financing structure
was put in place.

Secondly there may be several failed BEE deals that may not have been publicised that could
provide even better data as obviously the challenges faced would have been too great for the deal to
succeed. Data that has been collected for this research may possibly miss this.
7 REFERENCES AND BIBLIOGRAPHY


Department of Trade and Industry, 2007a, Codes of Good Practice on Black Economic Empowerment, Cape Town.


8 APPENDIX

8.1 Interview Question (All respondents)
What do you think are the main challenges that are being encountered in the financing of BEE deals?
What the problems do you think have been encountered by making use of the different funding structures for BEE?
How has legislation impacted the ease or difficulty in providing access to funds for BEE?
What can be done to ensure the sustainability of a funding model that is used?
What obstacles do you think BEE companies should look out for when applying for funding?

8.2 Interview Questions (Financial institutions)
How many applications for funding of BEE deals have you received since BEE started?
How many were approved and how many were rejected?
What were the main reasons for rejection in the majority of cases?
What challenges have you encountered when financing BEE deals?
What process do you follow when an application for funding is received?
How do legislations such as Financial Sector Charter and National Credit Act impact the ease or difficulty in providing access to BEE funds?
How important is a credit history as opposed to a business plan in providing funds to BEE companies?
What methods are being used by your organisation to help companies in accessing funds for BEE?
In what do factors such as industry and location play a role in the decision to provide funds for a BEE company?