What Avenues of External Financing are Available to South African Entrepreneurs?

MBA Full-Time 2010 Research Report

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This research report is not confidential, and may be used freely by the Graduate School of Business.

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**Introduction**

**Problem Statement**

Due to the current unemployment crisis in South Africa and the inability of the formal sector to provide employment to the growing number of job-seekers in the country, more and more South Africans are looking at entrepreneurial ventures in order to provide employment for themselves. However, South Africa ranks quite poorly in terms of entrepreneurial activity. Based on the Global Entrepreneurship Monitor (GEM) survey, which South Africa has been a part of since 2001, South Africa ranks 38th out of the 43 countries that took part in the survey in terms of new firm activity (Herrington, J. Kew, & P. Kew, 2008). Further to this, it is estimated that the failure rate of small, medium and micro enterprises (SMMEs) in South Africa is between 70% and 80% (Van Eeden, Viviers, & Venter, 2003).

Although there has been an increase in entrepreneurial activity in South Africa in recent years, there are still a number of challenges that are inhibiting would-be entrepreneurs from converting their good business ideas into start-up organisations. Among these challenges are the standards of education, cultural and social norms, access to financial and business support, the regulatory environment and government policies, and the lack of government support for small enterprises (Herrington, J. Kew, & P. Kew, 2009). Although I would like to briefly touch on some of the problems that are faced by South African entrepreneurs, the main aim of this report will be to look at the avenues of external financial support that are available to South African entrepreneurs.

In a survey carried out by the GEM, 50% of South African experts in the field cited financial constraints as a key constraint for entrepreneurial activity in South Africa, and 49% of global GEM experts agreed with this.

Access to finance has been noted by researchers in both developed and developing countries as a problem for entrepreneurs. Many entrepreneurs make use of their own funds in order to start their business ventures, rather than approaching financial institutions for support. Financial institutions generally require some sort of collateral and track record before approving loans. Given the fact that most South African entrepreneurs do not have
adequate savings to fund their start-ups, they are at a disadvantage when it comes to trying to get their own businesses going (Herrington, J. Kew, & P. Kew, 2009).

Small businesses and entrepreneurship play a vital role in stimulating economic activity, job creation, poverty alleviation and general upliftment of living standards, and given South Africa’s high unemployment levels and high levels of poverty, it is vital that entrepreneurship is encouraged in order to stimulate the economy and help to alleviate these problems (Van Nuuren, Groenewald, & Africa, 2007).

I have attempted to research what the different financing options are for South African entrepreneurs, as well as to find out what the requirements are from the entrepreneur’s point of view in order to access those finance through those options. I have also attempted to research why it is that access to finance appears to be such an inhibiting factor for South African entrepreneurial activity.

Research Questions

Research Question 1: What are the different options of financing available to South African entrepreneurs?

Research Question 2: What are the main challenges that South African entrepreneurs face when attempting to convert their entrepreneurial ideas into successful start-up companies?

Research Question 3: What are the institutional requirements for the different financing options that are available to South African entrepreneurs?

Research Question 4: What are the requirements for entrepreneurs to get financial assistance from non-financial institutions?

Objectives of the study

The objective of the study will be to research the different options that South African entrepreneurs might have in terms of financing their entrepreneurial ventures. I intend to outline the different avenues of financial assistance that are available through the different
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financial institutions, as well as the strengths and weaknesses of the various options from an entrepreneur’s point of view.

I will also attempt to outline the different types of financial support that are offered through non-financial institutions such as government initiatives and venture capital and private equity firms, private funding and angel investors. There are currently a number of government initiatives aimed at assisting entrepreneurial activity, such as Khula Enterprise Finance, Small Enterprise Development Agency, the Industrial Development Corporation and the National Youth Development Agency. One of the major problems with these initiatives is that there is little knowledge that they exist amongst those that require this sort of assistance, and they are also largely concentrated in urban areas, and particularly around Gauteng. Through this study, I hope to raise awareness of these initiatives so that entrepreneurs require financial assistance will be better positioned to take advantage of them.
Literature Review

What is Entrepreneurship?

There are ongoing debates about what actually constitutes entrepreneurship, but despite the varying definitions of entrepreneurship throughout the world, it is generally accepted that entrepreneurship is vital in any economy, and aids an economy’s ability to alleviate unemployment and the levels of poverty associated with unemployment (Herrington, J. Kew, & P. Kew, 2009).

The definition of entrepreneurship has somewhat evolved and differed over the years. In 1935, Schumpeter defined entrepreneurship as being seen as “…new combinations including the doing of new things or doing things that are already being done in a new way. New combinations include (1) introduction of new good, (2) new method of production, (3) opening of a new market, (4) new source of supply, (5) new organisations.” (Hitt, 2002). In 1985, Drucker defined entrepreneurship as “…an act of innovation that involves endowing existing resources with new wealth-producing capacity” (Hitt, 2002). For the purpose of this report, I will use the definitions of entrepreneurship that were offered by Low & MacMillan (1988) and Gartner (1988), which state that entrepreneurship is the creation of new enterprises or organisations, or the process by which these new organisations come into existence (Low & MacMillan, 1988; Gartner, 1988 cited in Herrington et al. 2009).

Financing Options for South African Entrepreneurs

Financial capital structure decisions for start-up businesses have important implications for the operations of the business, the risk of failure, performance and the potential of the business to expand. Subsequently, the choice of financing also has implications for the economy, given the fact that new business activity contributes to employment, competition, innovation and export potential (Cassar, 2004). There are a number of factors that
influence the financing decisions of entrepreneurs or owner-managers, including the firm owner’s attitude towards different types of debt and financing, culture, entrepreneurial characteristics, the entrepreneur’s prior experiences in capital structure, business goals, business life-cycle issues, preferred ownership structures, views regarding control, the age and size of the firm, and the sources of funds available for growth. Although these factors have been identified, there is little research that shows the relationship between these factors and the financing decisions of entrepreneurs. However, firms that are smaller with more family control, little business planning and unclear business objectives have been shown to be more associated with debt financing, while larger firms or firms with high growth potential have been more associated with equity financing (Romano, 2001).

For the purpose of this report, I will be looking at the predominant options of financing that are available to Entrepreneurs: Bank financing, angel investors, micro-finance organisations, venture capital and private equity firms, private funding and government funding and grants. However, the list of financing alternatives available to entrepreneurs is far more extensive than this. One of the reasons that there are so many options available is that the different providers of funds have different objectives, capabilities, and constraints when it comes to issuing funds. Some lenders, such as banks, are looking for low-investment, low-risk investments, while others, such as angel investors, are looking for higher risk investments with more involvement for medium to long-term durations. Another reason for the vast number of financing alternatives for entrepreneurs is that different businesses have different financing needs. For example, one business may be in a position to offer good security or collateral when it comes to seeking finance, assuming most of the risk, which is suited to the types of lending that banks have to offer, while others may require the lender to assume a lot more of the risk associated with the business, such as with venture capital investors (J. K. Smith & R. L. Smith, 2004).

The size of the business also has an influence on the capital structure of the start-up. Larger start-ups generally require more financial assistance in the form of debt, long-term debt, and other means of external financing. Another factor that affects the source of funds for lenders is their intent for growth of the new business. Business owners that expect high levels of growth are more inclined to seek financial assistance from banks in order to establish credit relationships as early as possible with these types of firms. The nature of a
firm’s assets also influences the source of funds. Firms with more tangible assets are more likely to secure loans through financial institutions such as banks, while firms with fewer tangible assets tend to be financed through less formal means (Cassar, 2004) such as venture capital, private equity or angel finance.

**Bank funding**

Obtaining credit from banks is not as easy as it used to be a few years ago, where the bank’s decision to lend you money was often based on the quality of your relationship with your bank manager. Nowadays, applications for finance through banks are sent to a central credit division, where the decision as to whether or not the loan is approved is often made by a computer. There is very little human intuition in the decisions that go into granting loans to potential entrepreneurs, based on things like the strength of their business plans or the individual’s track record in business. When assessing potential candidates for loans, the banks have certain criteria that they look at, such as profit to turnover ratios, in order to determine whether or not the business will be successful. The banks want the potential business to be viable and they want the borrower to be able to repay the loan. Even if a potential borrower has enough collateral to cover the loan, banks will often refuse loans based on those criteria that they look at in assessing the loans. There are two main reasons for this: firstly, it is expensive for the banks to claim the borrower’s assets and liquidate them in the case of default, and secondly, banks don’t want to be seen as taking assets away from people whose businesses have not been as successful as initially thought (Terblanche, Moeng, & Macleod, 2008).

There are a number of different ways that entrepreneurs can obtain finance through banking institutions. They all differ in terms of the size of the loan, the fees associated with the loan, the methods of repayment and the collateral that is required in order to obtain those loans (Terblanche, Moeng, & Macleod, 2008).

- An ordinary business loan is probably the best suited option for financing a new venture, provided the entrepreneur meets the requirements in order to secure such
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A loan. These loans are generally medium term loans, with a payback period of between two and seven years. Because the terms of the loan are agreed upfront, this can assist the entrepreneur with his/her future cash flow management. This also secures the funds for the entrepreneur for the agreed period of time, unlike an overdraft facility that can be cancelled at any time on short notice. Business loans are suitable for most applications to do with the business, from setting up a new business to growing an existing business through capital expenditure, or even to set up a new branch of an existing business (Terblanche, Moeng, & Macleod, 2008).

In order to secure a business loan, an entrepreneur – or anyone for that matter – would need to offer some sort of collateral, which would usually come in the form of fixed assets or possible insurance. The banks are not too concerned about how the business will do in the future, but rather whether or not they will be able to repay their loans. Banks also generally require a thorough business plan with an application for this type of finance. They are really only concerned with five main criteria: What type of business the finance is required for, how much is required, when are the funds needed, how long will they be needed for, and how will the borrower repay the funds. In South Africa, it is very rare for banks to offer business loans to start-ups, and if they are offered, they need to be accompanied by substantial collateral and surety (Herrington, J. Kew, & P. Kew, 2009).

- An overdraft facility can be offered by the bank in order to finance fluctuations in sales or working capital during normal operations. The limit to this facility is calculated automatically based on the candidate’s credit rating. An important point to note is that an overdraft facility is not designed to be used for starting a new business or expanding an existing business through capital expenditure on things like new machinery, or for paying salaries, but rather only to deal with the fluctuations that occur in a business’s financial needs during the normal course of business. Under special circumstances, a business may apply for a larger overdraft limit, but the request needs to be backed up with some sort of collateral. Although an overdraft facility is quite straightforward to attain, provided the business or individual has a good track record, there is the risk, although it is unlikely to happen, that the bank can cancel that facility at any time due to an increase in business or
industry risk and recall the outstanding funds within a short time period (Terblanche, Moeng, & Macleod, 2008). Another downside to using an overdraft facility is that the interest rates on this type of lending are relatively high in comparison with other types of bank lending.

- Another option for an entrepreneur to obtain finance from a bank is through an extension of an existing home loan. This is a lot simpler to get, as the banks will not require a business plan for this type of loan, however, they will require that the entrepreneur will be able to afford larger bond repayments (Terblanche, Moeng, & Macleod, 2008). It may not be in the entrepreneur’s best interests to finance a new venture in this way, as the lack of a business plan may lead to oversights in the future business that might have been picked up had there been one.

- Businesses owners can also use asset finance in order to fund plant and equipment that may be required in order to start a new business or grow an existing one. One of the benefits of asset finance is that the asset that is being financed is usually used as collateral, so the business owner does not need to offer other forms of collateral as with other types of loans. Asset finance can occur in many different forms, such as hire purchase or leasing. A business owner needs to assess the pros and cons of each type of asset financing that is available with regard to things like tax implications in order to choose the best option for his business (Terblanche, Moeng, & Macleod, 2008).

One of the key advantages for entrepreneurs when financing their ventures through bank loans is that they remain in full control of their businesses, offering sufficient incentives to make the business a success (Debettignies & Brander, 2007). However, there are a number of requirements that the financial institutions have that make it extremely difficult for a large number of entrepreneurs to obtain finance through this avenue. Banks generally require a solid business plan before offering credit to entrepreneurs, and this can be difficult for some of the smaller entrepreneurs to produce. They also require collateral, which puts bank loans out of reach for the majority of smaller entrepreneurs in the informal sector. Borrowers also need to have a good credit record, as well as a good track record in business, which can take some time to achieve, making it difficult for young entrepreneurs to get access to finance from the banks.
Micro-Finance

Micro-finance is a relatively new phenomenon in South Africa, especially as a formal means of borrowing. Prior to 1992, there were very few options available to individuals who wanted to borrow relatively small amounts of money, so these individuals would seek financial assistance from pawnbrokers or other informal operators (Herrington, J. Kew, & P. Kew, 2009). Banks do not offer micro-finance for a number of reasons. The micro-finance industry is generally aimed at the informal sector, and the risks associated with lending in this sector are generally far greater than the risks of lending in the formal sector. Schoombie (2000) outlines the following as factors contributing to the lack of interest from the formal financial sector in lending to the informal sector:

- The risk of default is far greater when lending to the informal sector
- The costs associated with lending in the informal sector are higher than those associated with the formal sector. As an example, the screening process can be far more complicated when lending money in the informal sector to individuals who cannot give any collateral
- Banks generally face low returns when dealing with the informal sector
- Other problems that the formal lending sector faces when dealing with the informal sector, such as socio-economic, language and cultural barriers

Because of their apparent unwillingness to operate in the informal sector and to supply micro-finance to entrepreneurs, banks have come under increasing pressure to change how they operate (or to start operating) in this sector. However, the banks have responded to the increasing criticism by indicating that they need to satisfy the needs of their debtors and shareholders, and their business models do not allow them to operate in the informal sector without letting down either of these parties. They argue that the returns that they generate from those markets do not meet their needs, and further that the conventional banking methods are not suited to lending in the informal sector (Banking Council, 1998).
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The Usury Act Exemption Notice of 1999 has somewhat impacted the micro-lending industry in South Africa for the better. Since its inception, there are a number of new trends in the micro-lending industry: it is becoming increasingly formalised; there are a number of new players in the industry; and the total amount of formal investment from the micro-lending industry is increasing (Herrington, J. Kew, & P. Kew, 2009). There are now a number of non-profit as well as for-profit organisations operating in the micro-lending industry in South Africa, and entrepreneurs that are failing to obtain finance from the major banks due to not meeting the qualification criteria are increasingly turning to these micro-financiers.

Angel Finance

The concept of a ‘business angel’ was developed in the US, and describes an individual that invests in a business that other lenders will not go near. These business angels usually decide to invest on the basis of some relationship with the entrepreneur, such as family or a friend, or on a recommendation from a trusted source that knows the entrepreneur. Although business angels have been around for some time, it is only recently that they have been recognised as a phenomenon in terms of business finance, together with the fact that the banking system is being recognised as inappropriate for business start-up finance. In South Africa, government recognises the importance of these investors by offering tax breaks to angel investors (Terblanche, Moeng, & Macleod, 2008). The main difference between angel investors and venture capitalists is that angels tend to be individuals, or part of a group, while venture capital comes from a venture capital company that may place a full-time manager in the firm that they wish to invest in (Herrington, J. Kew, & P. Kew, 2009).

Angel financing has evolved somewhat since it was first recognised, and an ‘angel’ now refers to anyone that invests his or her money in an entrepreneurial venture. The amount of angel investing has increased drastically in recent years due to the increased number of individuals looking to get better returns on their investments than they would from traditional investment vehicles. Angel financing can be classified into two broad categories: affiliated and non-affiliated. Affiliated angels are those that have had some sort of contact
with the entrepreneur or the entrepreneurs business, while non-affiliated angels are those that have no connection at all with the entrepreneur or the business (Entrepreneur Magazine, 2010).

In terms of affiliated angels, Fairchild (2009) suggests that Angel investors tend to be unsophisticated, and are not able to offer the same sort of value of managerial assistance to a firm that a venture capital investor is able to. He further suggests that investors tend to enjoy a more informal relationship with their entrepreneurs based on trust and empathy. These agreements are often set up on mutual trust between the entrepreneur and financier (Fairchild, 2009). Furthermore, some angels seek investment opportunities purely for the sake of helping others with their entrepreneurial activities, and are not necessarily driven by the need for high returns on their investments (Entrepreneur Magazine, 2010). They may also be seeking non-financial returns, such as job-creation in areas of high unemployment, the development of technology that meets social needs, or even just the personal satisfaction of helping entrepreneurs (Herrington, J. Kew, & P. Kew, 2009).

Fairchild (2009) offers two reasons why entrepreneurs may seek financial assistance from angel investors over other types of financiers. Firstly, the entrepreneur-angel empathy that exists between the entrepreneur and the angel is an attractive quality as it promotes mutual trust, and reduces the risk of the double-sided moral hazard problems that may arise during the development of the firm that may be more prevalent with other types of financing. Secondly, the empathy means that the entrepreneur has feelings for the angel, which further induces the entrepreneur to choose the angel over different financing options (Fairchild, 2009). However, it is important that entrepreneurs take economic and behavioural factors into account when choosing whether or not to make use of angel financing. If entrepreneurs make financing decisions based purely on their relationships with angel investors, they may be missing out on opportunities such as the value and managerial support that they can get by getting finance from a venture capitalist (Fairchild, 2009).

Herrington et al. (2009) suggest that most South African angels tend to be non-affiliated, and thus have no prior relationship with the entrepreneur. They therefore take an objective approach to investing in these entrepreneurial ventures, and tend only to invest where they
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can offer their skills and experience. These angels take a more hands-on approach to their investments, and add value by giving advice to the entrepreneur until their business is established.

There are a number of advantages associated with angel financing. From an investor’s point of view, the South African government offers a tax break for angel investors, which is good motivation for these individuals to invest in entrepreneurial activity (Terblanche, Moeng, & Macleod, 2008). These investors also often invest for good personal reasons as well as financial reasons, so it is in their best interest to offer the best advice to management in order to make the venture a success, and this advice is generally given free and willingly (Herrington, J. Kew, & P. Kew, 2009). Another major advantage is that because the financing is given by individuals, there is often less pressure for them to exit the venture in a certain timeframe as they are willing to wait longer for the returns on their investments than other lenders such as banks (Entrepreneur Magazine, 2010; Herrington, J. Kew, & P. Kew, 2009).

There are also a number of disadvantages that entrepreneurs need to be aware of when looking at raising capital from angels. In order for the investors to receive the tax break from the South African government, they need to take an equity stake in the business, so it is important to negotiate an exit strategy with the investor up front (Terblanche, Moeng, & Macleod, 2008). These investors will also often want a say in the business, so the entrepreneur needs to relinquish part of the control of the venture. Another downside to obtaining finance through angel investors is that should the venture require further funds for growth at a later stage, the funds may also be limited to what the angel has available or is willing to invest further (Herrington, J. Kew, & P. Kew, 2009).

Venture Capital and Private Equity

Venture capital is defined as money that is earmarked for investment in a new business. The money does not enter the new business as a loan that needs to be repaid, but rather it is given to the business in return for shares in that business. When a venture capital firm invests in a business, a member from the venture capital firm generally sits on the board of
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the new business. The new business usually has between three and seven years to use the money invested by the venture capitalist to grow the business. Once that period is over, the venture capital investor exits the business through one of two main ways: it either sells its shares to the original business owner or to another investor, or it converts the share value into a loan which the business needs to pay off over a set period of time. Venture Capitalists usually require a minimum of 30% annual return on investment (Terblanche, Moeng, & Macleod, 2008).

Venture capital is a major source of funding for entrepreneurs. They tend to focus on early stage and higher risk opportunities, in return for which they demand relatively high rates of return (Deventer & Mlambo, 2009; Herrington, J. Kew, & P. Kew, 2009). With venture capital financing, the entrepreneur must surrender partial ownership of the business, thus diluting the incentive of the entrepreneur to put in the required effort to make the venture a success (Debettignies & Brander, 2007). In comparison with bank financing, the criteria for obtaining venture capital finance are somewhat different. Venture capitalists base their decisions on both quantitative and qualitative methods of evaluation. With limited revenue and performance data available for start-up firms, purely quantitative methods of evaluation are less effective than for an established business. Venture capitalists also look at factors such as the entrepreneur’s personality, his integrity and previous experience when evaluating investment decisions (Deventer & Mlambo, 2009).

In a study carried out in 1985, it was found that five out of the top ten characteristics that were used to evaluate venture capital opportunities in the United States had to do with the entrepreneur’s personality and experience, and that other criteria such as their business plans were of relatively low importance when making their decisions. This is not to say that a business plan is not required, but rather that it is necessary, but not sufficient. A business plan must indicate to a potential venture capitalist that the entrepreneur and his ideas have potential in the marketplace (Macmillan, Siegel, & Narasimha, 1985). In a similar study carried out in India in 2004, it was found that although the investment criteria in India were different to those in other countries, the entrepreneur’s personality and experience were found to be the main focus point for investment decisions (Mishra, 2004).

Venture capital financing provides a relatively small portion of entrepreneurial finance, and is quantitatively less important than bank financing. Furthermore, venture capital funding is
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generally concentrated in a few industries such as software, telecommunications and biotechnology. In the US in 2005, 22% of all venture capital funds invested went into software firms, and another 17% went into biotechnology, which contribute less than 3% and 2% respectively to GDP. On the other hand, industries such as retailing and distribution, which accounted for 13% and 18% respectively to GDP, only received trace amounts of venture capital financing. The reason for this is that venture capitalists generally have more specialised industry knowledge in these areas, while they have very little knowledge in other sectors, and they tend to operate in firms where they can offer significant managerial input (Debettignies & Brander, 2007).

A key advantage to obtaining venture capital financing is the ability to get managerial contributions to the firm (Debettignies & Brander, 2007; Fairchild, 2009).

One of the downsides in obtaining finance through venture capital is that because the firm hands over partial ownership and control of the firm, the entrepreneur in less incentivised to put as much effort into making the firm successful had it been wholly owned by the entrepreneur (Debettignies & Brander, 2007).

De Bettignies and Brander (2007) offer three main managerial implications associated with venture capital financing. Firstly, from the entrepreneur’s point of view, venture capital funding is most beneficial when the entrepreneurial venture lies within the venture capitalist’s area of expertise, and they can gain the most from the venture capitalist’s managerial input. In this instance, an entrepreneur may also want to offer a higher equity stake than the minimum required to the venture capitalist in order that they may be more incentivised to contribute to the success of the venture. Secondly, from the venture capitalist’s point of view, the key to good performance lies with a firm’s ability to generate returns over and above the competitive normal rate of return. This will incentivise the venture capitalist to offer significant value to the venture through its proprietary managerial skills, thereby increasing the firm’s likelihood of success. Finally, it is important to understand that a venture capitalist is likely to do better if it can avoid investments where the entrepreneur’s input is highly important. In order for venture capital investments to be successful, the venture capitalist needs to have a high enough equity share to have appropriate incentives. However, this equity share will necessarily dilute the entrepreneur's
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incentive to provide appropriate effort and will also create potential problems or conflicts arising from the entrepreneur's loss of control. If the entrepreneur is crucially important to the venture, then these costs are much more significant than if the entrepreneur is less important to the venture's success (Debettignies & Brander, 2007).

Private equity is similar to venture capital in terms of its operating mechanisms. However, the businesses that private equity firms invest in are quite different to those that venture capitalists invest in. Private equity firms generally don’t invest in new businesses, and they also tend to invest in larger businesses than venture capitalists. They look for steady businesses, and are often involved in management buyouts (MBOs) of medium to large businesses, mergers and corporate Black Economic Empowerment (BEE) deals (Terblanche, Moeng, & Macleod, 2008).

In terms of venture capital and private equity funding, the chances of getting this sort of funding is extremely slim. In South Africa, a typical private equity or venture capital fund will only finance around three of four investments per year. As a sign of South Africa’s distrust in its entrepreneurs and their ability to succeed, in 2001 there was R8.4 billion worth of private equity and venture capital funding available for investment, but only R1.5 billion was put to use. Even if an entrepreneur has a solid business plan with a good business concept, the chances of getting finance through a private equity or venture capital fund is extremely slim (Terblanche, Moeng, & Macleod, 2008).

Government Funding and Grants

Prior to 1990, the government’s view towards small, medium and micro enterprises (SMMEs) in South Africa was that they should be supported purely for social reasons as a means to provide opportunities for employment in the informal sector. Because of this, the sector was marginalised and no effort was made to bring these SMMEs into the mainstream economy. However, since 1994, the new government of South Africa has chosen to adopt a strategy of development, and has encouraged the integration of SMMEs into the mainstream economy for their ability to contribute to economic growth, reduce unemployment and help to alleviate poverty (Herrington, J. Kew, & P. Kew, 2009).
then, the SMME sector has grown significantly. In 1996, around 19% of people employed were in the informal sector, but by 1999, this figure had risen to about 26% (Southafrica.info, 2010). Between 2004 and 2007, the SMME sector grew by 27%, which was predominantly made up of the growth of medium sized enterprises which grew by 208% (Herrington, J. Kew, & P. Kew, 2009). The current data on SMMEs suggests that this sector contributes about 50% of the total employment in South Africa, and accounts for about 30% of GDP. In addition to this, one out of five units exported from South Africa is produced in the SMME sector. In order to achieve this, the government has paid specific attention to the SMME sector through increased investment in a number of different ways, ranging from supportive legislation to a variety of funding institutions and government incentives to promote this sector through the Department of Trade and Industry (DTI) (Southafrica.info, 2010). The government has backed a number of institutions aimed at supporting SMMEs and offering financial assistance, such as Khula Enterprise Finance, Ntsika Promotion Agency, the Youth Commission, Umsobomvu Youth Fund and the National Empowerment Fund. Several of these have proved to be unsuccessful, and a large amount of restructuring has taken place in recent years (Herrington, J. Kew, & P. Kew, 2009). Today there are a number of government-backed institutions aimed at helping entrepreneurs to finance their businesses, such as Khula Enterprise Finance Ltd, the National Youth Development Agency and the National Empowerment Fund.

The South African government also offers support to entrepreneurs in the form of non-repayable Grants and Assistance Programs. Most of these Grants are aimed at manufacturing and tourism industries, as well as innovative R&D product development projects in South Africa. The difference between these grants and other types of government funding is that the grants don’t need to be repaid, but there is a huge amount of paperwork that goes into getting the grants approved. They have strict guidelines for applying, and the agencies that offer grants usually have a specific goal in mind that they are trying to achieve, such as job creation or providing specialised training to specialised groups (Entrepreneur Magazine, 2010b).

**Literature Review – Conclusion**
What Avenues of External Financing are Available to South African Entrepreneurs?

As outlined earlier in this document, the formal sector in South Africa is unable to support the growing numbers of individuals seeking employment. For this reason, a growing number of South Africans are looking to provide employment for themselves through entrepreneurial ventures.

One of the key challenges in getting an entrepreneurial venture going is an entrepreneur’s inability to obtain start-up finance. Through this research report, I hope to outline the main avenues of finance that are available to South African entrepreneurs, and to offer a framework for the different types of entrepreneurial ventures when it comes to seeking external financial assistance.
Methodology

Data Collection

In order to answer my research questions, I have made use of both primary and secondary data. The primary data was gathered in the form of in-depth, open-ended interviews with industry experts, as well as in-depth interviews with representatives from the business lending departments of the commercial banks (Leedy & Ormond, 2010). Further primary data was gathered from the various websites of the lenders and investors, and where the information offered on these websites was insufficient, further telephonic interviews were conducted with those organisations. Data was also gathered from the lending organisations’ brochures that they have available for potential borrowers.

The secondary data that was used was gathered from books, journals, and the results from surveys that have been conducted on the subject of entrepreneurship in South Africa.

Research Question 1: Different Financing Options

In order to answer this question, I used secondary data in the form of an in-depth literature review, gathering information from sources such as books, journals, government publications and internet websites (Leedy & Ormond, 2010). Primary data was also gathered from industry experts as well as individuals that work in the field of entrepreneurial finance. The primary data was gathered in the form of in-depth, semi-structured interviews (Leedy & Ormond, 2010). The reason for using this type of interview was that the question had already been partly answered through the literature review before the interviews were conducted. Certain questions could then be asked based on the findings from the literature review, with the freedom to ask further tailored questions that might arise from the findings of the interviews. The questions asked were also open-ended in order to give the interviewees the freedom to give their views beyond the questions that were being directly asked (Leedy & Ormond, 2010), as well as giving the interviewees an opportunity to share some specialised insights that they may have (Hair Jr., Money, Samouel, & Page, 2007).
What Avenues of External Financing are Available to South African Entrepreneurs?

Three in-depth interviews were conducted with individuals as outlined below:

- Interviewee 1 is the director for the UCT Centre for Innovation and Entrepreneurship at the Graduate School of Business. He is also on the board of the Global Entrepreneurship Monitor (GEM), the most authoritative and comprehensive study on entrepreneurship in the world today (Graduate School of Business, 2009).
- Interviewee 2 is a Founding Partner and the Chief Investment Officer of a South African investment management and advisory firm that focuses on private equity and expansion capital into established businesses as well as development and venture capital into early-stage ventures.
- Interviewee 3 is the Senior Transactor at a South African investment firm that focuses on South African investments in the telecommunications, media and technology sector, as well as in the rest of African and the Middle East.

Once these initial interviews had been completed, I was then able to do further, more in-depth research into the different broad categories of entrepreneurial finance that we discussed, those being commercial banks, micro-finance, private funding, private equity and venture capital, angel investors and government funding.

Research Question 2: Challenges Facing South African Entrepreneurs

In order to answer this question, I used secondary data in the form of survey results and journals articles that have been written on the subject. The reason for using this type of data is the fact that meaningful primary data would have been difficult to obtain in the limited time frame and using a limited sample size to gather primary data would have possibly ‘given an incomplete picture of the phenomenon in question’ (Leedy & Ormond, 2010), while the secondary data that was used was based on large enough sample sizes to offer meaningful results.

I have attempted to use data that looks at the challenges of South African entrepreneurs from two different points of view: the first is from an ‘industry expert’s’ point of view, and the second is from an entrepreneur’s or business owner’s point of view.
What Avenues of External Financing are Available to South African Entrepreneurs?

The ‘industry expert’s’ point of view data was gathered from the results of an annual survey that is carried out by the Global Entrepreneurship Monitor, in which a panel of experts, both local and international, are asked to rate South Africa’s entrepreneurial environment based on a number of different factors.

The data that was used to get an idea of the challenges from an entrepreneur’s point of view was gathered from journal articles that have been published based on the results of surveys that have been carried out with entrepreneurs and small business owners.

Although analysing all the challenges that South African entrepreneurs are faced with is beyond the scope of this research report, my main objective for collecting and analysing this data was to find out whether or not access to finance is a major driving factor for the fact that entrepreneurial activity is low in South Africa relative to other countries.

**Research Question 3: Institutional Requirements for Raising Capital**

The main data used to answer this question is primary data gathered from the financial institutions. This data was collected in the form of in-depth interviews with individuals at the financial institutions in the business lending departments, as well as through sifting through the information that is available in the financial institutions’ websites.

In order to collect data from the commercial banks, each of the ‘Big Four’ banks was interviewed in this manner. Capitec Bank was also contacted; however they do not offer business or entrepreneurial products. The reason for this format of interviews is that they usually take the format of unstructured, one to one discussions, where the interviewee is chosen for their specialised insight in the industry. It also allowed me to do further probing, going deeper into any responses that the interviewee might give to find any hidden reasons for particular responses by, for example, using the five-why’s technique. In-depth interview participants are also more likely to discuss sensitive issues and give more honest answers than if they were with a group of co-workers (Hair Jr., Money, Samouel, & Page, 2007).

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1 Nedbank, ABSA, Standard Bank and First National Bank
What Avenues of External Financing are Available to South African Entrepreneurs?

Additional data was gathered by looking at the financial institutions’ websites, as well as brochures or other information sources that these institutions have regarding their lending policies.

For the micro-lending institutions, I used secondary data that was gathered from the micro-lenders’ websites (Leedy & Ormond, 2010). The reason for using this method of data collection was that during the preliminary research and literature review, I found that the micro-lenders’ websites were quite comprehensive in terms of information that is available to potential borrowers on what types of products they have to offer, as well as what their lending requirements are.

The data that I gathered from the financial institutions can be broken down into three main categories:

- What are the different options for getting financial assistance from financial institutions?
- What are the criteria for individuals wishing to obtain finance for entrepreneurial ventures?
- How are potential candidates evaluated as to whether or not their ideas are suitable for financial loans?

In addition to this, I attempted to find out from the financial institutions about individuals that had applied for financial assistance, but were turned down. It was difficult to gather any statistical data on this subject; however some of the interviewees were able to offer some general information as to why individuals get refused finance.

Research Question 4: Non-financial Institution Requirements for Raising Capital

Non-government institutions

In order to answer this question, I gathered primary data by conducting interviews with experts in the fields of entrepreneurial finance and private equity and venture capital. During the interviews with Interviewee 1, Interviewee 2 and Interviewee 3, I went into more
What Avenues of External Financing are Available to South African Entrepreneurs?

detail on these types of financing options for entrepreneurs (private equity and venture capital, angel finance and private funding). I attempted to find out what the different financing options are through the different types of non-financial institutions, as well as what these institutions were looking for in terms of investment opportunities.

In addition to this, I used primary and secondary data that was gathered from the South African Venture Capital Association (SAVCA) website, which has listings of all the major venture capital and private equity players in South Africa. SAVCA also conducts surveys each year with its members to determine, amongst other things, the general sentiment towards investing in entrepreneurial ventures. The results from two of the latest surveys were used as secondary data.

Government institutions

For the government institutions that offer financial assistance to South African entrepreneurs, I used primary data that was predominantly collected from the institutions’ websites, as well as from telephone interviews with the institutions. While conducting the preliminary research and literature review, it became apparent to me that the government institutions that offer finance do have a comprehensive amount of information available on their websites from entrepreneurs looking to get finance, both in terms of products that they have available and in terms of the lending requirements. Where there was insufficient information available on the institutions websites, they were interviewed telephonically in order to gather the outstanding data. Telephonic interviews were conducted with the following institutions:

- The Industrial Development corporation (IDC)
- The National Youth Development Agency (NYDA)
- The National Empowerment Fund (NEF)

Data analysis methods
What Avenues of External Financing are Available to South African Entrepreneurs?

As with any qualitative research, there is no single ‘right’ way to analyse that data that I gathered for this research report. I started off with a large body of information, and through a process of inductive reasoning, sorted and categorised the data in an attempt to boil it down to a small set of underlying themes (Leedy & Ormond, 2010).

Creswell (1998) offers a framework for analysing qualitative data and getting from a starting point, where the researcher has a large amount of raw data, to the final report, where the data has been organised and synthesised into a format that draws out key themes and presents them in a manner that is suitable for the reader. Using this approach, the researcher goes through the data several times, using the following steps:

- First the data needs to be organised. This means taking the large body of raw data and breaking it down into smaller sections, and then organising those sections through a proper filing system or cataloguing system.
- Secondly, the entire data set needs to be studied several times to fully understand all the information that is contained within each section of the data. During this process, an attempt was made to categorise the data into various categories or themes.
- Once I had been through the data thoroughly a few times, I could properly categorise all of the data into categories and sub-categories, putting all the relevant data for each category together. By this stage, I started to get a sense of what all the data meant.
- The fourth step in the process is to integrate and summarise all the data, and to put it in a format that is suitable for the reader. This step offered relationships and differences between the different categories, as well as helped to identify trends in the different financing options for entrepreneurs through the various financing avenues.

Using this methodology, I have attempted to outline the different financing options that I feel are suitable for South African entrepreneurs, as well as the strengths and weaknesses associated with each.
Limitations of the study

The content covered in this research report will cover the means of finance that are available to entrepreneurs that are outlined earlier in this document. It will not include other forms of finance, such as ‘bootstrapping’ or funding that is obtained from family or friends. It will also not cover sources of finance that originate outside of South Africa.

I have chosen to focus the report on a limited number or sources of external financing, and those have been selected based on the findings from the preliminary research as well as in the literature review.

Within the broad categories that have been researched, there are a number of individual options that fall under those umbrellas. Under certain categories, such as government funding and micro-finance, I have selected a few of those options to research and discuss further based on what I felt were viable options to research further. For this reason, the sample size for those categories is not fully inclusive of all the options that are available, and as such should not be assumed to be representative of the whole population.

Due to the nature of the sampling and interview procedures, any subjective questions may be subject to the personal biases of the interviewees. The limited number of interviewees may also deliver data that is not representative of the population as a whole. The nature of the interview processes that took place are also susceptible to my own misinterpretation and misunderstanding of responses that are given to me during these interviews.
Research Findings

Challenges Facing South African Entrepreneurs

The Global Entrepreneurship Monitor (GEM) conducts an annual survey to assess the entrepreneurial environment in 40 countries around the world, of which South Africa is one. It uses nine Entrepreneurial Framework Conditions (EFCs) in order to determine the overall entrepreneurial environment, and to determine which factors are supporting entrepreneurship and which are inhibiting it. Experts are asked to rank the EFCs using a five-point Likert scale, where scores of 1 and 2 indicate a negative sentiment to the EFC, while scores of 4 and 5 indicate positive sentiment. A summary of the results from the 36 respondents of the 2009 survey for South Africa is given in Table 1 below, while a full description of each of the EFCs is given in Appendix 1.

Table 1 - Experts’ assessment of the entrepreneurial environment in South Africa (Source: Herrington, Kew & Kew, 2009)

<table>
<thead>
<tr>
<th>Category</th>
<th>Mean Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to physical infrastructure and services</td>
<td>3.15</td>
</tr>
<tr>
<td>Access to professional and commercial infrastructure</td>
<td>2.91</td>
</tr>
<tr>
<td>Vocational, professional and tertiary-level entrepreneurship education</td>
<td>2.86</td>
</tr>
<tr>
<td>Concrete government policies: entrepreneurship priority and support</td>
<td>2.78</td>
</tr>
<tr>
<td>Internal market dynamics</td>
<td>2.76</td>
</tr>
<tr>
<td>Cultural and social norms</td>
<td>2.70</td>
</tr>
<tr>
<td>Internal market burdens</td>
<td>2.45</td>
</tr>
<tr>
<td>Financial environment and support</td>
<td>2.41</td>
</tr>
<tr>
<td>Government policies: taxes, bureaucracy</td>
<td>2.26</td>
</tr>
<tr>
<td>Primary and secondary level entrepreneurship education</td>
<td>2.18</td>
</tr>
<tr>
<td>Government programmes</td>
<td>2.13</td>
</tr>
<tr>
<td>Research and development transfer</td>
<td>2.04</td>
</tr>
</tbody>
</table>

From the results of this survey, it is clear that the experts that took part view South Africa’s entrepreneurial environment as below average, with only one factor scoring above a neutral mean score. In addition to the questions from the survey, experts were asked to identify the three main factors that they felt were a constraint to entrepreneurial activity in South Africa. The top three factors that emerged from the survey results were education and training, government support and financial support (Herrington, J. Kew, & P. Kew, 2009).
In a study carried out by Ernst & Young in 2004, the following factors were highlighted by entrepreneurs and small business owners as inhibiting entrepreneurship in South Africa: Limited access to start-up capital, lack of an appropriate education system, government regulations and bureaucracy, lack of business knowledge, costs of entry, discrimination, lack of mentorship and government assistance and uncompetitive behaviour from established companies (Naude, 2004 cited in Van Nuuren, Groenewald, & Africa, 2007).

In a study carried out by Van Eeden, Viviers and Venter in 2003 on problems faced by small businesses in three of South Africa’s metropolitans, Nelson Mandela, Cape Town and Egoli, they divided the problems into six broad categories: Macro-environment, Marketing, Management skills, Social, Human resources and Finance. According to their study, the macro-environmental problems, such as rapidly changing technologies, new government legislation, HIV/AIDS, exchange rates, interest rates, crime, inflation and unemployment, were identified as the most influential factors in causing the failure of small businesses, while finance factors were the least influential (Van Eeden, Viviers, & Venter, 2003). However, it must be borne in mind that this study was carried out by surveying existing small businesses. When one takes a more detailed look at the results, ‘difficulty in obtaining finance / credit’ ranked 5th out of a total of 56 factors in terms of influential factors.
What Avenues of External Financing are Available to South African Entrepreneurs?

Avenues of Finance Available to South African Entrepreneurs

Commercial Banks

Business finance from commercial banks does appear to be readily available for entrepreneurs provided the applicants meet the banks’ requirements. However, as pointed out in the interviews that were conducted, many entrepreneurs in South Africa find it difficult to satisfy all of the requirements that the banks have, especially when it comes to providing collateral.

There are a number of different options for obtaining finance from the commercial banks depending on the entrepreneur’s needs and the type of collateral that he/she has to offer. The most straightforward and common financing option is a simple business loan, where the borrower pays back the loan amount with interest over a set period of time. The ‘Big Four’ South African commercial banks all offer business loans, starting with a minimum amount or R50 000. There is no specified maximum amount. The repayment period for a business loan varies depending on the circumstances of the entrepreneur’s business, but will generally be between six and sixty months. Depending on perceived risk associated with the business, a business loan is probably the cheapest option for an entrepreneur seeking finance from the commercial banks, with interest rates ‘linked to prime’. In terms of starting up a new business venture, this is the most suitable option for an entrepreneur as the entrepreneur has the freedom to use the money for whatever part of the business he/she deems appropriate, such as start-up machinery, equipment or working capital.

Once the business is up and running, the entrepreneur can apply for an overdraft facility in order to finance the business’s day-to-day needs. This facility is mainly aimed at financing working capital, and is not designed to finance plant and equipment. An overdraft facility is a lot more expensive than a business loan, and should therefore only be used as a temporary financing solution to cater for fluctuations in working capital.

In addition to these options, there are a number of other products that the commercial banks have to offer that are not necessarily aimed at entrepreneurs or businesses, such as
What Avenues of External Financing are Available to South African Entrepreneurs?

vehicle finance, plant and machinery finance, property finance and revolving credit plans that allow the individual or business to draw funds as and when required.

The lending requirements for the commercial banks are quite stringent, as they are not in the business of making what they perceive to be risky investments, but rather looking for low investment, low risk opportunities.

All of South Africa’s commercial banks require some sort of collateral when it comes to applying for finance and the value of that collateral needs to be 100% of the value of the loan. However, the security value of the collateral will very often be less than the realistic market value. There are three main reasons for this: Firstly, once finance charges have been taken into consideration, the settlement value of the loan may exceed the market value. Secondly, the market value of most assets is subject to fluctuation and the financier needs to take this into account by allowing for a safety margin, and finally, the value of assets is usually less than the market value at a forced sale auction.

There are two main reasons that the banks require collateral. Firstly, it lessens the risk of the financier by providing a form of insurance should the borrower not be able to service the loan for some unforeseen reason, and secondly, it ensures greater commitment from the borrower to meet his obligations to the financier.

Collateral can be assessed in a number of different ways, but it will generally be acceptable if it meets the following requirements:

- It needs to be stable and constant in value.
- It must be easy to sell, or there must be a reasonable demand for it.
- It must be valid in law, and
- It must not depreciate rapidly

The most preferred form of collateral from the banks is limited suretyship, where an individual undertakes to make good a specific loan should the borrower – in this case the business – not be able to repay the loan. If this is not available, entrepreneurs are able to secure loans with mortgage bonds over property that they own, but the bond will usually need to be transferred to the bank where the finance is being sought (ABSA, 2009).
What Avenues of External Financing are Available to South African Entrepreneurs?

If an entrepreneur is unable to offer 100% collateral but the banks feel that the business plan is good and will lead to a successful business, the banks are able to apply for indemnity cover through the Khula Credit Indemnity Scheme, which will cover loans from R10 000 to R3 million. However the entrepreneur is responsible for covering the cost of this indemnity cover. The cost for this cover ranges from 2% to 3.5% of the total loan per annum, depending on the amount of the loan. The amount of cover also depends on the size of the loan required. For loans up to R250 000, Khula will cover 90% of the borrowed amount; for loans between R250 000 and R1 million, 80% of the loan amount, and for loans between R1 million and R3 million, 70% of the loan amount.

The next important requirement from the banks in terms of approving a credit application for a business loan for a new business venture is the entrepreneur’s business plan. The business plan not only needs to explain what business the entrepreneur would like to set up, but it must also contain detailed financial forecasts of what the entrepreneur expects to achieve through the new business venture. Both Interviewee 1 and the representative interviewed from Nedbank suggested that before writing a business plan, it is a good idea to visit the bank that one is looking to get financial assistance from to find out exactly what they would like to be included, as the requirements are slightly different from bank to bank. Interviewee 1 suggests that the requirements can even differ between different branches of the same bank.

In addition to a good business plan and some form of collateral, the banks also require some information about the individual that is applying for finance for their entrepreneurial venture. These include, but are not limited to:

- CV of the business principal
- A personal balance sheet
- Personal bank statements for at least three months

In addition to these, the banks will do a credit check on anyone that applies for new finance, whether in their individual capacity or for a new business venture.

The commercial banks also require the entrepreneur to put up some of his own capital to invest in the new venture. The amount that is required varies depending on the risk
associated with the new business, but is generally not less than twenty percent of the total start-up capital that is required. If an entrepreneur is looking for finance to purchase an existing company, this percentage will be higher, and the interviewee from Standard Bank’s business banking department suggested that he will often look for at least fifty percent of the start-up capital to be supplied by the entrepreneur.

Micro Finance

Interviewees 1, 2 and 3 all suggested that micro-finance is not a viable option for entrepreneurs seeking financial assistance due to the high costs associated with borrowing in this manner. My supervisor, Dr Chipo Mlambo, also warned that when looking for assistance in the form of micro-finance, it is important to be able to distinguish the difference between legitimate micro-financiers and ‘loan-sharks’.

Despite these reservations regarding micro-finance, I will briefly outline a few options that are available to entrepreneurs in terms of micro-finance.

Small Enterprise Foundation

The Small Enterprise Foundation (SEF) is a ‘not-for-profit, pro-poor microfinance institution working towards the eradication of poverty by creating a supportive environment where credit and savings services foster sustainable income generation, job creation and social empowerment’ (Small Enterprise Foundation, 2010). It was established in 1992, and since then has disbursed a total of about 735 000 loans with an average loan amount of just below R2 000.

The SEF offers unsecured loans with an initial value of between R800 and R1 500 and up to a total maximum value of R10 000, with an expected return of 3.7% per month, which equates to an effective annual return of approximately 54%.

The SEF has two funds, the Microcredit Programme (MCP) and the Tshomisano Credit Programme (TCP) that entrepreneurs can apply for finance through, and depending on the fund, the lending requirements are slightly different. For both funds, applicants need to apply in groups of five individuals, and each of the five individuals guarantees the payments
What Avenues of External Financing are Available to South African Entrepreneurs?

of the others. This requirement is based on the Grameen Bank system of Bangladesh. In order to get finance through the TCP, applicants need to meet two additional requirements: they need to apply in groups of five women, and applicants need to prove that they have an individual income of less than R400 per month. Both funds are situated in the Limpopo Province, and as such are targeted at individuals that live in that province.

**Khula Micro-credit Outlets**

Khula Micro-credit Outlets have been established in rural and peri-urban areas, and are aimed at assisting individuals, especially women, to start and expand their businesses. These outlets are encouraged to promote diversification, and try to target non-traditional businesses such as small-scale manufacturing, tourism and crafts. They offer loan amounts between R350 and R3500 to very small enterprises. As with the SEF, Khula Micro-credit Outlets require no collateral, but they use a similar system to evaluate whether or not credit should be issued, and they give loans out to groups and not to individuals. Groups of between three and ten individuals approach Khula for credit, and the groups themselves then decide how much each member of the group should receive, but every member of the group stands surety for the entire loan amount.

**South African Micro-finance Apex Fund**

The South African Micro-finance Apex Fund (SAMAF) is an initiative of the Department of Trade and Industry (DTI) that was established to provide wholesale micro-finance to the poor people of South Africa living in rural areas (South African Micro-finance Apex Fund, 2010). The SAMAF does not offer loans directly to individuals, but rather it works through a number of financial intermediaries. For this reason, the types of loans that are available and the costs associated with these loans are dependent on the financial intermediaries that the finance is taken through.

The SAMAF has two types of loans that it disburses through its financial intermediaries, but only one of these is aimed at entrepreneurs: The Micro-enterprise loan is available to individuals who would like to grow their micro- or survivalist-businesses, and in order to qualify for this, individuals must earn less than R3 500 per month.
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In order to get finance through the SAMAF, entrepreneurs need to apply through one of its intermediaries, a full list of which is available on the SAMAF website www.samaf.org.za. The requirements for getting finance through this avenue will then be dependent on the financial intermediaries’ requirements.

**Women’s Development Business**

The Women’s Development Business (WDB) is a micro-finance organisation aimed at the poorest women in rural areas in order to provide them with training and micro-loans in order to increase their household incomes. It was established in 1991, and since then has accumulated a total of approximately 60 000 clients (November 2010) (Women’s Development Business, 2010).

The WDB has two programmes through which it offers loans to entrepreneurs. The Poverty Alleviation programmes is aimed at the ‘poorest of the poor’ (Women’s Development Business, 2010), which are considered to be households that earn less than R660 per month for a family of 5. This programme offers basic financial skills training, as well as loans between the value of R300 and R4 000. The Enterprise Development programme is aimed at women who already have a business that generates revenue, but would like to expand their operations to a bigger business or enterprise. This programme offers more substantive business training, as well as loans between the value of R5 000 and R10 000.

As with the SEF, the WDB’s lending criteria are based on the Grameen Bank system, where individuals need to apply for finance as a group, and each member of the group guarantees the repayments of the other members.

**Marang Financial Services**

Marang Financial Services (MFS) is a micro-finance institution ‘with a focus on making financial products accessible to the emerging entrepreneur and marginalised communities’ (Marang, 2010). Its main focus is on small-scale entrepreneurs living in townships. MFS has been operating since 2001 in five provinces in South Africa, and currently serves approximately 24 000 clients.

MFS offers loans between the value of R500 and R10 000, with a loan period of between four and nine months and an annual interest rate of 33%.
What Avenues of External Financing are Available to South African Entrepreneurs?

In order to obtain financial assistance from MFS, applicants need to apply in groups comprising between five and eight members, and all of the individuals are required to guarantee the payments of the others. It is also a requirement that all the members of the group that are applying know each other, and it is encouraged that they know what business ventures the other members of the group are planning and have gone through their business ideas to satisfy themselves that the business ideas are feasible.

**Blue Financial Services**

Blue Financial Services (BFS) is a micro-finance institution that operates in South Africa as well as thirteen other African countries. BFS offers loans to entrepreneurs and small businesses between the values of R15 000 and R3 million at rates that are ‘competitive with other small business financiers’ (Blue Financial Services, 2010).

BFS’s funding requirements are based on the viability of the new business, and as such they require a detailed business plan that covers all aspects of the business as per BFS’s guidelines, available on their website www.blue.co.za. The application is then assessed based on the viability of the business as outlined by the business plan in terms of a number of capabilities, including marketing, human resources, and operational, as well as on the entrepreneurial competence of the owners. In order to determine this, they look at things such as educational qualifications, previous business experience, drive and passion, sales ability and management ability. Although BFS does require the entrepreneur to make an own contribution towards the business in either cash or kind, for example stock, machinery, equipment, land or buildings, this contribution is much less than the commercial banks require, with a minimum of around 5% of the loan amount. BFS also requires some form of collateral, but again this is far less than the requirements from the commercial banks, in the region of 10-50%. The items that are financed through the business loan can also form part of that collateral.
Venture Capital and Private Equity Funding

From the interviews that were conducted, it appears that access to private equity and venture capital funding is extremely difficult for entrepreneurs in South Africa to get. The private equity market is only really aimed at existing businesses with a good track record, and will mostly only invest in companies that are displaying a positive cash flow and, as suggested by interviewee 2, are overall positive in terms of capital, or in other words, they have generated more cash than has been invested in them. Although there is a significant amount of capital that is available for investment by private equity firms, the investments that they are looking for are mainly existing companies that appear to be operating extremely well, but that require external financing in order to maximise their growth opportunities.

In terms of venture capital investment for entrepreneurs, the market in South Africa is small, with a limited number of players and therefore a limited amount of capital that is available for investment. Venture capital investors also look for companies that are already generating revenue, but they don’t necessarily need to be operating at a profit. They just need to be able to show that they have a good product or prototype that will be competitive in the marketplace. However, because the venture capitalists are generally smaller than the private equity firms, they are often less regimented with regards to their investment criteria, offering a bit more leeway to entrepreneurs if they are impressed with what the entrepreneur has to offer in terms of an excellent business idea. The venture capitalists are prepared to look at investing in riskier ventures, provided the potential returns are high enough to justify the risks involved.

KPMG and the South African Venture Capital Association (SAVCA) conduct an annual survey on the private equity and venture capital activity in South Africa. From the results of the 2008 and 2009 surveys, it is clear that there has been a large decline in the amount of private equity and venture capital investment activity over the past three years, especially in the ‘seed capital’ and ‘start-up and early stage’ areas. Total private equity and venture capital investment in South Africa has declined from R26.1 billion in 2007 to only R7.0 billion in 2009. In 2008, approximately R1.134 billion was invested as ‘seed capital’ or ‘start-up and
early stage’ investment, but by 2009 this figure had dropped to only R280 million, while the average investment amount declined from approximately R10 million to approximately R2.3 million (KPMG / SAVCA, 2010). A summary of the survey results is given below in Figure 1 and Figure 2.
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In a similar survey carried out by Deloitte and SAVCA in 2009, it is clear that the private equity investors and venture capitalists are becoming less interested in investing in ‘seed capital’ and ‘start-up and early stage’ investments. In 2005, approximately 40% of the respondents indicated that they were looking for investments in this category. By 2008, this had declined to approximately 23%, and by the third quarter of 2009, less than 5% of the respondents indicated that they were looking for investment opportunities in this area (Deloitte / SAVCA, 2009). See Figure 3 for a full summary of the results from the survey.

In order to get financial assistance from the private equity and venture capital investors, entrepreneurs need to be able to show the potential investors that they have an extremely good business opportunity that will offer them good annual returns in the region of 30% and above. In addition to this, entrepreneurs really need to be able to sell their business ideas to potential investors. As Interviewee 1 suggests, private equity and venture capital firms are becoming increasingly selective when it comes to choosing where to invest their funds. So there is an increasing amount of competition out there between entrepreneurs in order to get private equity or venture capital funding, while the results from the surveys mentioned above indicate that the amount of funding from those two sources is consistently decreasing.
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Angel Financing

From the interviews that were conducted, it is clear that there is a very good case for entrepreneurs to seek finance from angel investors, and that the amount of angel investment that is happening in this country is increasing. These angel investors are typically either entrepreneurs themselves that have been successful in ventures of their own, and now want to help other entrepreneurs with their new ventures, both financially and in terms of other business support, or they are business executives that are looking for higher returns on their capital than they can get elsewhere.

Unlike venture capital and private equity investments, angel investments are made by individual investors, and because of this, it is difficult to find any accurate statistics on the angel investing activity that takes place in South Africa. Most of the reported statistics come from anecdotes and surveys of confidence samples, and as such are prone to biases and inaccuracies (Investors Network, 2010). However, the Angel Investment Network reports that in South Africa, it is estimated that there are approximately 200 000 potential angel investors that invest a total of about R3 billion annually into South African businesses, with a current total equity holding of about R12 billion (Angel Investment Network, 2010). The average angel investment is in the region of about R200 000, but the investment amounts can vary from a few thousand rand to much larger amounts in the millions of rands (Investors Network, 2010). The results from a separate survey carried out by the Investors Network suggest that there is no shortage of angel finance in this country, provided the business ideas are good enough in the eyes of the investors. Investors that took part in the study indicated that they would have invested up to 35% more than they did if acceptable opportunities had been available.

One of the biggest challenges in getting finance from angel investors is knowing where or who to contact to get access to potential investors. In order to get finance from ‘affiliated angels’, an entrepreneur needs to be introduced to an investor through some or other channel such as a friend or acquaintance, or as Interviewee 3 puts it, ‘You need to be part of the club.’ There is a huge network of angel investors out there, and an entrepreneur needs to be introduced to that network in order to access its resources in terms of finance. This
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can be done by sharing your business plan or business ideas with as many people as possible in the hope that somebody that hears about it will have access to that angel network.

In order to get finance from ‘non-affiliated’ angels, the best way to go about this is to share your business plan with potential investors through an online platform that is designed to do that, such as the Angel Investment Network (www.investmentnetwork.co.za) or the Investors Network (www.investorsnetwork.co.za). These organisations charge a fee for making an entrepreneur’s business plan available to investors to look at, and depending on the amount of exposure that the entrepreneur wants to get and for how long, these fees range from approximately R500 to R1500.

Depending on whether an entrepreneur is looking to get affiliated or non-affiliated angel finance, the initial requirements will vary slightly, but ultimately the entrepreneur needs to convince the investor that the new business venture has a competitive advantage that differentiates it from other businesses doing similar things or selling similar products, and that the investor will realise high returns from his investment. For affiliated angel finance, the initial introduction between the entrepreneur and investor is usually very brief, and the entrepreneur needs to have a powerful ‘five minute elevator speech’ to deliver to the investor. Interviewee 1 suggests that many angel investors will make their decisions on whether or not to invest in the venture immediately based on the initial introduction with the entrepreneur, and any further meetings between the two are purely to check the finer details of the venture that are laid out in the business plan.

On the other hand, non-affiliated angels are looking for a strong business plan that not only outlines the new business venture, but one that also really shows how the business is going to deliver high returns to its investors and how it will be differentiated from its competitors.

On average, angel investors will accept three out of every ten investments that are considered, so it is really important that the entrepreneur knows how to sell his ideas to these investors. In a survey carried out by the Investors Network, the main reasons for investors not going through with deals were insufficient growth potential for the business, overpriced equity, lack of sufficient talent of the management, or lack of information about the entrepreneur or key personnel. It is therefore important that all of these aspects are
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covered in the entrepreneur’s sales pitch – both in the ‘elevator speech’ and in the business plan.

In terms of investor expectations, the Investors Network suggests that angel investors are looking for annual returns in the region of 26%, but the interviewees suggest that these expectations can in fact be much higher, in the region of five to ten times the value of the original investment over the life of the investment. They also do not want to be tied into the venture forever, and generally look for investments that will last between three and five years. This may be longer or shorter depending on the circumstances of the business.

In addition to financial assistance, there are other benefits that an entrepreneur can gain from getting angel investors involved in their new business ventures. Because many angel investors are themselves successful entrepreneurs, they are experienced in this field and are aware of what is required in order to make an entrepreneurial venture successful. The nature of the relationship between the angel and entrepreneur is such that the angel is often very involved in the entrepreneur’s business, and can quickly help to identify areas where the entrepreneur may be struggling or may be able to improve the business. However, this does come with a caveat that it is important for an entrepreneur to understand what the right balance is between getting expert help and allowing angels to totally take over control of the business.

In addition to this, entrepreneurs can gain access to the angel investor’s network of resources. Because angel investors usually invest in sectors or industries that they are familiar with, they have a lot to offer in terms of industry specific knowledge and experience, as well as vast networks of contacts, including customers and suppliers that the entrepreneur can use to grow the business into a success.

In the long term, angel investors can also be a good source of capital for growth and expansion. Once the relationship between the investor and the entrepreneur has developed, and the business is heading in the right direction, the angel investor will be a good source for further funding, either by the angel him/herself or through his/her networks. Angels will generally also be prepared to sign surety for commercial bank finance should the entrepreneurial venture rove to be a success.
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**Private Funding**

**Business Partners**

Business Partners Limited (BPL) is a private company that offers finance to small and medium enterprises in South Africa, as well as a few other African countries. It specialises in risk finance, and actively promotes entrepreneurial growth by providing financial assistance, and also provides other services such as specialist knowledge and added-value services, to entrepreneurial companies that they perceive to be viable. It operates across the commercial and manufacturing sectors, as well as in service industries. There are, however, a few industries that it specifically does not invest in such as farming and mining.

BPL has three investment vehicles through which entrepreneurs can get financial assistance: term loans, equity and shareholders’ loans. Financial assistance can also be given using a combination of these three options.

BPL prefers to invest more than R250 000 per application, and they will generally not invest more than R5 million. The average amount per transaction is currently R1.8 million, with an average prepayment period of five years, although the repayment period will be agreed in consultation with the applicant and a suitable period for the business will be agreed upon (Business Partners, 2010).

In order to get financing through BPL, an entrepreneur needs to be able to motivate to BPL that they have a viable business opportunity, and this is done through submitting a comprehensive business plan. BPL believes that the business is comprised of two parts, the business itself and the entrepreneur, and therefore the business plan needs to show that both will add to the success of the new business venture. BPL offers a guideline as to what they require in a business plan that is submitted to them, and it includes the following:

- A full breakdown of all the goods and services that need to be financed.
- An indication of what the entrepreneur is prepared to contribute to the business. Although there is no minimum requirement for the entrepreneur’s contribution, BPL believes that the lack of own contribution places strain on the gearing of the business and thus affects the viability of the business.
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- If an entrepreneur is looking for finance for an existing business, a full set of financials is required as well as realistic projections that present a viable business.
- It needs to indicate that the business will be a viable investment for BPI, and that it will be able to meet all of its cash flow requirements such as debt repayment, creditors and other expenses.
- The business plan needs to indicate that the entrepreneur has thought about all aspects of the business, including areas such as human resources, marketing, technical, production and corporate governance.
- It needs to demonstrate regulatory compliance through items such as tax certificates.
- It needs to show that the required expertise exists within the business in order to make it a success. This might include CVs of the management and key staff within the business.
- Any assumptions that have been made in the business plan with regard to forecasts need to be justified and supported with relevant documentation where possible.

Because BPL is a viability-based investment company and thoroughly investigates any investment before committing to offer financial assistance, the amount of security that they require is less than the commercial banks require. However, the amount of security that an entrepreneur has to offer will affect the kind of investment that BPL is able to offer to the entrepreneur.

Once the entrepreneur has put a business plan together that includes all the relevant information mentioned above, as well as any other information that the entrepreneur feels may influence the financing decision, the business plan must be submitted to the nearest BPL branch. Before putting together a business plan, it is a good idea for the entrepreneur to have an interview with a representative from BPL in order to determine exactly what is required, as the requirements will vary from application to application.

Once the application is received by BPL, they will do a basic assessment to determine whether or not they feel the business presents a viable investment opportunity, as well as liaising with the entrepreneur as to what type of financing they require. If the business plan
presented presents a viable business opportunity, BPL then conducts a due diligence, with a more in-depth analysis of the business by liaising with all the key players, such as the shareholders, managers, suppliers and possible customers. Once this has been completed, the approval will either be approved or rejected by the credit committee (Business Partners, 2010).

**Government Funding and Grants**

There are a number of different financing options that are available to entrepreneurs through government-backed initiatives. For the purpose of this research report, I will outline the four that I feel are the best suited for South African entrepreneurs, based on the findings from the preliminary research and literature review.

**Industrial Development Corporation**

The Industrial Development Corporation (IDC) is a ‘self-financing, national Development Finance Institution (DFI). It was established in 1940 to promote economic growth and industrial development in South Africa.’ (Industrial Development Corporation, 2010). The IDC is a valuable source of finance for South African entrepreneurs, but Interviewee 1 warns that one needs to know exactly what route to follow when applying to them for financial assistance.

There are a number of different financing instruments that the IDC has to offer, but these can be broadly classified onto three main categories: Wholesale finance in the form of loans, equity, and a combination of the two. The amount of investment from the IDC varies across the different sectors. Generally the minimum investment amount would not be less than R1 million, and there is no set maximum amount. The duration of the loan or equity investment also varies on a case by case basis.

The IDC operates across eighteen different sectors, and each sector appears to operate as its own small business unit (SBU). When applying for financial assistance from the IDC, it is important that the entrepreneur knows which business unit to go through, as the requirements for getting assistance vary across the different SBUs. However, the main
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requirement for getting finance through the IDC is through submitting a thorough business plan with detailed financial information. For an existing company, this needs to be in the form of historical financial statements, but for start-ups, the IDC would like to see detailed projections of financial statements. The business plan should also indicate what will set the entrepreneur’s business apart from others in the same market in terms of its competitive advantage. Once the business plan is received, the IDC conducts thorough due diligence to evaluate the proposal. Depending on the quality of the information in the business plan, this process generally takes between three and four months. If the business plan is not complete and detailed enough, this process will take longer.

In terms of collateral, the IDC’s requirements are evaluated on a case by case basis, and depending on the economic merit or the nature and risk of the business, applicants may be asked to offer security against loans in the form of collateral.

Once the finance has been approved and granted, the entrepreneur is required to submit audited quarterly financial statements to the IDC in order to show that the performance of the business is in line with the business plan. This is monitored through the business’s repayment record in the case of loans or dividends on the case of equity.

National Youth Development Agency

The National Youth Development Agency (NYDA) is an organisation whose function is to ‘initiate, facilitate, implement, coordinate and monitor youth development interventions aimed at reducing youth unemployment and promoting social cohesion’ (National Youth Development Agency, 2010). The NYDA offers financial support to young entrepreneurs, but that is not its only function. It also helps individuals to get bursaries or student loans. It assists individuals in finding employment, and they have a number of skills development programmes.

The amount of financial assistance that entrepreneurs can apply for from the NYDA ranges from R1 000 to R300 000, and this is divided into two categories: Micro loans are offered up to the value of R100 000, and SME loans are offered for amounts between R101 000 and R300 000. The main difference between these two options is that individuals are required to submit a business plan in order to apply for the SME loan, but no business plan is
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required for the micro loan. Depending on the viability of the business, the NYDA will offer
up to 100% finance to the entrepreneur.

The NYDA also offers franchise funding from R150 000 to R300 000, as well as funding for co-operatives.

The NYDA offers funding to any South African citizen between the age of 18 and 35. However priority is given to individuals from low income groups. In order to apply for finance from the NYDA, entrepreneurs are required to submit the following documents:

- Certified copies of qualifications
- Quotations for everything that will be required to start the business
- Up to date bank statements
- Certified copy of ID
- Company registration documents or certificate
- Samples of products that the entrepreneur intends to manufacture
- Tax clearance certificate

In addition to the requirements listed above, entrepreneurs applying for the SME loan are required to submit a business plan. If an individual is unable to submit a comprehensive business plan, the NYDA is willing to assist in drawing up the business plan provided the other requirements in terms of documentation are satisfied.

Entrepreneurs that are applying for franchise funding need to also have contacted the franchisor and applied for a franchise with them and had the application approved. The application requirements for co-operatives is the same as for individuals, except that the co-operative needs to consist of five or more members and all members need to submit the individual documents such as qualification details, ID documents and bank statements.

There is no requirement from the NYDA for entrepreneurs to provide collateral. However it will act in the entrepreneur’s favour if he/she is able to offer some sort of security. Furthermore, the NYDA is unlikely to offer 100% finance if the applicant is not able to give any collateral.
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Once all of the required documents have been submitted to the NYDA, the approval process takes between four and six weeks.

National Empowerment Fund

The National Empowerment Fund (NEF) ‘was established by the National Empowerment Fund Act No 105 of 1998 (“NEF Act”), to promote and facilitate black economic equality and transformation. Its mandate and mission is to be the catalyst of Broad-based Black Economic Empowerment (BB-BEE)’ (National Empowerment Fund, 2010). It provides risk capital through its Imbewu Fund to new businesses and to early stage businesses, specifically those that further Broad Based Black Economic Empowerment (BB-BEE).

The NEF provides financial assistance in the form of equity or quasi-equity between the value of R250 000 and R5 million, and their typical investment horizon is between five and seven years. At the end of that period, the entrepreneur is expected to buy back the equity share from the NEF. There is no cost associated with an application for funding to the NEF. However they would like to see a nominal pre-tax internal rate of return on their investment of between 12% and 18%.

In order to obtain financial assistance from the NEF, an entrepreneur needs to fulfil the following requirements:

- The Black Economic Empowerment (BEE) applicant needs to be actively involved on the business.
- The business must have a minimum black ownership of 50.1%.
- There needs to be a certain amount of industry experience within the business, either from the BEE party or from the non-BEE partners.
- Applicants must agree to take part in a mentorship programme that is offered by the NEF.
- The capital structure of the business as set out in the business plan must be sustainable.
- The business plan must indicate how the business will be viable and sustainable.
- The new business should employ a minimum of five people.
In order to share all of this information with the NEF, the application form that the applicant needs to fill out is extremely detailed in terms of BB-BEE and financial information that is required. In addition to this, a comprehensive business plan is required from the applicant.

Khula Enterprise Finance Ltd

Khula Enterprise Finance Ltd (KEF) was established in 1996 with the goal of promoting the development of small and medium enterprises in South Africa. Its goal is to maximise the access to finance for SMMEs in a way that leads to the development of sustainable small and medium businesses, creates employment and encourages economic development. KEF has four main products that are aimed at assisting entrepreneurs in getting finance for their new ventures (Khula Enterprise Finance Ltd, 2009).

The Khula Credit Indemnity Scheme was established to allow entrepreneurs to gain access to finance but who lack sufficient collateral or security to secure ordinary bank finance from the commercial banks. It offers loans between the value of R10 000 and R3 million. In order to get finance through this scheme, entrepreneurs need to apply to one of the ‘Big Four’ commercial banks, and they need to satisfy the bank’s lending requirements entirely, as outlined earlier in this document, apart from those that are related to collateral. Once the banks are satisfied that the entrepreneur meets their lending requirements, they can then apply to KEF to insure up to 90% of the value of the loan as an alternative to the entrepreneur providing collateral.

The Khula Land Reform Empowerment Facility (LREF) was set up to facilitate land transfer and economic participation by black people in economically viable, land-based agricultural enterprises and ecotourism sectors. It offers loans up to a maximum value of R10 million per project, with a maximum of R800 000 per person that is involved in the project. The repayment period for these loans is up to 20 years. The LREF also has an option for entrepreneurs to participate in an equity share scheme, where both the land reform beneficiaries and private sector partners have an agreement where they both buy equity in the form of shares in land-based agricultural ventures. In order to get funding through the LREF scheme, entrepreneurs need to identify a farm that they would like to invest in and then apply to the Department of Rural Development and Land Reform, where they apply for Land Redistribution and Agricultural Development grants. Once these grants are approved,
the entrepreneur can then apply at commercial banks for additional funding to fund the project. The banks will then evaluate the application and if it meets their lending requirements, they can apply to KEF for the LREF on the entrepreneur’s behalf. KEF will then evaluate the application, and provided it meets the requirements in terms of being a viable venture, and in terms of its BEE credentials, KEF will then approve the loan and disburse the funds to the bank, who in turn disburses it to the entrepreneur.

The third way in which KEF assists entrepreneurs in getting finance is through *Non-bank Retail Financial Intermediaries*, or RFIs. These are companies or independent organisations that are accredited by Khula, and that lend money directly to SMEs. The RFIs receive funds from Khula, and then lend those funds to SMEs through their own lending policies. These RFIs offer loans to entrepreneurs between the value of R10 000 and R3 million. As the RFIs are owned and operated by a number of different individuals or organisations, the lending criteria are different from RFI to RFI. However, the basic lending criteria are that the entrepreneur needs to be able to show that the business will be profitable, sustainable, and that it will be able to repay the loan. Most of the RFIs will also require a business plan from an entrepreneur when applying for finance.

The fourth and final way in which entrepreneurs can get access to finance from KES is through one of its *Joint Ventures*. KEF is currently involved in six joint venture funds aimed at entrepreneurs, however some of these are targeted at a very specific sector and will not be suitable for all types of ventures, such as the Anglo-Khula Mining Fund aimed at the mining sector, the Khula Emerging Contractors Fund aimed at contractors in the Eastern Cape, the Khula-Akwandze Fund aimed at the agricultural development sector, and the Enablis-Khula Loan Fund, aimed at the information and communication technologies sector.

The other two funds are the Business Partners-Khula Start-up Fund, and the Khula Enablis SME Acceleration Fund, which are not sector specific and aimed at assisting any entrepreneurs to establish new businesses, or for the expansion of existing businesses. All of these Joint Venture funds appear to be administered by KEF’s partners and the application and approval process is done through the partners and not KEF itself.
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Research Findings Analysis and Discussion

Challenges facing South African Entrepreneurs

Although raising capital is cited as being a common problem amongst entrepreneurs and industry experts in terms of stimulating entrepreneurial activity, it is not the only challenge that entrepreneurs are faced with. There are many other challenges that South Africans face when it comes to starting their entrepreneurial ventures. Furthermore, studies carried out by the GEM in 2004 suggest that South Africa is no worse off than other developing and developed countries (Herrington, J. Kew, & P. Kew, 2009).

The causes of the challenge in terms of gaining finance can be looked at from two points of view. First of all, entrepreneurs suggest that they are unable to get external financing, but one of the main issues cited by the lenders and investors in terms of approving finance applications is that they feel that the applicant is not well enough prepared, and has not properly explored the finer details of the proposed business venture. The majority of the avenues that have been researched in this report suggest that lack of preparation in terms of getting a business plan together, as well as a lack of research into the business venture, are the main reasons for not getting their finance applications approved. Entrepreneurs complain that they can’t get finance, but they need to show to potential investors or lenders that all the risks associated with their businesses have been thought about and that they will not be taking too much of a risk with their investment. Herrington et al. also suggest that South Africans are also often totally unrealistic when it comes to financial expectations. Many have a ‘copycat’ mentality, and do not offer a new product or service that is compelling or different (Herrington, J. Kew, & P. Kew, 2009).

On the other hand, there appears to be a lack of information out there as to all of the different financing options that are available to South African entrepreneurs. There is no centralised website or database that enables entrepreneurs to access a list of the different financing options that are available to them, as well as a description of what the different avenues of finance have to offer. Herrington et al. also suggest that many of the websites of the various lenders and investors are not kept up to date, and there are several websites
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that refer to financing organisations that no longer exist (Herrington, J. Kew, & P. Kew, 2009). It is imperative that these organisations keep their information up to date so as to reduce the confusion that currently exists as to what the different financing options are.

**Debt versus Equity Financing**

When trying to obtain finance for new business ventures, it is important that entrepreneurs understand the differences between debt and equity financing, and the pros and cons associated with each. Equity financing in the form of private equity or venture capital funding, angel funding, or even some of the government funding options, comes with the advantage of business support beyond purely financial support, which can be critical for the success of new ventures should the entrepreneur not have too much prior business experience, but it does come with the downside that equity financing can lead to high early dilution of the company, and should the company grow quickly and deliver high returns, the entrepreneur will not benefit from the full value of those returns, but rather share it with the equity investor. Debt financing, on the other hand, will not lead to any dilution of ownership of the company, and the entrepreneur knows exactly what his financial commitments are before the loan agreement is signed, but one downside of this can be the lack of non-financial support that one gets from equity financing.

**Non-financing services**

Many of the organisation that are out there offer services to entrepreneurs that are beyond purely financing their new ventures, and it is important for entrepreneurs to understand all of these services that are available to them before deciding which financing avenue to follow.

Private equity and venture capital investors as well as angel investors can be a valuable resource for any new venture with their vast experience in operating businesses and gaining access to their networks of expertise, suppliers and customers. Most, if not all of the
government financing organisations have some sort of mentorship programmes where entrepreneurs can be guided through the process of setting up their new business by experienced consultants. Business Partners has a pool of 300 mentors that are available to offer guidance to entrepreneurs from all different aspects, including business counselling, specialised assistance for specific parts of a business and sectoral assistance to help deal with issues in a specific sector of the industry that the business is operating in.

The commercial banks also offer non-financing services to entrepreneurs. Although their mentorship and guidance that they give to entrepreneurs may be less ‘hands-on’ than that offered by the other financiers, they do offer a lot of advice to entrepreneurs through information booklets and workshops aimed at educating entrepreneurs in certain aspects of business. They also have banking options that are aimed at servicing entrepreneurs specifically, such as Nedbank’s ‘Start-up Offer’ that offers free banking to businesses that have been in operation for less than two years\(^2\) (Nedbank, 2010).

All of these non-financing services may be able to play a vital role in the success of the entrepreneur’s new business venture.

**Business Plan**

When applying for external finance, a business plan is a common requirement for most forms of external finance, however the requirements for what the business plan needs to include differ between the different avenues of finance. One common theme is that the business plan must not be a generic one, where the entrepreneur has simply ‘filled in the blanks’. All of the potential lenders or investors want to see that the entrepreneur has thoroughly thought the business through, and has covered every foreseeable obstacle that the business might encounter within reason, and that the business will make enough money to be able to service its debt or satisfy its investors’ requirements in terms of returns.

Before writing a business plan, it is important that an entrepreneur knows what needs to be covered for the specific financial option that he/she is looking for. Most of the lenders and

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\(^2\) Conditions apply. Entrepreneurs need to take out a minimum loan of R100 000 and meet other requirements as set out by Nedbank.
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Investors have these requirements listed on their websites, and they have advisors available to help with giving guidance as to how it should be written, and it is worth investigating these before starting to write it up.

If it is within the entrepreneur’s means, I believe that it is worth getting assistance from an external consultant in order to draw up a professional business plan. Organisations such as the Real Enterprise Development, or Red Door, are perfect for this, and are relatively inexpensive. They can also offer good advice as to what they believe will be the best form of external finance for the entrepreneur (Red Door, 2010).

In addition to a good business plan, certain avenues of finance, such as private equity and venture capital and angel financiers, require the entrepreneur to really be able to sell his/her business idea to a potential investor. In these instances, the business plan can often just get the entrepreneur a foot in the door with the investor, and the chances of getting finance will then rely on the entrepreneur’s ability to motivate why he/she thinks that his/her business idea is superior to the other business ideas that the investors are looking at.

One of the common reasons that was cited in a lot of the interviews why entrepreneurs are not getting access to finance was a lack of preparation on the entrepreneur’s part, as well as a lack of understanding from him/her as to what the specific requirements are from the lenders or investors point of view in terms of getting external finance.

**Commercial Bank Finance**

Business loans from the commercial banks are one of the cheapest and most convenient forms of entrepreneurial finance. The loan amount is transferred into the entrepreneurs business account, and the money can be used as and when required for any aspect of the business. The cost for this type of finance is also relatively low, with interest rates ‘linked to prime’.

However, the commercial banks operate as businesses, and as such are not able to share the risks associated with entrepreneurial ventures with the entrepreneur. They need to act
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in the best interests of their investors, and the risks associated with this type of investment for them are too great for the rewards that they offer. For this reason, the banks require some form of collateral or security to cover the loan, and this may be out of reach for many entrepreneurs.

If an entrepreneur is able to offer security to the banks, this is probably one of the best options in terms of external finance. In addition to the cost and convenience of the original loan, entrepreneurs are able to gain access to further funding as the business grows and the entrepreneur has more in the way of collateral. It is also a good option in terms of further finance through different channels once the business is up and running, such as an increased overdraft facility in order to allow for fluctuations in working capital requirements, debtor finance once the business has money owed to it by its debtors, and vehicle and asset finance to purchase additional plant and equipment for further expansion.

Even if an entrepreneur is unable to offer the banks 100% collateral, it is worth enquiring whether or not he/she can qualify for security through the Khula Indemnity Scheme to gain access to commercial bank finance.

**Micro-Finance**

From the research findings, it would appear that micro-finance is not really a viable option for entrepreneurs looking to finance their new ventures. By definition, the values of the loans that are offered through micro-finance lenders are quite small, and the costs associated with this type of finance are exorbitant, sometimes with annual effective annual interest rates in excess of 50%.

Interviewee 2 also suggested that entrepreneurs, or anyone for that matter, can be subject to falling into the ‘micro-finance trap’, where the interest repayments become so large that the individual needs to take out further finance just to service the initial loan.

In a business lending environment, micro-finance only really seems to be suitable for existing tiny or survivalist businesses that are in dire need of a quick financial fix to help...
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alleviate a short term cash flow problem, but that business should not rely on this type of finance as a long term solution for starting up a new business or growing an existing one.

Another factor to take into consideration when considering micro-finance as an option for raising entrepreneurial finance is the fact that because most of the micro-financiers appear to lend based on the Grameen Bank system, where individuals are required to guarantee the repayments of other individuals within a group, borrowers are subject to the risks associated with failure of all the other businesses within the group. This means that should an entrepreneur’s new business venture prove to be successful, that entrepreneur can still be held liable for the other businesses within the group that turn out to be less successful and need to use some of his profits to repay the loans of others.

Venture Capital and Private Equity Finance

Venture capital or private equity funding can provide the perfect platform for entrepreneurs to launch their new business ideas if they have a phenomenal business idea but lack the skills or experience to start and run a business, although the amount of investment in start-up and early stage businesses by private equity investors and venture capitalists has severely declined over the past three years.

One of the main advantages to getting finance through this route is the non-financial support that the entrepreneur stands to gain from the investor in terms of business guidance and mentorship. Because private equity firms and venture capitalists generally only invest in sectors that they are familiar with and have experience in, the entrepreneur stands to benefit a great deal from their input, both in terms of the advice that they may have to offer as well as having access to their networks of expertise, clients, suppliers or customers.

However, on the downside, raising finance through this channel will dilute the entrepreneur’s equity stake in the business, and the entrepreneur will not reap all of the financial benefits should the business start to generate high returns. The amount of dilution will vary from investor to investor, and it is in the investor’s interests not to take too much
of the equity share in the venture, as the entrepreneur may be less inclined to succeed should the benefits from that success not be worthwhile to the entrepreneur. In order to mitigate this risk, it is important for the entrepreneur to agree on a good exit strategy up-front before agreeing to the deal.

Another downside to this sort of investment from an entrepreneur’s point of view is the loss of control of the business that goes with it. If an entrepreneur raises capital through a private equity investor or venture capitalist, any major business decisions usually need to be approved by the investor before being implemented.

Angel Finance

For an entrepreneur looking to start a new business venture, finding the right angel investor can be the perfect first step in getting finance to get the business going. From the data that was collected, there appears to be a surplus of funds available through the network of angel investors that is out there, and potential investors are continually looking for new business opportunities to invest in. However, as with private equity investors and venture capitalists, angels are not looking for investment opportunities that are going to deliver average returns, or that are merely going to be duplicates of existing business that are already out there. They are looking for new and exciting opportunities that are differentiated from existing businesses and that will continue to have a competitive advantage over other businesses operating in the same sector. Although the literature suggests that some angels are looking for investment opportunities for reasons other than purely financial, Interviewees 1, 2 and 3 all suggest otherwise, and angels are generally looking for very good returns on their investments. Interviewee 3 suggested that although it may appear that angels often target investments for non-financial reasons such as community upliftment, employment and the personal satisfaction of being able to help others, these factors are often, by chance, a by-product of the investment, but the real reason that they invest is for the financial returns that they stand to achieve.

Due to the fact that angel investors are less formal that institutional investors, the due diligence and ‘approval’ process can be a lot less cumbersome, and the time it takes to receive the funds can be a lot shorter than with the institutional lenders or investors.
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One thing that the entrepreneur needs to be aware of when looking to angels for finance is that the investor will generally want to be quite involved in the business. The degree of this involvement will vary from angel to angel, but they generally will want to know what is going on in the business at all times, as well as being involved in any major decisions that need to be made with regards to the business. It is of the utmost importance that the relationship between the entrepreneur and the angel investor is structured in a way that suits both parties upfront to avoid any conflict in this regard later on, and the entrepreneur must be careful not to relinquish too much of the control of his/her business.

It is also important that an exit strategy is agreed upfront that suits both parties. The investor does not want to have his/her funds tied up forever in the entrepreneur’s business, and the entrepreneur does not want to have the investor around too far beyond the duration for which the investor’s funds are required.

**Private funding**

Private funding through Business Partners is an excellent source of finance for entrepreneurs that have a solid business idea. As an investment group for small and medium enterprises in South Africa, they specialise in entrepreneurial finance, and they are able to offer products that are specifically tailored to suite the entrepreneur’s needs.

During the interviews with two of the commercial banks, the interviewees actually said that if it was clear to them upfront that an applicant with a good business idea was not going to be able to access finance through the bank due to the bank’s lending requirements that they would refer him/her to Business Partners in order to get finance because that’s what Business Partners specialises in.

In addition to offering finance, they offer a range of mentorship services that can be valuable to entrepreneurs that might be inexperienced in running their own business, or indeed other aspects of business. It has a pool of approximately 300 mentors that are available to clients, potential clients and the general public in all areas of business. They offer many different services, from general counselling to specialised assistance with
specific management functions to sectoral assistance for specific types of business. The interviewee from Nedbank actually suggested that should they receive an application for business finance that they are generally satisfied with, but that they feel the entrepreneur lacks certain business skills, they will often approve the loan subject to an agreement from the entrepreneur that he/she will take part in Business Partners’ mentorship programme.

With Business Partners, an entrepreneur can apply for the right type of finance, debt or equity, or the right mix of finance that is best suited for his/her business, as well as make use of their extensive resources that are available for business support, which is ideal for inexperienced entrepreneurs looking to start their new ventures, and because their evaluation process is quite rigorous, any oversights that the entrepreneur has made while putting together a business plan should be picked up by Business Partners before the business gets to the point where it is too late to rectify.

**Government funding**

Government funding can be a good source of finance for entrepreneurs that have a good business idea, but one that will not necessarily have massive growth potential. These government-backed organisations are looking to give financial assistance to entrepreneurs that are able to demonstrate that they will be successful in starting a sustainable business that will be able to support the entrepreneur and be able to repay its loans. They are not necessarily looking for business ideas with huge growth potential, or that are differentiated from other business operating in the same market.

When considering government finance as an option, it is important that the entrepreneur understands what funding is available, as some of the organisations and funds are targeted at specific sectors or specific groups of individuals, which may or may not be suitable for him/her. It is also important to understand which channels to go through in order to get that finance. It can be quite confusing knowing exactly where to go or who to speak to. For example, the IDC has eighteen different divisions that it lends through, and the entrepreneur needs to find out which of these divisions is best suited to service his/her business. Khula Enterprise Finance Ltd also has a number of financing options, but many of
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these are offered through its financial intermediaries of joint venture partners, and the application process is often not directly with Khula.

In addition to this, entrepreneurs need to understand that the approval process for obtaining government funding can take some time, and he/she must allow for these lengthy processes to take place when planning his/her venture.
Research Conclusions and Recommendations

Although access to finance appears to be a major inhibitor for entrepreneurial activity in South Africa, there are many different external financing options that are available to entrepreneurs in South Africa in order to assist in getting their new business ventures up and running. However, it is up to the entrepreneur to demonstrate that he/she has a viable business opportunity, and that the potential returns on the investment of the financier will be enough to outweigh the risk. The investors or lenders want to know that the entrepreneur has really applied his mind to the new business venture, either through the business plan or through meetings with potential investors. They are not looking for investments in businesses that merely copy other business that are already out there that they will try to compete with, but rather new and innovative business ideas that will be sustainable and not easily overwhelmed by competitors.

Although it is advisable for entrepreneurs to seek assistance from professionals in terms of drawing up a business plan, it is of the utmost importance that the professionals do not actually compile the business plan, or even worse, simply fill in the blanks on a generic business plan. The entrepreneur must take ownership of drawing up his/her own business plan, and during the process will hopefully cover all the angles in terms of areas that might be a cause for concern. In this way, potential investors can see that the entrepreneur is serious about the new business, and that all the risks, within reason, have been taken into consideration.

From an entrepreneur’s point of view, before seeking external financial assistance, it is important for an entrepreneur to fully research all of the different options that are available, and to understand the benefits and drawbacks that are associated with the different financing options. There are a number of factors that the entrepreneur should take into consideration before deciding which avenue of finance the entrepreneur should apply for, such as the amount of funding that is required, the costs associated with the different types of funding or the expected returns from potential investors, the amount of non-financial input such as mentorship and guidance that the entrepreneur would like to receive from an investor or lender, whether or not the entrepreneur is satisfied with the
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dilution of ownership and control that is associated with equity financing, how long the entrepreneur intends to make use of the external financiers funds, and whether or not the entrepreneur is likely to need access to further funding for growth or expansion.

It is also important that an entrepreneur understands which options are available for the specific circumstances of the individual and business in terms of lenders’ or investors’ requirements, and then to be able to demonstrate to those potential lenders or investors that the entrepreneur’s business will be a safe investment for them.

Researching available external financing options should be the very first step in the development of any business idea that can be converted into a successful business venture. Too often it is merely an afterthought when all other decisions have already been finalised. Seeking appropriate external finance is in fact integral to the success of any sustainable business longer term.

‘If someone has a good enough business idea that they can communicate well to others, they WILL find somebody that is willing to give them finance for it.’ ~ Interviewee 2

‘There’s plenty of finance out there available to entrepreneurs. It’s just a matter of knowing where to go and how to access it.’ ~ Interviewee 1
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Further Research Directions

This research report has been conducted by looking at the subject of entrepreneurial finance in South Africa from an investor’s or lender’s point of view by looking at what they have to offer and what their lending or investing requirements are, and as such does not cover the subject from an entrepreneur’s point of view.

As an area for further research, it would be interesting to look at the subject from an entrepreneur’s point of view, and to investigate some of the successes and failures in terms of getting entrepreneurial finance. During the course of completing this research report, I spoke informally to a number of entrepreneurs operating across a number of different sectors, and obtaining finance for starting or expanding their businesses appeared to be one of their biggest challenges. It would be interesting to investigate what proportion of entrepreneurs are making use of external financing through the different options that have been outlined here, as well as to find out how well known these different options are amongst the entrepreneurial community.
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## Appendices

### Appendix 1 – The GEM Entrepreneurial Framework Conditions (EFCs)

Source: Adapted from Bosma & Levie, 2010

<table>
<thead>
<tr>
<th>Framework Condition</th>
<th>Description</th>
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<tbody>
<tr>
<td>EFC 1: Financial support</td>
<td>The availability of financial resources, equity, and debt, for new and growing firms, including grants and subsidies.</td>
</tr>
<tr>
<td>EFC 2: Government policies</td>
<td>The extent to which government policies, such as taxes or regulations, are either size-neutral or encourage new and growing firms. There are two sub-divisions – the first covers the extent to which new and growing firms are prioritised in government policy generally; and the second is about the regulation of new and growing firms.</td>
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<tr>
<td>EFC 3: Government programmes</td>
<td>The presence and quality of direct programmes to assist new and growing firms, at all levels of government (national, regional, municipal).</td>
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<tr>
<td>EFC 4: Education and training</td>
<td>The extent to which each level of the education and training system incorporates training in creating/managing new, small or growing business entities. There are two sub-divisions – primary and secondary school entrepreneurship education and training; and post-school entrepreneurship education and training.</td>
</tr>
<tr>
<td>EFC 5: Research and development transfer</td>
<td>The extent to which national research and development will lead to new commercial opportunities, and whether or not these are available for new, small and growing firms.</td>
</tr>
<tr>
<td>EFC 6: Commercial and professional infrastructure</td>
<td>The presence of commercial, accounting and other legal services and institutions that allow for or promote the emergence of small, new and growing business entities.</td>
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<tr>
<td>EFC 7: Internal market openness</td>
<td>The extent to which commercial arrangements undergo constant change and redeployment as new and growing firms compete with and replace existing suppliers, subcontractors and consultants. There are two sub-divisions: market dynamics, i.e. the extent to which markets change dramatically from year to year; and market openness, i.e. the extent to which new firms are free to enter existing markets.</td>
</tr>
<tr>
<td>EFC 8: Access to physical infrastructure</td>
<td>Ease of access to available physical resources – communication, utilities, transportation, land or space – at a price that does not discriminate against new, small or growing firms.</td>
</tr>
<tr>
<td>EFC 9: Cultural and social norms</td>
<td>The extent to which existing social and cultural norms encourage, or do not discourage, individual actions that might lead to new ways of conducting business or economic activities which might, in turn, lead to greater dispersion in personal wealth and income.</td>
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