ANNEXURE 8

GENERAL FUNDING

[1. Introduction]

1. The Inquiry's Provisional report published on 13 July 2022, identified several issues and market features that adversely affected the lack of participation of Historically Disadvantaged Persons/Entrepreneurs ("HDPs") in digital markets. Features such as access to funding and gaps in investments for pre-seed and seed phase start-ups have exacerbated the challenges faced by HDP entrepreneurs from participating in the online economy, compared to their white counterparts. The funding gap is recognized by industry stakeholders as a significant concern for the inclusion of many black entrepreneurs in tech. Due to a lack of transformation and a nascent environment, and the lack of access to capital and lack of accumulated wealth for black South Africans, and because of our apartheid past, these features have significantly contributed to very few black entrepreneurs being able to access opportunities in the online sector and a large part of the population being excluded from participating in the online economy.[1] Many Stakeholders[2] who provided comments on the provisional findings concur with the Inquiry's findings.

2. The Inquiry considered the VC industry to be a funding solution to lower barriers and for HDP entrepreneurs to access capital. Unlike traditional lending models, VC firms can offer invaluable guidance and access to business development resources at each stage of the start-up process, especially for first-time founders. However, the South African VC industry is small in size, nascent and untransformed, making VC funders risk averse with little incentives to invest in start-ups at very early stages. Therefore, many South African start-ups rely on 'angel' investors, family, friends, and networks to help them get off the ground. The VC industry confirmed in the provisional report that they consider early-stage start-ups as high risk. They consider themselves risk averse and invest in businesses that are scalable, with an already accumulated track record, an established user base, consistent revenue, and other performance indicators (Series A, B and C businesses). It is widely recognized that large firms are well served by commercial banks and the capital market, whilst micro businesses typically access personal credit, microfinance, grants, and other government funding. Debt or credit guarantees are the most widely used forms of financing in South Africa, making it especially difficult for black entrepreneurs to access capital and funding due to lack of collateral.[3]

3. SAVCA disagrees that the industry does not support HDP entrepreneurs, which was the provisional finding of the Inquiry. SAVCA maintains that VC investments are ones that best attract return on capital and that fund managers seek the most lucrative deals where they are convinced that they can achieve returns that are commensurate with the risk they are taking on. The background of the entrepreneur, SAVCA states, plays no part in effecting deals.[4] SAVCA suggests that the exclusion of black entrepreneur investments

1 Findings of the Online Intermediation Platforms Market Inquiry (OIPMI) Provisional Report, 13 July 2022, Chapter 8 paragraph 30 and 31.

2 The Inquiry was able to engage with industry players such as the National Empowerment Fund ("NEF"), Public Investment Corporation ("PIC") , Investment Development Corporation (IDC") , the Department of Communication and Digital Technologies ("DCDT") the SA SME FUND and the private sector Venture Capital industry, the Southern African Venture Capital Association ("SAVCA") on behalf of its members, Business Partners and 4Di Capital.

3 SA SME Fund, written submission (WS1), *Discussion Paper on Small Enterprise Financing,* 08 September 2022.

4 SAVCA Response to OIPMI Provisional Report, written submission (WS1), 30 August 2022, page 3.

is due to the availability of investment capital, the R6.87 bn[5] worth of investments made in 2020 is insufficient to meet the market demand, due to the lack of overall risk capital available in the SA VC industry compared to the R205 billon available in private equity. Without an overall increase in investment into the VC asset class, investments for HDP entrepreneurs will be suboptimal. Furthermore, at present the VC industry has very limited institutional investment, and without a significant increase, the industry will fail to adequately scale and support the number of businesses requiring investment.[6]

4. However, in the provisional report, the Inquiry made note of SAVCA's submitted B-BBEE level numbers and support. Where SAVCA does have information on transformation numbers, only 6% of the overall deal flow went to level 1 B-BBEE scoring in 2020, in a country where majority of the population is black, only 14% was made to level 2 B-BBEE status businesses.[7,8] The vast majority went to level 3 and 4 B-BBEE statuses. Another reason offered by SAVCA for the investments is that, equity may move from the founders to the funder at the end of the funding period, reducing the B-BBEE level scoring of the business by the end of the investment period.

5. Although the Inquiry acknowledges this line of thinking, HDP entrepreneurs are at a greater disadvantage in receiving lucrative deals, as the majority of investment deals are focused on post-revenue businesses, due to the VC industries mandate to focus on Series A, B or C level funding it excludes pre-revenue stage businesses and this where most of the black entrepreneur business lie. Whether intentionally or not, the financing models and mandates of the VC industry excludes are large portion of the South African population. Where VC fund managers assess the risk of the deal, due to a lack of wealth accumulation and angel networks, HDP entrepreneurs are unable to bootstrap to get to the post-revenue funding phase where their business can be assessed as lucrative by a fund manager.

6. HDPs are the most affected by this funding model, unlike their white counterparts, as many black entrepreneurs have no accumulated wealth, little access to networks or "angel" investors or the necessary collateral to mitigate risk for debt financing. In turn, far fewer black entrepreneurs are able to participate in the digital economy, facing perpetual funding barriers as a result of historical disadvantages and the lack of transformation. Although there has been growth in the number of angel investors as the black middle class has grown over the years, it is still not enough to assist the greater South African demographic. Comments received from stakeholders on the Provisional Report supports these findings adding the following "*…Most Black People do not have access to funding to assist their businesses and most funding institutions including development finance institutions (DFI's) do not cater for such businesses. In order for businesses to enter this [digital] space, they require access to substantial project development funding in the form of venture capital finance. The economy is moving towards online business and if the issue of access is not addressed, the economic inequalities will be perpetuated and will deepen*. "[9]

7. The Inquiry benefitted from the insights received in the submissions to the Provisional Report and the engagements held in terms of section 43E of the Act with stakeholders after its publication. Many stakeholders provided deeper insight into the solutions

5 In 2020, R1.39 billion was invested in 122 companies. SAVCA Public Hearing Transcript, 3 November 2021 by Mr Keet van Zyl, Ms. Shelley Lotz and Tanya van Lill, page 4.
6 SAVCA Response to OIPMI Provisional Report, WS1, 30 August 2022, page 3.
7 SAVCA Response to OIPMI Provisional Report, written submission (WS1), 30 August 2022, page 2.
8 SAVCA Response to OIPMI Provisional Report, written submission (WS1), 30 August 2022, page 2.
9 National Empowerment Fund Submission, written submission (WS2) dated 22 September 2022, page 3.

that are required for alleviating these challenges identified in the Provisional Report and assisted the Inquiry in providing specific recommendations to its findings. The submissions from industry players offered alternative approaches and global initiatives supporting the development of SME and HDP entrepreneurs that could catalyze for transformation.[10]

8. The Annexure will, in conjunction with the Provisional Report, consider and discuss some of the insights that have emerged from stakeholder discussion and submissions that would help stimulate this process. Discussions with industry stakeholders offered six ways and models in which the VC industry and Development Financial Institutions ("DFIs") can support black entrepreneurs in moving funding towards more inclusion and to alleviate the challenges faced by black entrepreneurs in South Africa. Global initiatives in the use of alternative instruments and models (particularly quasi-equity instruments, impact investing, mandates, and incubators / accelerators) have been impactful and effective tools with the support of government and the crowing in of private sector investment. These approaches have been used as a means of reducing risk and to crowd in funding at the same time.

10 SA SME Fund, written submission 1 ("WS1"), discussion paper on Small Enterprise Financing, 08 September 2022 V4.0, page 14.

[2. Platform Funding]

2.1. Venture Capital Funding Phases and Models

9. As discussed in the Provisional Report, the VC industry identifies two broad phases of funding, pre-revenue, and post-revenue. Pre-revenue is at the very early stages of the business (pre-seed and seed phase), where the business is starting its operations. Depending on the nature of the business and the initial costs involved with developing the business idea, this stage of funding may take some time. The seed phase is also at the early stages of the business determining the company's final product and target market. These phases are viewed as high risk for VC investors and are typically taken on by the founders themselves, family or 'angel' investors. Post-revenue is Series A, B and C phases and this is where the VC industry typically considers its investments, after the start-up has bootstrapped to demonstrate proof of concept and scalability (developed a product a user base, consistent revenue figures and key performance indicators).

10. The VC industry uses what they call the '*traditional funding model*'[11] to pool in capital. An independent VC fund raises capital by pooling from multiple third-party investors, alongside their own capital, in exchange for equity or an ownership stake at the end of the funding period. Pooling multiple investments into multiple startups reduces risk. The fund manager is a custodian of the investment capital; he/she grows, expands, and scales the startups and produces returns for investors. The fund manager also uses the fund's profits, which typically fall at 20% of the overall returns, to run the operational expenses i.e., paying staff, due diligence, and other office expenses.[12] The rule of thumb for a typical "closed fund" [13] with a time span of up 5- 10 years, depending on the mandate of the fund, is the 2&20 arrangement,[14] the management fee sits at 2% and the 20% is the carried interest or "the carry".

11. This is the typical funding model which according to the industry is not conducive to funding at pre-revenue (pre-seed and seed phase). For a traditional funding model that follows this form, it may be difficult for a fund manager to run 350, R10 million deals for instance, at very early stages because of the time and due diligence it takes to manage these funds, so the fund manager will tend to focus on less deals that will yield higher returns, at for example R50 Million, requiring less development time and more returns.[15] This model forces the VC fund managers to invest in businesses with more traction and ones that are scalable (Series A, B and C funding rounds) in order to manage their constraints. Because VC funding is returns based, investors want to make an investment in exchange for equity in the business, which at pre-revenue stage, would leave the entrepreneur with nothing early on.

12. The corporate funding model is where corporates fund start-ups within the industry they operate. The corporate model involves investing their own capital in startups, often in their own industry, with a clear strategic focus on accessing technology and business ideas.[16]

11 SAVCA, SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
12 SAVCA Response to OIPMI Provisional Report, written submission (WS1), 30 August 2022, page 3.
13 Business Partners, OS1, Jeremy Lang.
14 Business Partners, OS1, Jeremy Lang,
15 SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
16 Corporate Venturing, https://corporatefinanceinstitute.com/resources/capital-markets/corporate-venturing-corporate-venture-capital/ accessed 22 February 2023.

This is a strategic investment that seeks to exploit synergies between itself and the new venture. Here, the corporate, can compete with external VC firms because of its market knowledge but also its ability to be a patient investor. This may spark investment interest which builds traction for the corporate brand and raises returns. This is typically popular and gaining traction in agriculture, Fintech and Insuretech. The SA financial institutions operate such a model in fintech/insuretech which generates the most funding activity.[17]

13. Lastly, the SA SME Fund uses the fund of funds model, pooling third party investors to invest in other VC funds creating a portfolio of various underlying funds, becoming a fund of funds.[18] "*This form of funding model aims at achieving a broader diversification and asset allocation with investments in a variety of fund categories that are all wrapped into one portfolio*".[19] A fund of funds can be a form of alleviating risk as it leverages the funding by acting as an anchor fund and in turn crowds in other capital from commercial investors. Being the *fund of funds*, the SA SME Fund takes on the first capital investment that is matched by third parties who follow suit. Government can play a role in this form of funding model acting as a form of risk reduction by being an anchor investor and committing initial capital. This essentially helps gather momentum for the fund and garners credibility and networks to attract other investors.

14. The current investing environment and traditional models do little to catalyze transformation for HDP start-ups in South Africa. Some of the views that have been raised in this regard is that traditional VC funding models will not transform the industry: because (1) fund managers invest in businesses with more traction that will yield high returns, (2) the fund manager spends time building and supporting the development of the start-up and (3) the inclusion of the 2&20 rule for staff support and management fee makes it inefficient to invest in pre-seed and seed phase businesses.[20] Therefore, South Africa needs to look at global models that will open funding for SMEs and HDPs. However, the SA SME Fund has been able to bypass this challenge by being a fund of funds.[21]

15. The SA SME Fund also uses a mandate model to target investment for 75% black entrepreneurs. Using a mandate model, SA SME Fund pools its portfolio and directs funds to targeted SME and HDP businesses or specific geographic location in more racially diverse areas, townships or where there's less concentration of VC industry funding. The SA SME Fund has found that the mandate model can be effective in supporting HDP entrepreneurs.[22] The Inquiry's understanding of these models has provided much deeper insight into how the VC industry can invest in riskier deals and become more transformed and be more inclusive in directing funding for early stage HDPs.

16. Other government institutions such as the National Empowerment Fund ("NEF"), have been involved in some post-revenue funding cycles along with private investors, The NEF has an existing venture capital fund called the Strategic Projects Fund, which is a specialist venture capital arm to support projects aimed at increasing the number of black people participating in early-stage projects. It has managed to leverage about R4 billion in third-party funding, but this is at a lower risk stage,

17 Naspers Foundry, WS1, 10 September 2021.
18 SA SME Fund, Ketso Gordhan OS1, 29 September 2022.
19 https://www.investopedia.com/terms/f/fundsoffunds.asp#:~:text=The%20fund%20of%20funds%20(FOF,on%20a%20different%20investment%20scheme accessed 15 February 2023.
20 SAVCA, SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
21 SA SME Fund, written submission 1 ("WS1"), discussion paper on Small Enterprise Financing, 08 September 2022 V4.0, page3.
22 Home Page - SA SME Fund "Overview of the Fund".

requiring businesses to be commercially viable and at post-revenue phase to receive funding. Most of the funding is not in the tech space, but rather in sector targeted projects defined by the industrial Policy Action Plan.[23]

17. We discuss the findings of each of these models as well as other international models that have been used globally, that can alleviate risk for investors that perceive early seed to be higher risk. We also discuss how these models can be incorporated into the nascent VC industry, to grow it and to be more inclusive.

2.2. Incubators / Accelerators

18. The Provisional Report's findings on the significant advantages of setting up investment models around incubators / accelerators to alleviate the challenges of risk at pre-seed and seed phases continue to be valid. Industry players agree with the Inquiry's findings. Incubators / accelerators assist pre-seed phase businesses to develop their ideas in a manner that will create interest from VC industry funders. VC funders, corporates and tech companies deliberately use programs like these to assist in the selection process of new ideas that may create future investment opportunities and to aid in determining a business model that is able to scale and grow, which is the interest of VC investment.[24] Incubators will provide shared office space and services, along with mentorship, to a group of 30-40 selected startups for up to a year with the aim of developing the idea, including a revenue model. Accelerators focus on a more intense 3-month period of support for startups with strong potential before pitching them to potential investors at the end.

19. One of the challenges raised by the industry funders in discussions post the Provisional Report is the poor quality of deals available for funding in South Africa. The industry's concern is that there is a lack of quality of the deals and lack of technical skills from entrepreneurs that are lucrative enough to invest.[25] The Inquiry recognizes that the tech startup industry is far more high risk and specialized, requiring specific skills for mentoring and support, along with networks of funders and technical / business assistance, to get a startup to the point where it realizes its full potential. What is required to solve this problem is to build the pipeline, making sure that quality ideas exist, and businesses are lucrative enough and will guarantee success from very early on.[26]

20. Incubators / accelerators may serve as this pipeline build for early-stage startups, where the founders of the business are supported from very early in the business development through various business support grants. VC firms can use incubators / accelerators as effective tools to create this support. VC firms have the advantage of funding resources and knowledge of requirements for post-revenue investments and so having incubators / accelerators as part of the investment deal guarantees higher success rates of the business. To be able to generate quality deal flow, incubators / accelerators remain a viable option for investor control over risk and to determine the quality of the investment deal where the investment is perceived as too risky, unscalable or not yet established enough to be considered for more traditional funds.[27]

21. Unfortunately, a majority of South African incubators / accelerators are linked to university programs and not all VC firms have established accelerators, this is because small funds may not have the financial pool

23 National Empowerment Fund Submission, written submission (WS2) dated 22 September 2022, page 3.
24 Online Intermediation Platforms Market Inquiry (OIPMI) Provisional Report, 13 July 2022, Chapter 8 , para 15, 17 and 19.
25 NEF, OS1, 11 August 2022 and SA SME Fund, Ketso Gordhan OS1, 29 September 2022.
26 SAVCA, SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
27 Online Intermediation Platforms Market Inquiry (OIPMI) Provisional Report, 13 July 2022, Chapter 8.

or management fee base to cover costs of people, space and services to run incubators / accelerators. The other concern that has been raised is that incubators / accelerators that do exist, are mandated to measure the quantity of the entrepreneurs that participate in the accelerator programs rather than the quality of the deals and their inability to draw in investment interest.[28] So, the problem may lie with the quality of the incubators themselves and their failure to generate lucrative start-ups for deal flow rather than the availability of quality of deals.[29]

22. VC funders and tech companies need not be the only organizations or institutions to provide this form of non-financial support; government can provide a source of grant funding that can assist in building quality accelerators / incubators. At this stage the government can step-in by providing soft money into credible accelerators / incubators or can direct funds to credibly managed accelerators / incubators that can demonstrate revenue growth for its startups. Government grant funding can be used for these support services, including providing universities with pre-seed grant funding to aid commercialization of intellectual property, as these have fixed upfront costs and may be under-provided by the market if the probability of recoupment is too low.[30]

23. To date, there are a few tech companies that provide incubators in South Africa (highlighted in the Provisional Report) and the SA SME Fund is one of the few institutions to also provide this type of support as part of its portfolio. The SA SME Fund works together with various universities to build this pipeline. For example, recently, the SA SME Fund put up grant funding of R2-3 million with the University of Cape Town, North West University and the Tshwane University of Technology to develop the pre-seed program.[31] Unfortunately, not all SA SME funds are directed at digital or tech startups as the focus of the Fund is to disburse this funding over an array of industries. The fund still functions on a returnable capital model and so pre-seed and seed are still perceived as high risk, so the funds form a small part of the overall SA SME Fund investment budget.

24. The Inquiry believes that government can play a part in adopting this form of modelling for grant funding to feed into the pre-seed and seed funding pipeline for wider scale universities and funds that are managed by private fund managers. This model of joint collaboration is a form of wholesale funding to VC firms in order to support the expansion of the VC industry and to increase finance for HDPs.

25. In the UK, government already implemented this model of bridging the gap and building the pipeline at university level in 2010.[32] Some government institutions have started adopting this idea with the NEF and the Department of Small Business Development ("DSBD") adding into their long-term strategic goals for 2023-2025, a pipeline for incubator start-ups.[33] The NEF has started doing this with its "Life-to-date" program which attracted R10 billion in third-party funding by de-risking transactions. The NEF submitted that it provides business incubation support

28 SAVCA Public Hearing Transcript, 3 November 2021 by Mr Keet van Zyl, Ms. Shelley Lotz and Tanya van Lill, page 26.
29 Online Intermediation Platforms Market Inquiry (OIPMI) Provisional Report, 13 July 2022, Chapter 8 para 16; SAVCA Public Hearing Transcript, 3 November 2021 by Mr Keet van Zyl, Ms. Shelley Lotz and Tanya van Lill, page 21; Business incubation programs are often sponsored by private companies or municipal entities and public institutions. Their goal is to help create and grow young businesses by providing them with necessary support and financial and technical services. https://www.entrepreneur.com/encyclopedia/business-incubator accessed 19 June 2022.
30 SA SME Fund, Ketso Gordhan OS1, 29 September 2022.
31 Northwest University, UCT and Stellenbosch universities were one of the first to receive this form of grant funding about R2-3 million per university and the Fund required the universities to match this amount with 25% capital to match this.
32 SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
33 Department of Small Business Development SMME Support Plan 2020-2024, WS1, 17 August 2021.

and training where applicable, especially in the SME and rural transactions, as well as by supporting feasibility and related funding. These interventions provide third-party funders greater comfort and confidence to support what the market considers high-risk transactions.[34]

26. To date, NEF disbursed over R2.6 billion into the support of 600 SMEs.[35] However, this funding is not directed at digital or tech startups. Governments globally have administered their funding assistance at tech startups as these are some of the fastest growing industries in the world. Sectors such as Agritech, Fintech and insuretech, cloud computing and healthcare technology are rapidly growing tech industries.

27. As in the Provisional Report, the Inquiry maintains that incubators / accelerators serve as an essential feature in curbing the high-risk perception by the VC industry in South Africa. The VC firms submit that there is a need for the development of innovation hubs, upskilling young people and the provision of adequate funding for SMEs and HDPs that aim to develop online platforms.[36] Incubators / accelerators can act as a source of streamlining the entrepreneurs that already have some element of traction or user base at early-stages to help them develop a value proposition that can the mitigate the start-ups' risk. As highlighted in the Provisional Report, there are a number of tech companies that have tech education initiatives which may assist the ecosystem of developing tech entrepreneurs and in addition to these initiatives the Inquiry believes that government can also direct some grant funding towards these pipeline initiatives and programs.

2.3. First Loss

28. SME finance remains high on the policy agenda around the world. Prior to the COVID pandemic financial support for small to medium businesses across OECD countries focused on credit guarantees as the most widely used instruments, but there has also been increased effort to stimulate the use of alternative instruments, in particular equity-type instruments. This has been accompanied by increased attention to innovative fast-growing industries. Globally, governments have sought to support the funding of tech startups given their potential for high growth and employment. In countries where asset classes are nascent, small or new, as in the South African context for the VC industry, governments have implemented alternative de-risking incentives to attract private investors.[37]

29. The OECD notes that global challenges remain in accessing finance, especially for start-ups and micro-enterprises. Many DFIs focus on debt instruments as a form of financing, this is of course ineffectual in trying to solve the problems faced by pre-revenue businesses, and unfortunately do little to move the funding gap. Data submitted by the SA SME Fund shows that expanding and enhancing government funding and support to encourage VC funding can stimulate traction for investments. This intervention comes in the form of 'first loss' and could be critical in the South African context.[38]

30. Typically, a 'First Loss' Capital arrangement is when a capital provider, in this case government institutions, provide an initial contribution of capital to a fund manager and bears the first loss from the trading account. In other words, the private investor is assured

34 National Empowerment Fund Submission, written submission (WS2) dated 22 September 2022, page 3.
35 NEF Submission, WS2, 22 September 2022, page 4.
36 Naspers Foundry, OS1, page 8.
37 SA SME Fund, written submission 1 ("WS1"), discussion paper on Small Enterprise Financing, 08 September 2022 V4.0, page 2-5 and 4Di Capital, Justin Stanford, OS1,15 August 2022.
38 SAVCA, WS3, page 5.

that they will receive their capital investment first, before the first loss funder.[39] This assists in de-risking the asset class and acts as a credit enhancement tool provided by the initial funder to catalyze the participation of co-investors that would not have otherwise entered the deal. First Loss capital is beneficial especially for impact investment purposes.[40]

31. Government could assume the 'first loss' in the portfolio of investments held by a VC fund, and in so doing reduce the risks of other investors by reducing their exposure to the potential downsides. Government does not take on all the risk but is able to leverage its own funding to grow the pool available.[41]

32. Government could consider providing matching funding, working hand-in-hand with private VC firms with necessary skills and track record to allocate and disburse the capital, typically through VC Fund managers. A VC would then deploy the money into suitable investments.[42] Government would not be the sole financier as the VC would be expected to co-finance and share the risk. This may offer mechanisms to expand the available financing that the government would provide and ensure that interests are aligned for the survival and growth of the fund.[43] Thus, cultivating growth with infrastructures that are already available. First loss enables VC firms to take on riskier businesses and enter new sectors. The blended finance structure of this funding should attract investors that usually would avoid this asset class and lower the risk. This form of de-risking can be targeted at technology startups as they have a higher growth rate and potential for employment.[44]

33. As mentioned, globally many development funders adopt this idea of 'first loss'. For example, US AID has provided the SA SME Fund with 'first loss' capital of $2 million in 2021/2.[45] The Department of Science and Innovation has provided funding to the SA SME Fund of about R25 million in 2021[46] and recently the SA SME Fund has partnered with the Gauteng Government to initiate a 'first loss' fund that has also drawn in the Industrial Development Corporation ("IDC"). From its experience, the SA SME Fund has typically endured a first loss of around 10%-20% on its initiative for SMEs. However, these funds are not being run in-house and are rather used as leveraging through other funds. The Public Investment Corporation (PIC) could be grouped into this form of investment funding. Recently it indicated to the Inquiry that it was considering operating its own startup fund, but it is a large institutional pension fund investor in a different category to government funding.

2.4. Returnable Capital

34. As established in our findings in the Provisional Report, there is generally a limited role for traditional debt funding as this demands interest and repayments of loans that burden entrepreneurs early on, and essentially assumes an underlying revenue stream and profits within the business.[47] Equity capital is more patient but taken to the extreme it leaves the entrepreneur with little upside in growing the business. In other words, Debt strangles the business before it gets off the ground and

39 SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
40 SA SME Fund, Ketso Gordhan OS1, 29 September 2022.
41 SA SME Fund, Ketso Gordhan OS1, 29 September 2022.
42 SA SME Fund, Ketso Gordhan OS1, 29 September 2022.
43 Business Partners, Jeremy lang, OS1, 13 September 2022.
44 4Di Capital, Justin Stanford, OS1,15 August 2022.
45 SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
46 Department of Science and Innovation has also allocated about R100 million into the SA SME Fund in 2022 for more direct funding investments into SMEs.
47 Online Intermediation Platforms Market Inquiry (OIPMI) Provisional Report, 13 July 2022, Chapter 8 para 5.3 and 9 (i.e., an established user base, consistent revenue figures, or some other key performance indicator). This was reiterated further with Business Partners, Jeremy lang, OS1, 13 September 2022.

if DFIs take an equity stake at an early stage, it leaves nothing for the entrepreneur.

35. The use of 'Returnable capital' has played an increasing role globally. DFIs have found that providing capital as returnable instead of pure grant funding is ideal for the growth of a business' development as it provides better incentives to succeed. Many start-ups that access pure grant funding have weaker incentives to repay the grant.[48] Instead, government grant funding should be used for support services, such as incubators / accelerators (as mentioned above), including building the pipeline within universities to aid commercialization of intellectual property.[49]

36. This form of soft or quasi-equity instruments was used successfully in Israel, where returnable capital was used to grow its nascent VC industry 20 years ago.[50] The Israeli government provided loans in the form of returnable capital or subordinated debt to businesses and VC firms which allowed businesses to raise capital without giving up equity or control. It was seen as less risky and provided the entrepreneurs with the benefits of a loan for the startup without the risk of defaulting.[51] Returnable capital is perceived as less risky than pure equity investments or grant funding, and also provides some of the benefits of loans for the startup.

37. Returnable capital is a form of soft loan, which allows a business to raise capital without giving up equity or control for the repayment of that loan. Depending on the terms of the repayment, it can also be converted into equity at later funding stages for a rebated amount. Convertible loans can assist the entrepreneur to raise cash quickly in the early stages of its business when full funding rounds are not achievable.[52] This form of equity or quasi-equity instrument is used by VC firms that have mandated impact targets to invest in SMEs, firms such as Business Partners, use convertible debt and other quasi-equity instruments to circumvent the small startup from defaulting on the loans. For instance, collateral capital funding may be used but against intellectual property assets rather than physical ones.[53]

2.5. Impact Investment over Commercial Returns

38. It is generally accepted that VC funding models are returns seeking. VC firms seek startups that have high growth potential that will yield high equity or ownership stake at the end of the investment period. Commercialized returns-based funds will not necessarily look for small opportunities to invest in because these require far greater time and development and a lot of capital to grow, i.e., much riskier. VC investments fill the void between sources of funds for innovation and require sufficient return on capital for the risk they are embarking on. VC seeks attractive returns for its own participants, and sufficient upside potential to entrepreneurs to attract high-quality ideas that will generate high returns. Discussions with the VC industry demonstrate how the traditional funding model is unfavourable for smaller startups because of how significant effort is required to gain returns.[54]

39. In many instances VC firms invest in various startups before whittling down to make larger investments in better prospects. For example, a typical investment deal of R10 million requires the business to be worth R50 million for a VC fund manager to consider it lucrative

48 SA SME Fund, Ketso Gordhan, OS1, 29 September 2022.
49 SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
50 The Israeli government provided capital of $100 million to private sector firms promising returnable capital guarantees of up to $8million dollars; if the VC funds could raise targets of $12 million of third-party capital. Ultimately, each firm grew its capital pot to $20million using governments returnable soft money.
51 SA SME Fund WS2, discussion paper on Small Enterprise Financing, 08 September 2022 V4.0, page 14 & 15.
52 Business Partners, Jeremy lang, OS1, 13 September 2022.
53 Business Partners, Jeremy lang, OS1, 13 September 2022.
54 SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.

at Series B or C.[55] Even black mandated VC firms like Kulisani Fund[56] or Digital Africa Ventures[57] have a minimum deal size required to invest. One of the solutions postulated by industry players is for government intervention, incentivizing through first-loss as discussed above, but also for government not to compete on a commercial returns basis but to provide more 'patient capital' that is measured through societal outcomes.

40. Technical Development Assistance ("TA" funding) is not return seeking but rather impact based, where the investors actively seek to place capital in businesses or industries that address social concerns. Nowadays this is seen through green funds for environmentally friendly initiatives such as alternative energy or climate change initiatives or sustainable living. Impact Investors accept disproportionate risk or concessionary returns to generate positive impact for societal gains. In this case, investors like government institutions, contribute more patient capital that is focused on impact returns rather than commercial returns, measured through outcomes such as job creation, pipeline building, or ecosystem building, with little to no return expectations.[58] The Inquiry has found that even private sectors or corporates have an interest in this form of investment as it essentially can be a long-term gain or part of their corporate social investment.

41. In some cases, impact investors may require returns to be converted into equity for the founder if certain targets are met, including impact targets, providing strong incentives to develop the business and make it succeed. VC funders that have a mandate that can provide some form of risk finance to SMEs do so through *Impact measure investments.*[59] VC firms like Business Partners provide mandates that measure returns on impact metrics, for example the green industry momentum on environmentally friendly initiatives measured through the operational model of the business.

42. Impact investments made for the intention to generate positive measurable social outcomes for HDP startups in online markets can quickly plug the funding gap recognized in South Africa.

2.6. Mandates

43. The Inquiry's Provisional Report found that the broad mandates around the VC funds' investment strategies in South Africa is to invest in high-growth companies. Many of the mandates may also extend to the types of businesses and the level of risk that the funders are willing to take on, but essentially the big early-stage funding gap in South Africa is due to the types of mandates that drive the VC funds. VC funds are mandated to target "post-revenue" Series A to Series C funding and not necessarily early-stage start-ups.[60] There are a great deal of advantages for mandates and the use of targeted mandates, which were discussed extensively in the Provisional Report. The Inquiry finds that industry players concur with the Inquiry's findings and have advocated for more mandates to be targeted at HDPs for VC funders.[61] Mandates provide targets for the funds and provide guidelines on priorities, goals, and benchmarks for the fund.[62]

44. The SA SME Fund, which has a mandate of 75% for HDPs, has found that a mandate

55 SAVCA and Grindstone, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
56 Business Partners, Jeremy lang, OS1, 13 September 2022.
57 Supported by the SA SME Fund, Digital Africa Ventures is an early-stage and seed stage investments in digital technology acceleration.
58 SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
59 Business Partners, Jeremy lang, OS1, 13 September 2022.
60 Naspers Foundry - Submission by Webber Wentzel, dated 10 September 2021, page 9. Online Intermediation Platforms Market Inquiry (OIPMI) Provisional Report, 13 July 2022, Chapter 8, para 6 and 7.
61 Business Partners, Jeremy lang, OS1, 13 September 2022.
62 Business Partners, Jeremy lang, OS1, 13 September 2022.

model in providing funds to the VC industry can be used effectively in supporting HDP entrepreneurs. The mandate provides targets for the funds and uses a penalty clause on the 'carried interest' component of the fund to create stronger incentives to identify, develop and invest in HDP entrepreneurs to meet those targets.[63] For example, the SA SME Fund has reported that for every target not met by a fund manager, the SA SME Fund will reduce the fund's profit share or "carry" by 1%.[64] One of the other SA SME Fund mandated targets for instance is that it has provided support for incubators, in the form of grant funds, and the mandate requires the incubators to be located in Johannesburg rather than Cape Town to improve racial diversity.[65]

45. The real benefit of the mandate model is that it can leverage the funding and can crowd in other capital, for the potential benefit of HDP entrepreneurs depending on the mandate target.[66] If the use of fund mandates moves HDP entrepreneurs into a post-revenue position, they are likely to get the support of other investors in series A, B and C rounds. Government funding can also be mandated for a particular sector, a type of business, groups of people or for a specific location. Mandates would establish a set of performance parameters and target markets, addressing pressing issues and aligning investor beliefs and values with the allocation of capital to address these funding needs.[67] Government can incentivize private sector funders, just as how the SA SME Fund has done, through a 'fund of funds' model with targeted mandates, rebates, and penalties.

46. For example, the International Finance Corporation (IFC) provides Business Partners with mandate funding at a certain rate as a debt instrument to the firm, and one of the measures or incentives to maintain the mandate is a rebate on the interest rate on the debt instrument. The debt is rebated at a certain percentage, if the fund reaches its mandated impact targets. The objectives of the IFC mandate is for a certain percentage of funds be given to startups or initiatives that provide woman empowerment.[68] The Job's Fund is another example of a mandated fund that is managed by a VC firm, where it will act as an anchor or co-funder for the VC and the firm manages that fund according to the anchor funders' mandate.[69]

47. The Inquiry concludes in its provisional finding that there is funding impediment for HDP inclusion and participation in the platform markets, with particular challenges at the pre-revenue stage. This funding gap particularly affects HDP entrepreneurs as they are in all likelihood at the initial stages of their businesses at pre-revenue (pre-seed and seed phase) and require the most capital to assist in business development and to realize their ideas. The Inquiry finds that first loss and/or convertible debt instruments, along with some direct funding support for incubators and accelerators to reduce risk and crowd-in private investors will assist in alleviating these challenges, which is missing in the current package of funding provided by the South African government.

48. The Inquiry also finds that the VC industry along with institutional funders require transformation and a shift in resources to support the development of HDP entrepreneurs. In the context of the growth and importance of the digital economy, remedying this is a constitutional imperative and aligned to government's emphasis on the digital economy for growth and development.

63 SA SME Fund, Ketso Gordhan, OS1, 29 September 2022.
64 SA SME Fund, Ketso Gordhan, OS1, 29 September 2022.
65 SA SME Fund, Ketso Gordhan, OS1, 29 September 2022.
66 SA SME Fund, Ketso Gordhan, OS1, 29 September 2022.
67 Business Partners, Jeremy lang, OS1, 13 September 2022.
68 Business Partners, Jeremy lang, OS1, 13 September 2022.
69 Business Partners, Jeremy lang, OS1, 13 September 2022.

[3. Business User Funding]

49. The Inquiry finds that the same challenges that affect HDP entrepreneurs with establishing digital platforms affect business users that use those intermediation platforms. Funding is still a concern even at business user level. Although the Inquiry has required specific remedial action from all leading platforms to support HDP business user access, afford and attain visibility on those platforms, funding is still likely to present another challenge for some businesses in making the necessary investments to achieve and exploit an online presence. This applies universally across intermediation platforms, whether it is black estate agents or auto dealerships on classified platforms, restaurants on food delivery platforms, marketplace sellers on eCommerce platforms, accommodation providers on travel platforms or app developers on the app stores. An effective online presence provides considerable opportunities for business growth through exposure to a national consumer audience (or global apps) and reach beyond the physical confines of a retail presence. Therefore, it is fundamental that initiatives are created to support black entrepreneurs that use intermediation platforms.

50. The historic exclusion from the economy and inability to accumulate wealth presents a barrier to HDP entrepreneurs using platforms to grow their businesses and their inability to effectively compete. Submissions from stakeholders agree with the Inquiry's findings. Capital is important for online businesses to compete effectively on prices and initial subscriptions.[70] Small businesses that use these platforms need to attract customers through specials and discounts. For an online business user to thrive, it needs financial backing to fund "intentional losses" like initial discounts for first time users and promotions.[71] These initial losses get recoup over the long run as the business grows.[72]

51. Global tech support for business user funding has been limited. VC firms that do collaborate with global tech companies like Knife Capital and Grindstone who have in the past partnered with Google or Amazon AWS for developmental funding have shown that much of the developmental concepts are at product and service level offerings rather than increased capital investment.[73] However, their experience is that the purchase or sourcing of other support services such as technical assistance are still necessary even if not on the same complexity as tech startups. This may include assistance on how to effectively make use of the tools provided by platforms to maximize sales through the platform to the extent their own programmes do not include this, products and services such cloud credits[74] from both Amazon and Google may assist on this.

52. Moreover, domestic experience of business user funding from VC firms such as Business Partners who work with HDP entrepreneurs to secure franchising and distribution opportunities, is that commercial funders expect entrepreneurs to bring some of their own capital to have 'skin in the game'.[75] This

70 National Empowerment Fund Submission, WS2, 22 September 2022, page 5.
71 National Empowerment Fund Submission, written submission (WS2) dated 22 September 2022, page 6.
72 National Empowerment Fund Submission, written submission (WS2) dated 22 September 2022, page 6.
73 SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
74 SAVCA, Keet van Zyl, Thiru Pather and Shelley Lotz, OS2, 15 September 2022.
75 Business Partners, Jeremy Lang, OS1, 13 September 2022.

type of modelling perpetuates the exclusion of black entrepreneurs in business more broadly but also online presence. Therefore, learning from global initiatives instruments such as Impact investments and incentives that will mitigate risk and crowd in funding as discussed above and will assist in overcoming the funding gap for HDP business users. However, it also requires certain concessionary financing or the types of soft equity instruments, including convertible loans (to founder equity too) to reach this goal.[76]

53. There are more government programmes to support these types of businesses including on a funding level. For example, the NEF has indicated that they provide venture capital focused on assisting Black Owned estate agency businesses through venture capital for the development of visibility on the platforms that can operate in lower priced properties in areas where low to middle income earners reside like townships. The NEF has also submitted on black founders' initiatives for accommodation-based businesses (hotels, BnBs, rental properties, property sales etc). The fund enables black entrepreneurs to develop properties which will attract such businesses in historically black residential areas like townships.[77]

54. The NEF has also pledged in their development plan to start initiatives that will be developed to ensure that black entrepreneurs have resources that will enable them to operate businesses that support multinational OEM's in the motor vehicle space. The venture capital fund will allow the NEF to fund the prohibitive costs to meet the requirements of the multinationals to authorize HDP entrepreneurs to do business with global brands. This will focus on both the dealer networks and vehicle repair services and panel beaters.[78]

55. The Inquiry believes that this fund will assist at alleviating part of the transformation problem, especially with the target of the township economy. Perceptions play an important role, with some observers noting that within the VC industry not only is there a perceived higher risk for township businesses but also for HDP entrepreneurs more generally, based on a perception that they are lending to someone with little set of skills, business support or capital for any loss. This perception may lie with the investor or the fund managers themselves.[79] The experience of the SA SME Fund is that geographic location also matters, with incubators in the broader Cape Town / Stellenbosch area, the home of a high concentration of the SA VC industry, being far less racially diverse than those located in Johannesburg, which can draw on a much larger black middle class.[80] Therefore, the Inquiry welcomes these initiatives from the NEF, however Inquiry believes that more needs to be done as a collaborative effort by both government and the VC private sector to remove these perceptions and transform the VC industry.

56. The Inquiry therefore finds that there is a gap for funding and additional assistance for HDP businesses to build their online presence and take advantage of the other remedial actions determined by this Inquiry.

76 Business Partners, Jeremy Lang, OS1, 13 September 2022.
77 National Empowerment Fund Submission, written submission (WS2) dated 22 September 2022, page 6.
78 National Empowerment Fund Submission, written submission (WS2) dated 22 September 2022, page 6.
79 SAVCA Public Hearing Transcript, 3 November 2021 by Mr Keet van Zyl, Ms. Shelley Lotz and Tanya van Lill, page 41.
80 SA SME Fund, Ketso Gordhan, OS1, 29 September 2022.

[4. Appendix A: List of Submissions]

Submission made by	Stakeholder type	Submission full name	Date	Submission made by	Report shorthand reference
Southern African Venture Capital Association	Association	Comments on Provisional Report	30 Aug 2022	Shelley Lotz,	SAVCA, WS3
Southern African Venture Capital Association	Association	Meeting SAVCA	15 Sep 2022	Shelley Lotz, Keith van Zyl and Thiru Pather	SAVCA, OS2
Southern African Venture Capital Association	Association	Public Hearing Session with SAVCA	3 Nov 21	Shelley Lotz, Keith van Zyl and Tanya van Lill	
SA SME Fund	Venture Capital	Meeting with SA SME Fund	29 Sep 2022	Ketso Gordhan	SA SME Fund, OS1
SA SME Fund	Venture Capital	Comments on Provisional Report: *Discussion Paper on Small Enterprise Financing*	08 Sep 2022	Ketso Gordhan	SA SME Fund, WS1
National Empowerment Fund	Government Department	Meeting with NEF	22 Sep 2022	Mziwabantu Dayimani, Nhlanhla Nyembe, NM Moleka,	NEF, OS1
National Empowerment Fund	Government Department	Comment on Provisional Report	27 Sep 2022	Mziwabantu Dayimani, Nhlanhla Nyembe, NM Moleka,	NEF, WS1
Public Investment Corporation	Government Department	Meeting with PIC	22 Sep 2022	Kentse Yende,	PIC, OS1
Business Partners	Venture Capital	Meeting with Business Partners	13 Sep 2022	Jeremy Lang	Business Partners, OS1
4Di Capital	Venture Capital	Meeting with 4Di Capital	15 Aug 2022	Justin Standford	4Di Capital, OS1
Department of Small Business Development	Government Department	Response to RFI	17 Aug 21	Mojalefa Mohoto	DSBD, WS1
Naspers Foundry	Investment subsidiary of Naspers Ltd	Comments on Provisional Report	7 Sep 2022	Daryl Dingley	Naspers Foundry, WS5
Southern African Venture Capital Association	Association	Consultation process post-provisional report	23 Jun 2023	Shelley Lotz,	
B-BBEE Commission	Government Department	Comments on Provisional Report	19 Jun 2023	Tshediso Matona	
Department of Trade, Industry and Competition	Government Department	Meeting for Comments on Provisional Report	8 June 2023	Tanya van Meelis	