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ASSESSMENT OF SOUTH AFRICA'S
FINANCIAL SECTOR AND THE
OPERATIONAL FEASIBILITY OF THE
SOUTH AFRICAN GROWTH FUND (SAGROF)

AFRICA VENTURE CAPITAL PROJECT (AVCP)
U.S. Agency for International Development (AFR/ONI/PSD)

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(Task Order Nos. 14A and 14B)

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EXECUTIVE SUMMARY

I. INTRODUCTION

Discussions during early 1991 between the Africa Venture Capital Project (AVCP) and the South African Growth Fund Steering Committee (SAGROF) led to a formal request by SAGROF for technical assistance. Technical guidance was requested to assist SAGROF in the following areas:

- . Capital mobilization from local sources;
- . Recruiting an effective, full-time management team; and
- . Developing a precise definition of business investment opportunities for black entrepreneurs.

The AVCP team traveled in South Africa from September 15 to 27, 1991 and included: (1) Dr. Barron Harvey, Harvey & Company President; (2) Mr. Gilbert Crawford, former AVCP Assistant Project Manager; (3) Mr. Clarence Haynes, Vice President of Pryor, McClendon and Counts (a minority-owned/managed Washington, DC based investment banking firm); and (4) Mr. Jeffrey van Rooyen, CPA and partner, Deloitte, Pim and Goldby, Johannesburg, and SAGROF Steering Committee Secretary.

A. Assessment Methodology

The following tasks were established:

1. Review previous AID studies and assess the progress of SAGROF's Steering Committee.
2. Review SAGROF's ability to raise capital for a fund.
3. Review the fund's investee opportunities.
4. Review capabilities of the management groups available in the RSA.
5. Recommend follow-up actions for AFR/ONI, USAID/South Africa and the AVCP.

Methodology:

1. Review other studies undertaken for AID, and report on critical legal issues. (See Appendix A for list of documents.)

2. Conduct extensive in-country interviews with black entrepreneurs and accountants, middle and upper management at white-owned financial institutions, accounting firms, and conglomerates in Johannesburg, Cape Town, Durban and Port Elizabeth.
3. Review books, research reports and news articles on black and white business enterprises in South Africa.
4. Incorporate the findings of previous studies completed for AID/ONI under the AVCP, including work done in Zimbabwe, Botswana, Kenya, Uganda, Ghana, Cameroon, Guinea and Senegal.

B. Acknowledgements

The AVCP assessment team is greatly indebted to Mr. Jeffrey van Rooyen, his staff, and the offices of Deloitte, Pim and Goldby for organizing the mission's meetings and in-country logistics. Without this support it would not have been possible for the team to have conducted as large a number of interviews as it did.

II. CONCLUSIONS

A. Review previous studies and assess SAGROF's progress

A SAGROF initiated venture capital fund is viable, based on interviews, meetings, and careful reviews of the studies of the SAGROF fund. However, the relationship between SAGROF's Steering Committee and USAID/South Africa remains unclear. Equally unclear is how the [BICSN] Project's venture capital activity, the Black Equity Capital Fund (BECF), will interact with SAGROF's Steering Committee. It should be noted the SAGROF Steering Committee believes that they, or some other elected body of the black community, should have veto power over individual investment decisions of the venture capital fund.

In light of the BICSN activity, any decision to launch two USAID backed venture capital companies under two distinct management companies would confuse the investor market and result in unnecessary increases in management costs.

B. SAGROF's ability to raise capital for a fund

SAGROF should be able to raise between R2.5-5 million (\$1mm-\$1.6mm) from black communities. Nominal grant support should enable them to raise an additional R2.5-10 million (\$1mm-3.3mm).

A determination could not be made as to whether the present Steering Committee has the necessary level of experience or acceptance in the financial communities to raise these funds. This issue should be addressed by the Steering Committee.

A U.S.-based investment bank specializing in Africa, and working in conjunction with the AVCP, could locate private investment of roughly R1-5 million (\$333m-\$1.6mm). Donor agency investment bank funding could provide R10-30 million (\$3.3mm-\$10mm). The total capital fund potential is R16-50 million (\$5.6 -16.5mm).

C. SAGROF fund's investee opportunities

There is wide agreement in all of South Africa's business communities that the expertise needed to manage a locally-based venture capital fund is seriously lacking. Moreover, the apartheid system has resulted in an unfavorable environment for developing trained black middle management. If the breakeven/profitability threshold is to increase, this constraint must be addressed by directing extraordinary expenditures toward management assistance.

The dearth of black middle management will increase the venture capital fund's cost and reduce the profitability of its investments.

Quantifying the internal rate of return of proposed projects is difficult because of limitations on available data and the generally poor quality of the business plans reviewed.

Black-owned firms which exploit market niches offering 20 to 30 percent after-tax venture capital returns will face extremely stiff competition from white-owned businesses.

D. Capabilities of RSA-based management groups

Few managers in either the white or black financial communities are capable of managing the venture capital fund's investments. With the exception of the van Rooyen company and Deloitte Pim Goldby, SAGROF does not exhibit extensive management capabilities for a number of reasons. Inter alia, SAGROF committee members have highly demanding political and business schedules which hinder the group's ability to meet on a regular basis. SAGROF does not exhibit sufficient ability to singlehandedly manage a venture capital fund.

III. RECOMMENDATIONS

A. Additional technical assistance

AVCP could provide additional technical support to SAGROF to help the organization become operational. AVCP acknowledges that USAID/South Africa does not intend to fund separate venture capital funds. The Mission's position is consistent with the team's assessment.

B. Pre-Award collaborative working agreement

Before AVCP formally recommends grant assistance to SAGROF there should be agreement on future collaboration among AVCP SAGROF and the BICSN venture capital project.

If a venture capital fund is to be established, the following preliminary actions should be taken:

1. VC fund proforma operating budget

Send a team to the RSA to create a proforma operating budget for a SAGROF-initiated venture capital fund. The budget should include: (i) expenses; (ii) income projections; and (iii) a proforma balance sheet showing the types of deals and when they would be booked. This team should incorporate the findings of existing research studies.

2. Preparation of SAGROF information memorandum

The VC fund proforma operating budget should provide material necessary for a formal information memorandum detailing:

- a. the terms of the fund's structure;
- b. the size of deals;
- c. the types of investments;
- e. the board of directors and corporate bi-laws; and
- f. how to defray the management service costs needed to train effective business managers.

3. Team actions

Draft a grant document to cover the costs for:

- a. Development of a prospectus by a South African investment banking or accounting firm. The budget and information memorandum would serve as the blueprint for the prospectus.

- b. Issuing a grant to support the SAGROF Steering Committee's efforts to raise local capital for the fund. There are no black South African investment banks. Therefore, AID/W, USAID/South Africa and the AVCP should consider subsidizing this activity. The Steering Committee's ability to raise capital is a politically significant step because they envision receiving the mandate to vote many of the shares of the capital that they raise.

- c. Establishing a subcontract with an American investment bank to raise capital for a SAGROF-initiated venture capital fund in Western capital markets. This would include private investors, public donor agency investment banks, and NGOs.

C. Implementation Timetable and Requirements

If USAID/South Africa agrees to support AVCP with buy-in funds, then a team should arrive in RSA within 30-45 days after approval. Approval for funding of the second phase should be forthcoming 60 days later in order to begin work on a prospectus. The founders of the venture capital fund should be prepared to issue the prospectus to potential investors by the end of the quarter following funding approval for the second action phase during FY1992. Under this timetable, the designated management company could begin operations by the end of CY1992.

ASSESSMENT

I. INTRODUCTION

As a result of several discussions during early 1991 between the Africa Venture Capital Project (AVCP) and the South African Growth Fund Steering Committee (SAGROF), USAID/South Africa in June 1991 formally requested that AFR/MDI (currently AFR/ONI), through the AVCP, provide technical assistance to SAGROF in response to that organization's formal request for assistance. Harvey & Company indicated that a team could be in the field in August/September 1991. It was agreed among AID/W, HC and the South Africa Mission that AVCP core funding would be used to finance this consultancy.

Technical guidance was requested to assist SAGROF in the following areas:

- . capital mobilization from local sources;
- . recruiting an effective, full-time management team; and
- . developing a precise definition of business investment opportunities for black entrepreneurs.

The AVCP team traveled within South Africa between September 15 and 27, 1991. The team consisted of: (1) Harvey & Company President, Dr. Barron Harvey; (2) Mr. Gilbert Crawford, former AVCP Assistant Project Director; and (3) Mr. Clarence Haynes, Vice President, Pryor, McClendon and Counts (a minority-owned/managed investment banking firm). The South African team member was Mr. Jeffrey van Rooyen, CPA and partner, Deloitte, Pim and Goldby. Mr. van Rooyen, his staff, and the offices of Deloitte, Pim and Goldby organized the team's meetings and in-country logistics. Mr. van Rooyen also is a member of the SAGROF Steering Committee.

A. Report Scope and Assessment Methodology

Team tasks were identified based on group discussions at Harvey & Company offices in Washington, DC in order to respond to SAGROF's request for assistance in the three areas. These team tasks were as follows:

1. Review previous AID reports and assess the progress of SAGROF's Steering Committee.
2. Review SAGROF's ability to raise capital for a fund.

3. Review the fund's investee opportunities.
4. Review the capabilities of the venture capital management groups available in the RSA.
5. Recommend follow-up actions.

In undertaking this assessment, AVCP:

1. Analyzed other studies undertaken for AID, including the two venture capital pre-feasibility studies, assessments of U.S investor interest, capabilities and attitudes of black entrepreneurs in South Africa, venture capital divestment options within South Africa, and a report on critical legal issues. (See Appendix A.)
2. Conducted extensive in-country interviews in mid-September 1991 with black entrepreneurs and accountants, middle and upper management at white-owned financial institutions, accounting firms, and conglomerates. Subjects were considered representative of a wide cross section of black, mixed race and Asian business persons in Johannesburg, Cape Town, Durban and Port Elizabeth.
3. Reviewed books, research reports and news articles on black and white business enterprises in South Africa.
4. Incorporated the findings of previous studies completed for AID/ONI (formerly AFR/MDI) under the Africa Venture Capital Project, including work done in Zimbabwe, Botswana, Kenya, Uganda, Ghana, Cameroon, Guinea and Senegal.

B. Acknowledgements

The AVCP assessment team is greatly indebted to Mr. Jeffrey van Rooyen, his staff, and the offices of Deloitte, Pim and Goldby for organizing the mission's meetings and in-country logistics. Without this support it would have been difficult for the team to have conducted as large a number of interviews as it did.

II. CONCLUSIONS

A. Findings

1. Review work previously accomplished and assess progress of SAGROF's Steering Committee

A SAGROF-initiated venture capital fund is viable, based on interviews, meetings, and careful reviews of the studies of the SAGROF fund. However, the relationship between SAGROF's Steering Committee and USAID/South Africa remains unclear. This is especially notable in terms of how the recently awarded BICSN Project's venture capital activity, the Black Equity Capital Fund (BECF), will interact with SAGROF's Steering Committee.

In light of the BICSN activity, any decision to launch two USAID/South Africa backed venture capital companies under distinct management companies foster confusion in the investor market and result in unnecessary in management costs.

2. Review SAGROF's ability to raise capital for a fund

SAGROF, should be able to raise between R2.5-5 million (\$1mm-\$1.6mm) from black communities. If they receive nominal grant support from either AVCP or USAID/South Africa, they should be able to raise an additional R2.5-10 million (\$1mm-3.3mm).

The team could not determine whether the Steering Committee has the necessary level of experience in the financial communities to raise these funds. This issue should be addressed by the Steering Committee and communicated to the Mission, AID/W and the AVCP.

It is important to note a major difference of viewpoint between the SAGROF Steering Committee and the AVCP team: SAGROF believes that they, or some other black-elected body, should have veto power over individual investment decisions of the venture capital fund.

The AVCP team position is that proportional ownership should determine relative representation on the board of directors. The team further recommends that the board set broad investment criteria to be carried out by a board-selected management group. No other group should have binding input on investment decisions. The team believes that failure to adhere to this principle will lead to the

establishment of a fund resembling the now bankrupt development banks that litter the developing world.

In addition to SAGROF's capital raising efforts, the team thinks that a U.S. based investment bank, specializing in Africa and working in conjunction with the AVCP, could locate private investment of roughly R1-5 million (\$333m-\$1.6mm). Donor agency investment bank funding could contribute R10-30 million (\$3.3mm-\$10mm).

3. Review the SAGROF fund's investee opportunities

There is wide agreement in all of South Africa's business communities that the expertise needed to manage a locally-based venture capital fund is seriously lacking. Moreover, the apartheid system has resulted in an unfavorable environment for developing trained black middle management. If the breakeven/profitability threshold is to increase, this constraint must be addressed by directing extraordinary expenditures toward management assistance.

During its short mission, the AVCP assessment team encountered some difficulty in quantifying the internal rates of return of proposed projects because of limitations on available data and the generally poor quality of the business plans that were reviewed.

Black-owned firms which exploit market niches offering 20 to 30 percent after-tax venture capital returns will face extremely stiff competition from white-owned businesses.

The dearth of black middle management will increase the venture capital fund's cost and reduce the profitability of its investments.

4. Review the capabilities of RSA-based management groups

The AVCP team's assessment is that few managers in either the white or black financial communities are capable of managing the venture capital fund's investments.

With the exception of the outstanding logistical support from the van Rooyen company and Deloitte Pim Goldby, the AVCP team believes that SAGROF, as an institution, currently does not exhibit extensive management capabilities. The assessment team holds this opinion for a number of reasons, including the fact that SAGROF committee members have highly demanding political and business schedules which hinder the group's ability to

meet on a regular basis. Therefore, at this time, the assessment team does not believe that SAGROF exhibits sufficient ability to singlehandedly manage a venture capital fund.

B. Recommendations

1. Additional technical assistance to SAGROF

The assessment team recommends that AVCP provide additional technical support to SAGROF in order to help the organization become operational. The team acknowledges, however, that USAID/South Africa does not intend to make monies available to two separate venture capital funds at this time. This is consistent with the team's technical assessment that two Mission-supported venture capital funds would not be practical as they would tend to confuse the market.

The Mission and AFR/ONI should decide how to share the information contained in this report with SAGROF.

2. Pre-Award collaborative working agreement

The assessment team recommends that before an AVCP memorandum is sent to AFR/ONI formally recommending grant assistance to SAGROF, an agreement should be reached regarding the means by which AVCP, SAGROF and the BICSN venture capital project might work together.

If these parties reach an agreement which permits the AVCP, SAGROF and BICSN's Black Equity Capital Fund activities to work together, then the AVCP assessment team recommends implementing the following to establish a venture capital fund:

a. VC fund proforma operating budget

A team must be sent to the RSA to create a proforma operating budget for a SAGROF-initiated venture capital fund. The budget should include: (i) expenses; (ii) income projections; and (iii) a proforma balance sheet showing the types of deals and when they would be booked. This team should be aware of and incorporate the findings of each of the extensive research studies that have been undertaken in the past.

b. Preparation of SAGROF information memorandum

The VC fund proforma operating budget would provide material necessary for a formal information memorandum detailing:

- (i) the terms of the fund's structure;
- (ii) the size of deals;
- (iii) the types of investments;
- (iv) the board of directors and corporate by-laws;
and
- (v) how to defray the management service costs needed to train effective business managers.

c. Team Actions

The team must draft a grant document to cover the costs for:

- (i) development of a prospectus by a South African investment banking or accounting firm. The budget and information memorandum would serve as the blueprint for the prospectus.
- (ii) issuing a grant to support the SAGROF Steering Committee's efforts to raise local capital for the fund. There are no black South African investment banks. Therefore, AID/W, AID/South Africa and the AVCP should consider subsidizing this activity. The Steering Committee's ability to raise capital is a politically significant step because they envision receiving the mandate to vote many of the shares of the capital that they raise.
- (iii) establishing a subcontract with an American investment bank to raise capital for a SAGROF-initiated venture capital fund in Western capital markets. This would include private investors, public donor agency investment banks, and NGOs.

In light of the above, the team strongly recommends that the South Africa Mission and AFR/ONI work out an agreement whereby the Mission can buy-in to the AVCP to bolster support for a sole USAID-backed venture capital fund.

C. Implementation Timetable and Requirements

If USAID/South Africa agrees to support AVCP with buy-in funds, then a team should arrive in RSA within 30-45 days after approval. Approval for funding of the second phase should be forthcoming 60 days later in order to begin work on a prospectus. The founders of the venture capital fund should be prepared to issue the prospectus to potential investors by the end of the quarter following funding approval for the second action phase during FY1992. Under this timetable, the designated management company could begin operations by the end of CY1992.

III. COUNTRY CONDITIONS - REPUBLIC OF SOUTH AFRICA

A. Sanctions

Though official U.S. sanctions were removed by President Bush in August 1991, many sanctions remain in place at the state and local levels within the U.S. These sanctions severely hamper economic growth in the RSA and continue to contribute to negative perceptions of that country in the United States. Because of the sensitivity of the underlying issues and the lack of close monitoring by local authorities, the U.S. Embassy expects sanctions to remain in place in the medium term. The continued imposition of sanctions will negatively affect the venture capital fund's ability to engage a venture capital management firm from a highly respected U.S. firm. Sanctions also will hinder the fund's ability to raise capital in the U.S. market.

B. Capital Flight

Capital flight perhaps is even more of a troubling issue to the country's business community than are sanctions. No one can expect the international community to channel investments to black venture capital funds as current business leaders simultaneously expatriate large sums of capital.

IV. LOCAL AND INTERNATIONAL CAPITAL POOL MOBILIZATION

At this historical juncture it is unrealistic to expect large amounts of foreign capital from either the private sector or from the donor agencies. It is, therefore, critical for a USAID-sponsored venture capital fund to focus efforts toward locating internal sources of capital. There are several benefits associated with internal sources of capital. First, local capital will help to protect the fund from excessive foreign exchange exposure. Second, it will help to organize investors into consortia. This has been recommended by black South Africans as

a means of mobilizing the capital of black business associations: Third, many of the large multinational companies have expressed an interest in investing if other companies in their peer group invest.

A. Local Capital Sources

1. Black Communities

a. Business and Professional Associations

The Foundation for African Business & Consumer Services (FABCOS) has organized 11 associations of business persons, including the increasingly powerful taxicab association. These associations, united by FABCOS, represent a significant grouping of potential investors. The taxicab association alone is credited with collecting the bulk of the R25 million (\$8mm) in capital for Future Bank.

Because this area was not sufficiently investigated, FABCOS' willingness to invest remains unclear. However, many professionals in underprivileged communities have responded to the loosening business codes by investing their savings in small businesses.

b. High net worth Black South Africans

Though opinions from a significant cross section of wealthy black South Africans were solicited, those with whom the team did speak, primarily entrepreneurs, reported extremely limited interest in tying their capital up in a venture capital fund. Their sentiments mirrored those of other African entrepreneurs when they said that their capital could be put to better use in their own high return projects.

There are reported to be a large number of pre-"New South Africa" millionaires who made their fortunes in the informal sector or extra legal markets. The SAGROF Steering Committee may find value in investigating these high net worth individuals' interest in investing in the venture capital fund.

c. Pension fund contributions and banks

The Black leadership is becoming increasingly aware of the magnitude of the funds invested in insurance and pension funds for black South Africans. The ANC and other groups

have begun to investigate by urging their labor union leaders to direct fund managers to invest in projects in black communities. Members of SAGROF's Steering Committee think that the venture capital fund could make a strong case to union leaders for an investment of R5 million (\$1.6mm).

Africa Bank. During the AVCP's meetings with Jack Theron, Chief Executive of Johannesburg-based Africa Bank Limited, Theron indicated that without formally committing the bank, that he could easily envision an investment of less than R1 million (\$333m)--at perhaps around R500,000. He indicated that the bank would be very eager to review all of the venture capital fund's presentations to see if the bank could make commercial bank credit available to viable projects. Theron also said that the bank would consider making an additional contribution to the fund, in the form of an in-kind donation of office space on their premisses.

Future Bank. Future Bank was conceived in August 1989 under the leadership of Mr. Gaby Magomola of the Foundation for African Business & Consumer Services (FABCOS). Mr. Magomola was formerly Chief Executive of the Africa Bank. Future Bank seeks to provide services to black South Africans, with a focus on FABCOS members. The Bank began operations in 1991 and is a joint venture of FABCOS and West Bank. West Bank, wholly owned by First National Bank, owns 49 percent of Future Bank. Future Bank was capitalized at R20 million with a R300 million asset base.

While Mr. Magomola has no direct management responsibility in Future Bank, his opinion is that the Bank is interested in all activities that impact African business persons in a positive manner. Toward that end Future Bank would consider investing in the type of venture capital fund conceptualized. He stated that the fund should be focused on R100-R200 million deals instead of small R1 million deals.

2. Asian Bank

New Republic Bank Limited, headquartered in Durban, and a self-acknowledged "Asian" bank with total assets of around R500 million (\$150mm), was less committal when it came to discussing investing in a black venture capital fund. However, bank officials did express interest in reviewing the prospectus as well as the terms of the deals that would be financed by the fund.

3. White Communities

Some companies expressed interest in investing in a well-managed, non-political venture capital fund, especially if their peers invested. They all expressed a sensitivity to the goals of the fund. The issue of "peer response" appears to be very important in South Africa, a country with a high concentration of wealth and production in the hands of relatively few conglomerates.

The white businesses appeared interested in establishing new business linkages and in identifying innovative methods of financing these linkages. Several white-controlled businesses are currently examining Anglo American's Small Business Initiative to determine its replicability. It might be useful to consider using the "Edinberg" model of linkage venture capital, developed at UNDP.

a. Institutional Investors

Insurance Companies. The AVCP team did not have an opportunity to solicit responses from large insurance companies. This task must be completed by the next team.

Pension Fund Managers. The pension funds are coming under increasing pressure from the black, mixed race and Asian communities to invest a portion of their premiums in the communities that are paying the pension premiums.

b. Merchant Banks

Investec was interested in working on the product. They might be approached to capitalize this. Noting that venture capital has fared poorly in South Africa because of the numerous failures and poor reputation of the firms that initially peppered the market, Investec believes that a foreign management company will add significant appeal for local investors.

Syfrets, a major player in the investment banking arena, expressed great interest in the venture capital concept and indicated that it might be willing to invest in a venture capital fund following further review with the Executive Committee.

c. Commercial Banks

The limited number of meetings with bank officials was not sufficient to gain a strong sense of the commercial

banking community's willingness to invest in a venture capital fund.

d. Western Corporations and their South African Subsidiaries

More time must be spent to determine whether subsidiaries of Western corporations would be interested in investing. It might be relevant to note at this point that many American firms have been in the forefront of progressive corporate policies in the RSA. If the venture capital fund were viewed in a "politically correct" context, it is highly likely that it would attract significant investment interest from the subsidiary market.

4. **Public Agencies**

a. Southern Africa Development Bank

The SADB was created to play a role similar to that of the World Bank and ADB, as a lender to government institutions with an emphasis on infrastructure projects. It has made significant financing available to the so-called homelands. The SADB currently is considering opening a fund analogous to the IFC or ADB's private sector window. SADB's private sector General Manager, Mr. Nick Christodoulou indicated that, at this juncture, the bank is not in a position to invest in a venture capital fund. However, the SADB could play a supportive role by getting the insurance and pension fund companies to invest. He noted that IDT, Old Mutual and Sumlun will be willing to play a role and that they would expect SADB to be a major player.

b. Small Business Development Corporation

The SBDC has been active in financing with debt small and medium size companies. Officials were noncommittal regarding their interest in considering a R1 million investment.

B. International Capital Sources

1. International donor agency investment banks

It will be in the fund's best interest to have its prospectus forwarded to the donor agency investment banks after R10mm to 20mm are secured from the South African capital markets. A significant investment of approximately 20 to 33 percent of the fund's capital would give a donor

investment bank significant leverage on the board of directors and reduce some of the SAGROF members' concern that the fund will be hijacked by white investors.

AVCP team member and investment banker Clarence Haynes believes that the venture capital deal may hold some interest to the IFC. AVCP should contact the ADB's private sector window to determine their willingness to review a prospectus. Based on previous conversations with Mr. Leigh Durland of the African Development Bank, ADB most likely would be willing to review this work. Also, AVCP should contact representatives of the CDC, FMO, Swedefund, UNDP and DEG.

2. Multinational corporations considering direct investment

The team is of the opinion that without significant profit-enhancing grants to the venture capital fund, new investment from the multinational community at this time will be relatively limited. This is partly due to the continuing effect of sanctions. However, multinationals which reinvest in RSA stand to profit based upon their ability to leverage proven technical skill in an underdeveloped market.

V. ESTABLISHING A SAGROF-INITIATED VENTURE CAPITAL FUND

A. Fund Management

1. Local market

There is strong consensus within the discrete business communities that the South African market lacks individuals equipped with the skills required to run a venture capital fund. Middle management expertise may not exist at this time in the black and mixed race communities. This is a significant factor that must be taken into account from the standpoints of profitability as well as sustainability.

2. International market

It was clear to the AVCP team that during the venture capital's early years, most of the management expertise will need to come from abroad. The team's cursory review of the support for BICSN's venture capital component is not sufficient to cover the extensive direct management and management training required by the fund.

3. SAGROF Steering Committee

The team interviewed Steering Committee members about the feasibility of a venture capital fund in South Africa. Members elected by entrepreneurs and association leaders have relatively little direct financial management experience. This group, by its own admission, currently has neither the managerial nor the technical skills to manage a venture capital fund.

Having noted this, the AVCP team believes that the Steering Committee could play a very important role in raising capital from various black associations.

B. Fund structure

Following are the AVCP team's initial recommendations regarding the fund's structure:

1. Fund size

The team believes that it is reasonable to talk of a fund of between R30mm and R100mm. This would be large enough to cover some of the management operating expenses.

2. Size of investments and investee companies

The target investment company is the middle to large black-owned company which may have between R1mm and R10mm in turnover but which may not have the managerial or financial backing to make the next quantitative move into the first world markets. Equity investment is envisioned to range from R500m to R5mm.

3. Period of investment

The standard period of venture capital investment ranges between five and seven years. In the context of the RSA, this may need to be extended to eight or nine years.

4. Investment Policy

The stated investment policy is to invest in firms that will substantially increase the involvement of the communities historically denied access to the formal economy because of the apartheid system.

5. Ownership

The AVCP team recommends that ownership and voting rights accrue based on Rands invested. Any deviation from this would cause serious perception problems among first world investors.

6. Ownership rights and representation on the Board of Directors

The AVCP team again recommends that proportional ownership determine relative representation on the board of directors. The team further recommends that the board set broad investment criteria to be carried out by a board-selected management group. No other group should have binding input on investment decisions. The team believes that failure to adhere to this principle will lead to establishment of a fund resembling the now bankrupt development banks that litter the developing world.

C. Exiting (Portfolio Divestment)

Unlike those in much of Sub-Saharan Africa, the South African financial markets offer ample opportunities for divestment of profitable portfolio companies. The Johannesburg Stock Exchange has a special listing for small capital stocks. In addition, the private placement market is very active and exhibits significant absorptive capacity. The sale of Sorghum Breweries to a black community is indication that even this economically under-represented community has the ability to purchase significant companies.

VI. BLACK BUSINESS INVESTMENT OPPORTUNITIES

A. Market Competition (First World/Third World)

Black-owned firms which exploit market niches offering 25 to 30 percent after-tax venture capital returns will face extremely stiff first world business competition.

B. Economic Sectors

Business investment opportunities in black business communities include:

1. High labor-intensive industries, e.g., the garment industry;
2. Distribution in black areas;

3. Construction and Sub-Contracting; and
4. Transportation, specifically the micro-bus industry.

C. Franchising

The franchising sector promises to be a major avenue for black business empowerment in South Africa. It offers technical assistance, a proven marketing formula and relatively low capital costs. This sector helps to bridge the post-apartheid middle management gap.

A fund that worked in conjunction with one or more major foreign franchisors could prove highly successful in achieving the goals of AID and of SAGROF.

D. Business Linkages

Business linkages between black SMES and major white firms represent an important opportunity for black business persons to begin to supply the first world market. Advantages include an established market and purchaser credit. Major corporations in the RSA appear to be supportive of these initiatives but have failed to follow through, either because they are unfamiliar with the process or because they find the nurturing relationship to be too cumbersome.

A venture capital fund specializing in business linkages could act as a program advocate to the major corporations. The venture capital fund could stand between the small entrepreneur and the major corporations, thereby guaranteeing delivery timetables and quality control. In addition, the fund could work on developing financial packages for companies that had secured linkage contracts.

* * *

APPENDIX A - LIST OF DOCUMENTS REVIEWED

Maddox, Edward C. (December 1989) Analysis of the Venture Capital Strategy for the Black Enterprise Development Project.

Austin, J.E. Associates. (October 1990) South Africa Private Sector Study, Summary of Research and Implications for Assistance Strategy.

Werksmans. (Undated) Determination of Critical Legal Issues Related to the Future Operations of a Venture Capital Company in South Africa Making Investments in Black Enterprises.

Hale, Jr., Samuel. (December 15, 1989) Venture Capital Feasibility Analysis Washington, DC.

Ernst & Young. (July 1990) Black Private Enterprise, Report to the Venture Capital Steering Committee on a Proposed Structure for a Venture Capital Project in South Africa.

Bell, Martin; Ross-Larson, Bruce; Westphal, Larry E. (1984) Assessing the Performance of Infant Industries.

Hern, Ed; Koornhof, Johan, (September 1989) A Determination of Viable Strategies for Divestment of Shares of Black Controlled Enterprises Held by a Venture Capital Company. Rudolph Inc.

Butler, C. (January 15, 1987) Outline Proposal to the Urban Foundation for Support of a Venture Capital Fund. L.S. Associates.

Sunnyside Group, (August 1991) Access to Finance for Small Enterprises. Discussion document.

APPENDIX B - LIST OF ORGANIZATIONS CONTACTED
 AVCP SAGROF TECHNICAL ASSISTANCE ASSESSMENT TRIP REPORT
 (Johannesburg, Cape Town, Port Elizabeth and Durban)

SEPTEMBER 16 - 28, 1991

<u>MEETING</u>	<u>DATE</u>	<u>VENUE</u>
		<u>JOHANNESBURG</u>
VCRT/SAGROF EXCO	17	JOHANNESBURG SUN TOWERS
SA BROADCASTING	17	SA BROADCASTING CENTRE
DELOITTE PIM GOLDBY (DPG) SANDTON	18	DPG OFFICES
SA HOUSING TRUST	18	SA HOUSING TRUST PREMISES
SMALL BUSINESS DEVELOPMENT CORPORATION (SBDC)	19	SBDC PREMISES
GEORGE FOSTERS	19	FOSTERS CAR SALES
JIMMY SMITH	19	PANDORA KITCHEN
LUCAS SEBOBE	19	MEDICOS HAIR PRODUCTS FACTORY
DINNER - BUSINESS INTERACTION GROUP (BIG) & VCRT	19	LINGER LONGER RESTAURANT
AFRICAN BANK	20	AFRICAN BANK PREMISES
METBOARD	20	INVESTEC BANK PREMISES
SYFRETS	20	SYFRETS PREMISES
SA DEVELOPMENT BANK	20	SA DEVELOPMENT BANK PREMISES
EXCOM	21	EXCOM PREMISES
VINCENT MOFFAT	21	UNION WHOLESALERS/SOUTH FOLK LIQUOR STORES
SOLLY NETHONONDA	21	SOLLY'S DRY CLEANERS
VCRT/SAGROF EXCO	22	JOHANNESBURG SUN TOWERS

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Appendix B

<u>MEETING</u>	<u>DATE</u>	<u>VENUE</u>
		<u>CAPE TOWN</u>
DELOITTE PIM GOLDBY (DPG)	23	DPG PREMISES
LESTER PERTENT	23	VARIOUS ENTREPRENEURS
		<u>DURBAN</u>
DELOITTE PIM GOLDBY (DPG)	24	DPG PREMISES
NAVAL RAMASAR	24	VARIOUS ENTREPRENEURS
		<u>PORT ELIZABETH</u>
DELOITTE PIM GOLDBY (DPG)	25	DPG PREMISES
MARK HEADBUSH	25	VARIOUS ENTREPRENEURS
		<u>JOHANNESBURG</u>
WRAP UP SESSION	26	J VAN ROOYEN & COMPANY PRES SMALL

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