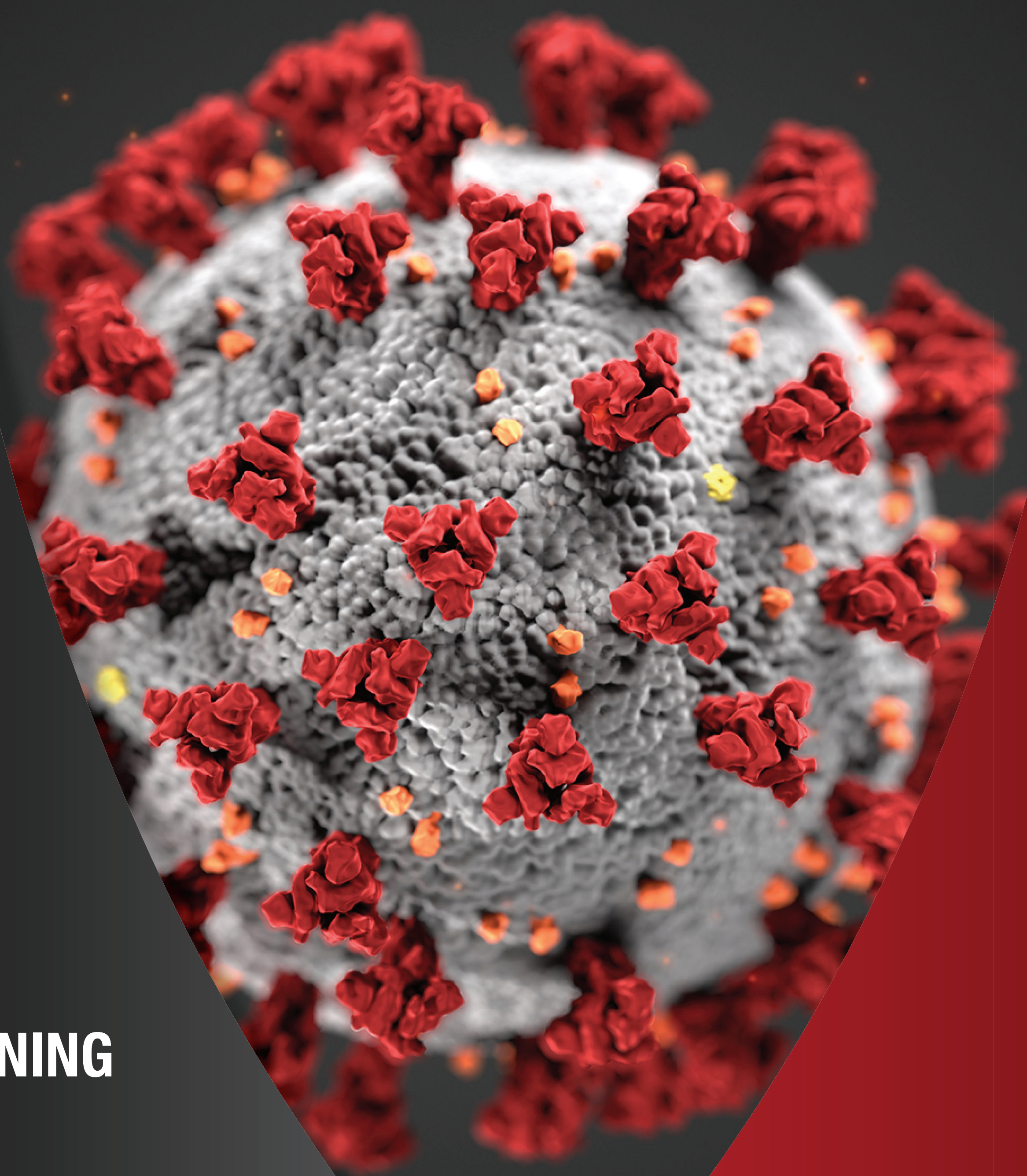
SAVCA
SOUTHERN AFRICAN VENTURE CAPITAL AND PRIVATE EQUITY ASSOCIATION



SAVCA POSITIONING PAPER

The SA Venture Capital and Private Equity industry responds to the COVID-19 crisis

COVID-19

CORONAVIRUS PANDEMIC

SOUTHERN AFRICAN VENTURE CAPITAL AND PRIVATE EQUITY ASSOCIATION

25 March 2020

The SA venture capital and private equity industry responds to the Covid-19 crisis

The Covid-19 epidemic is an unprecedented public health and economic crisis. President Cyril Ramaphosa and his ministers have taken decisive leadership in confronting the pandemic. Global evidence is clear that early interventions to limit contact and trace infection pathways help to slow infection rates. Support from opposition parties, civil society and business is helping to achieve this. The pressure will continue to be immense as we all work to limit the spread and impact of the pandemic, but we have high confidence in national leadership to lead us in doing so.

The private equity and venture capital industry manages R175-billion of investments in private companies, mostly small- and medium-sized businesses, on behalf of pension funds and other investors. We are at the front line of working with particularly small- and -medium sized companies to confront the crisis.

Our members are urgently engaged with their portfolio companies to support them in facing the challenges presented by the pandemic. This includes both managing market disruption and helping companies rapidly shift strategy to better cater for public needs. However, while the industry has experienced difficult economic cycles, the economic challenges presented by the pandemic are unprecedented. Our members are specialists in helping companies adapt to change and manage challenges. We will bring all the tools in our arsenal to help companies problem solve as active owners of businesses working closely with management teams.

The situation facing many companies is serious. If we are to have a functioning economy when we have worked through this crisis, it is important that certain economic interventions are made now. We outline below what we as an industry are doing to confront the crisis and what additional policy measures we believe would best support companies to survive the crisis. This is also in response to National Treasury's call for suggestions on how government can use its limited public finances to deal with the crisis.

Confronting the public health emergency

The private equity industry is invested across the economy including hospitals, walk-in health services, pharmacies and related technology companies. Our members are working with their investee companies in the following ways:

1. In the case of health-related businesses, members are ensuring staff and customers are safe with appropriate access to personal protection equipment, transport to work locations and appropriate protocols for hygiene and social distancing at health facilities.
2. Members are also working on rapidly expanding capacity of health services to cope particularly with Covid-19 by accessing equipment and consumables that are indicated. Demand for equipment such as ventilators and face masks has soared worldwide and we are using our global contact networks to source inputs. In some cases, our members are helping manufacturers re-tool and repurpose to be able to increase or switch production to essential

requirements. We are engaging with public sector counterparts to ensure we can support the overall health response.

3. In other businesses, our members are working with staff to ensure their safety, enabling them to work from home where possible. For businesses defined as providing essential services, our members are helping to ensure staff and clients are safe with appropriate protection equipment and protocols. Essential services will play a critical public function during the lockdown, ensuring public access to necessities.
4. The industry is also a major driver of health-tech businesses that develop ways to automate many aspects of medical care. Companies in this sector are working hard to scale up tech interventions to enable wider treatment, for example via digital consultations. We are also working to improve administrative processes so resources across the medical sector can be allocated optimally.
5. Our members are widely invested in ICT infrastructure and are ensuring that systems remain stable to ensure that communications infrastructure can manage higher demand. This includes increased rollout of new connections to support individuals and businesses who are having to switch to working from home.
6. Our members fund many tech start-ups which are now looking to rapidly develop tech solutions to support the fight against the pandemic, including track-and-trace apps and apps to enable sharing of critical information to fight the pandemic.
7. During the lockdown, communities will have extensive social needs including childcare, particularly in less-resourced areas. Our industry is looking to aid communities through innovations to support social and psychological health through communication, new means of digital interaction and other steps.

Beyond these steps, we will strongly support national efforts to manage the disaster including supporting the lockdown and ensuring all stakeholders have access to information to govern their own behaviour.

Supporting workers

All South Africans face a dramatic change to their lifestyles and working arrangements during the lockdown and generally as a result of the pandemic. The private equity industry plays a critical role in ensuring investee companies develop the human resources and governance systems required to effectively and efficiently manage their staff. We are working with investee companies to implement the systems required to ensure staff can safely continue working wherever possible, including extensive use of work-from-home systems.

Many companies, however, will face major demand shocks. Restaurants, hotels, travel companies and others have seen their entire marketplaces practically close. Where possible, companies can repurpose themselves to continue serving the public by providing takeaway food, for example, but even in such cases companies are likely to have excess capacity. Across the board, sales cycles are pushed out and purchasing is disrupted as senior management turns its attention to short-term crisis management. The disruption in normal purchasing will put pressure on small- and medium-sized companies across sectors, adding cashflow constraints and shortening runways for growth companies.

No company wants to reduce staff and our members are working closely with their investees to do everything possible to avoid such measures. Working on strategy to trade through this period is a critical step. As we discuss below, our members can, in some cases, provide emergency funding to support companies and obviate the need for short-term cost reductions. The objective is to bridge the gap to the point at which demand will recover.

However, many companies will have to reduce capacity in order to reduce the costs they incur during the period of low demand. This is to ensure survival so that they can recover

when demand returns. In such cases, our members are working to cushion staff as far as possible. We will take our problem-solving tools to work with labour to find solutions that have the least impact on staff while ensuring business sustainability. There will need to be bold thinking to find unusual solutions and we need open-minded counterparts to engage with.

All government support will also be used to minimise the impact on staff and the private equity industry appreciates the measures taken early by government to support the economy. In our view, the measures will likely need to go further than those already implemented but we believe it is a bold start. Ultimately, where no alternatives are available, retrenchment arrangements should be as generous as possible with support to access unemployment insurance benefits. Companies should consider giving staff an explicit right to be rehired when demand returns.

We believe that the Unemployment Insurance Fund can play an important role in supporting employees, as President Cyril Ramaphosa has announced. We believe that employers who are unable to keep staff on the job for an extended period should be supported to keep staff on payroll. In our view, the UIF funding would be best deployed by supporting companies' payrolls to prevent retrenchments. For those companies who cannot keep staff working, the UIF should provide a payroll subsidy, provided companies do not retrench.

We believe these scheme features would be best:

- The UIF should enable companies to continue paying employees at least 60% of their salaries up to R20,000/month (taking into consideration the average worker in SA is paid R21,432/month, according to the StatsSA QES for 2019Q2 and 60% is the top of the range of UIF benefits under current schemes).
- Companies should not be able to top up the salaries of those who receive the 60% UIF payments. This is important to ensure that the 40% reduction in pay applies so that there are clear incentives for workers to continue working where it is possible to do so and the scheme isn't abused.
- Practically, this can be achieved through a reverse monthly UIF contribution in company tax returns. The UIF claim can be offset against PAYE contributions.
- Companies will need to prove that workers are unable to work and any abuse should be vigorously prosecuted.
- The scheme should be implemented for 90 days initially.

Such a scheme would:

- Position the economy well for a rapid recovery as companies would not need to go through a rehiring process.
- Support aggregate demand in the economy by ensuring workers continue to have access to cash.
- Protect workers from economic hardship at a highly vulnerable time.
- Obviate the need to set up an elaborate UIF scheme by using company payroll and tax return mechanisms already in place.

The pay-as-you-earn holiday announced by the president, by which companies with a turnover of less than R50m can delay paying 20% of PAYE for four months, is a very helpful aid to the liquidity of small and medium-sized companies but will have only marginal impact on job retention. Also, the R500 subsidy for workers earning less than R6,500/month will help companies to retain low paid workers, but not the median worker. Our recommendation on how to deploy UIF funding would significantly enable companies to keep staff on payroll during the period of disruption.

Confronting the economic crisis

The economic fallout from Covid-19 is likely to be larger than the financial crisis which triggered the recession in South Africa in 2009. All businesses, except essential services will be closed from Friday, ranging from mines to factories. Several industries have already seen a dramatic fall in demand ranging from conference venues to airport catering companies.

The consequences will be an immediate loss in economic activity. The three-week shutdown will directly reduce gross domestic product by a few percentage points for 2020. Government and monetary authorities' efforts to provide economic stimulus to cushion the blow are welcomed, however there will be major disruptions that our members will be facing through their investee companies.

During this time, it is important that supply chains continue functioning as well as possible. We must ensure that there is no existential shock to points along the supply chain that would undermine long-term recovery. The best scenario is a "V-shaped" recovery with a rapid return to normal levels of output with some pent-up demand to satisfy. In order to position the economy for such a scenario, we must ensure that value chains remain intact throughout the crisis.

Our objective must be to ensure as much output as possible is deferred rather than destroyed. Companies need to continue purchasing inputs and customers need to continue purchasing outputs. The ultimate consumers at the end of many supply chains are government, large companies and retail consumers. There will inevitably be a demand shock at this level, but efforts must be made to lessen the propagation of this shock deeper into the economy. Government itself should ensure that it does not delay payments on projects that have been postponed because of the lockdown. Large companies should also work as much as possible to ensure cashflows to suppliers are not disrupted. Inevitably, however, there will be increasing working capital needs as companies pay suppliers but struggle to move stock to customers as one moves up the value chain towards the ultimate consumers.

The challenge is one of bridging the gap until normal economic activity resumes (Figure 1, below). Our members are well positioned to support companies through crisis periods and to find ways through it with minimum disruption. The industry had total undrawn commitments from ultimate investors of R30bn when last measured at the end of 2018. The industry can also raise further capital from its investors and members are already engaging with funding sources to support the industry's work at this time.

We encourage pension funds and other investors to engage with the industry to identify opportunities to direct further funding towards saving companies. This can be the most effective intervention that capital can achieve to support overcoming the crisis. We call on institutional investors to use regulatory allowances to back the industry to deliver support for the real economy to survive and adapt to the crisis and stimulate growth beyond it.

Where companies will be able to resume operations within a reasonable timeframe and profitability can be restored, this can be deployed quickly to support companies. Our members also have extensive relationships with lenders and can assist investee companies to access funding where possible. However, where there is no prospect of a return to profitability given the funding costs and time that it will be required, there may be little option but to tap into the facilities that government has made available. The final option is to suspend support, ultimately affecting our fiduciary responsibilities to our funders. There are inevitably going to be companies whose financial position is too precarious to access either debt or equity both among our investees but far more so in the economy generally.

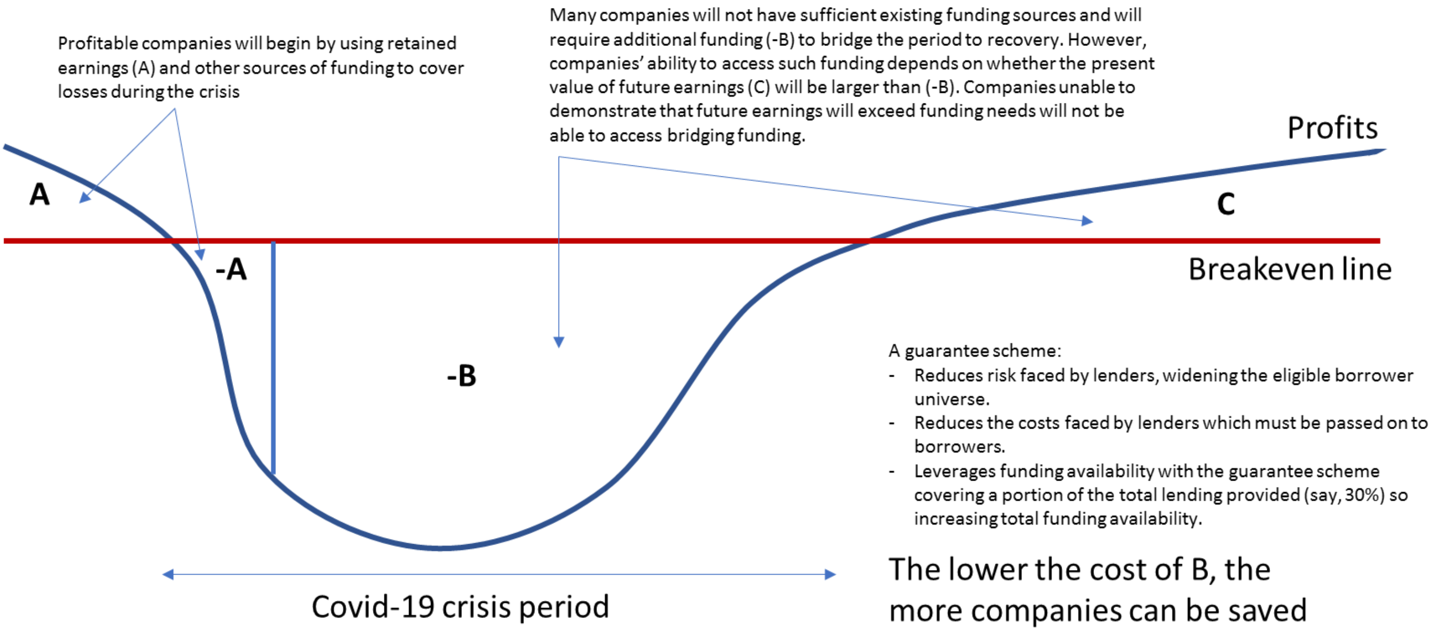


Figure 1: The importance of funding to improve probability of company survival

We believe a national scheme has to be developed to provide access to additional funding to bridge this gap. In this spirit we welcome the Solidarity Fund that business and government have set up. Companies need access to working capital to ensure they can keep buying inputs, so supporting downstream supply chains, even though their outputs may well accumulate. We recommend, however, that the fund focus on providing guarantees to existing lenders and equity providers who already have loan assessment and disbursement infrastructure.

Only businesses such as restaurants, beds and breakfasts and others who can demonstrate severe loss of revenue due to Covid-19 should be eligible. This can be verified by the Solidarity Fund in the event of any claim.

Loans issued in terms of the scheme should capitalise fees and interest for the first year, ensuring that there is no cost to businesses in the short term. This is, to our minds, an appropriate mechanism to ensure lenders and equity providers have the right incentives to direct funding only to appropriate beneficiaries under the scheme. It will be important that banks and other lenders approach the challenge of extending such loans with the requisite risk appetite and administrative expediency. We call on the National Credit Regulator and Reserve Bank to support lenders in doing so through appropriate regulatory relaxations at this urgent time to enable rapid deployment of loan support. Loans should be priced at a discount to prime to reflect the risk impact of the guarantee.

Ultimately, our members recognise that, like previous crises, this too will pass. Our objective as a society must be to minimise deaths and serious illness while doing what we can to ensure the economy can continue to support as many people as possible. The venture capital and private equity industry is dedicated to serving the economy by developing and supporting dynamic and competitive companies.

When we do emerge from this crisis, it is important that we do so invigorated to take on further challenges to make up lost ground and expand economic potential. Long-discussed structural reforms include the need for greater infrastructure investment (many of our members are infrastructure specialists with capital ready to deploy), resolving the energy crisis by restructuring the energy supply sector (our members are major funders of independent power producers), ensuring easier access to global skills through visa schemes, and lowering the cost of broadband through digital migration and spectrum auctions.

If there is any long-term good to come from this crisis, let it be a renewed determination to work together to build a South Africa free of poverty in which all our citizens can realise their potential.

We welcome the opportunity to engage further with the public sector, labour, civil society and other business organisations to determine other interventions that could save jobs and enable a greater response to the crisis. We believe the private equity and venture capital industry brings specialist skills in to the table, both in enabling companies to cope with the crisis and in supporting the fight against the pandemic by directing investee companies to use their resourcefulness and innovativeness to best confront the challenges that face us.

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