

# Private equity and venture capital in South Africa:

A study of the role  
of private equity  
and venture  
capital in delivering  
on public policy  
objectives

Commissioned by





### About this report

This report was commissioned by the Southern African Venture Capital and Private Equity Association (SAVCA) and independently researched and developed by Intellidex. It aims to analyse South Africa's national policy objectives and the role of private equity and venture capital in delivering on them.

### About Intellidex

Intellidex is a leading research and consulting firm that specialises in financial services and capital markets. Its analysis is used by companies, investors, stockbrokers, regulators, policy makers and companies in South Africa and around the world. It has offices in Johannesburg, London and Boston.

### About SAVCA

SAVCA is a non-profit industry association, representing 180 members in Southern Africa, who collectively manage in excess of R205bn in assets.

SAVCA promotes Southern African private equity and venture capital by engaging with regulators and legislators on a range of matters affecting the industry; providing relevant and insightful thought leadership and research on aspects that impact the industry; offering training and capacity building opportunities to stakeholders in the ecosystem; and by creating meaningful networking opportunities for industry players, investors and capital seekers.

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# Overview

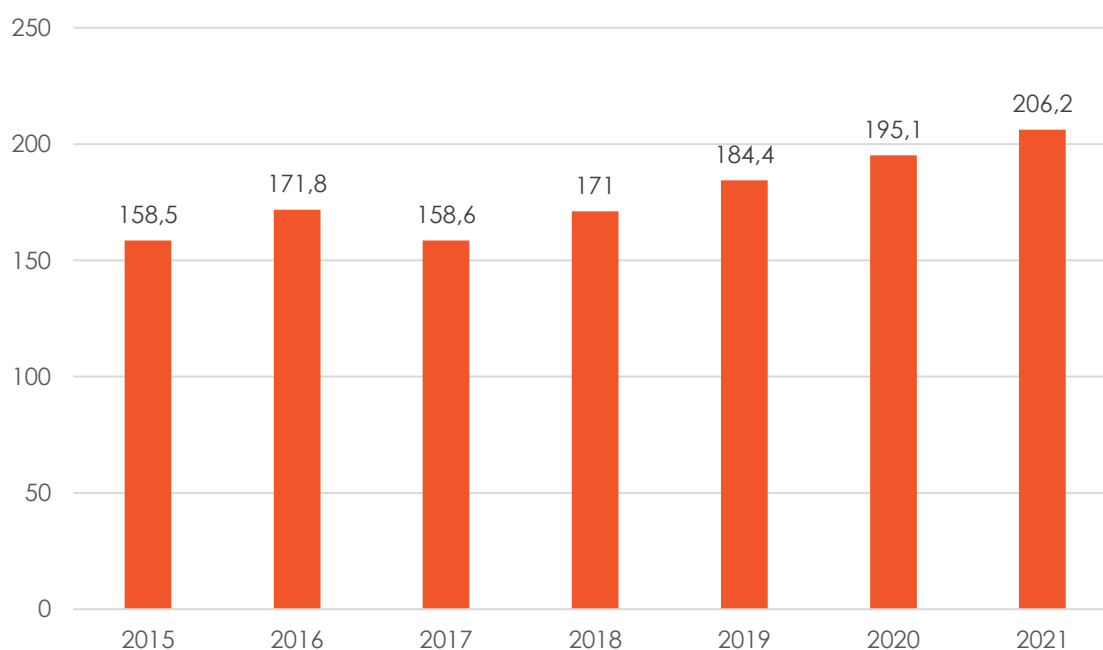
This report provides an analysis of how the private equity and venture capital industries intersect with South Africa's public policy objectives. It concludes with recommendations on how these objectives can be better served by the industry and what policy changes would ensure better outcomes. This overview sketches out the key findings presented in detail in the rest of the report.

**To accelerate economic growth, reduce poverty and inequality, South Africa needs to mobilise significant levels of investment.** This report sets out how an appropriately regulated and incentivised alternative investment vehicles industry can support these objectives. In particular, the critical role that the industry can play to grow the companies it invests in, accelerate innovation, and improve the competitiveness and export intensity of South African businesses.

**Venture capital (VC) and private equity (PE) are uniquely placed to support the growth agenda.** The venture capital industry focuses on the early stage of companies, enabling start-ups with great potential to rapidly build scale. On the other hand, the private equity industry focuses on more mature businesses that can benefit from a private equity firm's experience in building scale, management and reporting structures and improving the marketing strength of the firm. In many cases, particularly in South Africa, this involves supporting the firm to access international markets and tap into new sources of demand for its products and services. While such activities are not always the objective of transactions undertaken by private equity and venture capital firms, South Africa's investment opportunity set is dominated by small- to medium-sized companies that require the expertise and capital afforded by PE and VC to develop.

**In particular, the industry is playing a central role in solving the energy crisis.** PE finances critical infrastructure, including electricity generation and related investments that contribute to solving the energy crisis. It also funds much other infrastructure, including social infrastructure like hospitals and schools.

Figure 1: How big is the private equity industry?  
Funds under management by PE funds (Rbn)



**The industry specialises in providing at-risk finance for companies.** This finance is usually provided through the acquisition of shares issued by the company, with private equity investors taking an ownership stake in

companies. This capital is the first to be lost if a company fails and is often critical to enabling companies to raise debt as well, providing a layer of protection for lenders. Such share subscription usually results in new investment into the company, rather than the acquisition of existing shares, and so directly drives growth. Private equity fund managers tend to be active owners, holding their interest for an extended period, often sitting on the boards of directors and supporting the growth and development of investee companies. They aid in putting in place good governance practices at companies, assist in commercialising the products and services being developed by companies, and provide access to new markets by utilising their extensive networks.

**Globally, the private equity industry has been growing rapidly.** Research by Deloitte shows the total assets in the industry grew from \$1.6-trillion to \$4.5-trillion in the 10 years to 2019 (Henry, Fumai, Taylor, & Patel, 2020), an annual compound annual growth rate of 11%.

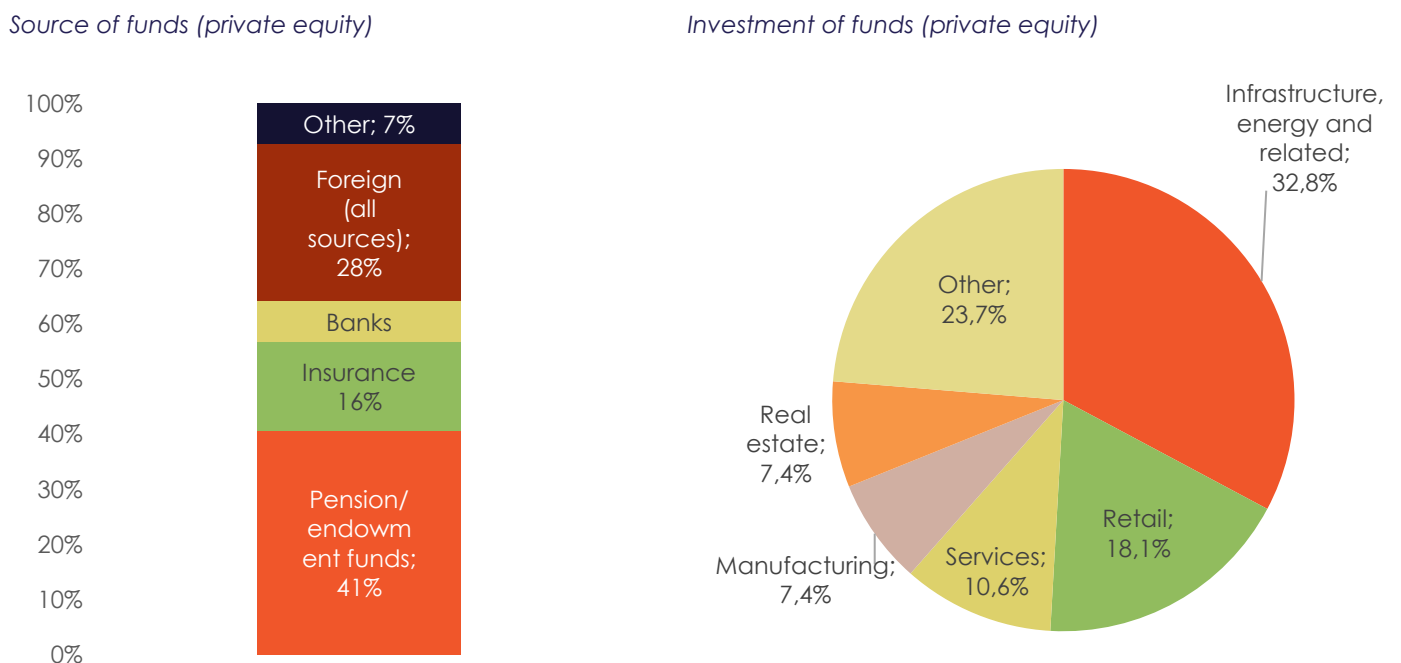
**In contrast, the South African venture capital and private equity industries are still small.** Private equity dominates – with R206.2 billion under management, compared to R8.13 billion under management in the venture capital industry. The total funds under management in private equity industry grew from R113.6bn to R206.2bn in the 10 years to 2021, a 6% compound growth rate (SAVCA, 2022). This lag in growth of the local industry coincides with a relative underperformance of the economy compared to global averages.

Companies generally seek out private equity and venture capital investors when looking to **achieve their expansion or growth objectives**. They usually cannot access public capital markets such as stock exchanges, either because they are too small or because they need the active ownership and mentorship that a private equity investor can provide and which public shareholders cannot.

A SAVCA survey of private equity fund managers found that, aside from growing the value of companies, their primary concerns were product and strategy expansion, improving companies' environment, social and governance ("ESG") performance, and hiring and onboarding new staff (SAVCA, 2022). **The industry has recently invested extensively in renewable energy**, helping to reduce the risk for lenders who contribute debt to fund large-scale electricity generation plants, with 11% of all new private equity investments in 2021 going into energy and related activities. That investment of risk capital is critical for companies to then be able to raise debt, ensuring that lenders are comfortable there is a layer of first loss capital to protect them.

**Private equity investee companies are likely to grow at a pace faster than the average company.** Various international studies support this conclusion. Gudiškis and Urbšiene show that private equity stimulates economic growth by commercialising innovations in the short term (2015). Malik and Dhankar find that private equity increases the capital base of companies, adding more employment and innovations, which then stimulates growth (2017). Berger & Udell find that private equity and debt supports small firms who cannot provide large amounts of public information needed to access banks or public markets (Berger & Udell, 1998). Similarly, Capizzi, Giovannini and Pesic find that private equity and venture capital is more likely to finance younger and smaller firms, which are driving forces for economic growth, job creation and structural change (Capizzi, Giovannini, & Pesic, 2011). Literature we cite further on in this report shows that private equity investors stimulate innovation, helping to commercialise it in companies. They also increase both the share of total exports in countries and the export intensiveness, i.e. a company's ratio of exports to total sales. In short, most evidence supports the contention that economic growth is enhanced by small- and medium-sized businesses (SMEs) and that the private equity and venture capital industries accelerate the growth of SMEs. It follows that private equity and venture capital are drivers of economic growth.

Figure 2: The industry is a conduit for funding to critical areas including infrastructure, energy and education



Source: SAVCA, 2022

**The industry is a crucial conduit of funding, particularly foreign direct investment and pensions savings, to infrastructure.** It sources a large share of its funding from pension funds (41%) and foreign sources (28%, see Figure 2), and channels it mainly to infrastructure, including energy. The industry is now gearing up to further support pension fund investors to invest in infrastructure assets. Recent amendments to Regulation 28 of the Pension Funds Act have increased the maximum exposure of pension funds to private equity assets to 15% of their funds under management (National Treasury, 2022). Previously, pension funds had a 10% cap for an alternative investments category that included both private equity and hedge funds. In addition, the amended Regulation 28 provides an overlaying category for infrastructure investments of up to 50% of assets. This significant expansion in potential investment flows to private equity is an important driver of development of the industry. With the increased availability of investment funds, the industry will be under pressure to provide investment opportunities, but an appropriate regulatory framework is key.

The importance of SMEs is well recognised in South African government policy. **Policy objectives like financial inclusion, financial sector transformation, market conduct and sustainable finance all have a bearing on the private equity industry.** The National Development Plan recommended developing small businesses through better coordination of relevant agencies, development finance institutions and public and private incubators. It also recommended strengthening financial services to bring down their costs and to improve access for SMEs.

National Treasury's vision for the financial sector emphasises **access to finance by small businesses as a policy priority.** One recent set of interventions internationally is the creation of Start Up Acts to facilitate the creation of new businesses. In Africa, Tunisia and Senegal have enacted Start Up Acts, with a further 16 African countries known to be developing similar legislation (ICR, 2021). Such legislation is appropriate where the legal framework for companies is less developed, but there is still much South Africa could learn from the Start Ups Act approach, including improving the incentives for founders of companies and giving more regulatory space for innovation.

### **South Africa has in the past implemented policies specifically to support venture capital and private equity.**

For example, in 2008 the Section 12J incentive was created as an incentive for individuals to invest into venture capital companies, on the view that this would stimulate growth in the venture capital industry. The scheme was not extended beyond its sunset in 2021. By February 2019, more than R8.3bn had been invested into Section 12J investments. Individual investors received a tax deduction on their investments, though they would still be liable for capital gains tax on exit (currently 40%), which would be after a minimum of five years. Although the results from this incentive were mixed, the 12J investment incentive did help to enhance the visibility of venture capital as an asset class, which will leave a positive legacy. In the view of National Treasury, the provision had been exploited by investors to gain exposure particularly to property assets, rather than the high growth venture capital companies that had been expected. It was also seen to clash with policy objectives of financial inclusion, given that the minimum investment size was R100,000 (Balfour, 2021). Since this provision, there has not been any further policy measures specifically to support private equity or venture capital.

**Currently, the industry has no specific regulatory dispensation.** Most fund managers are registered in terms of the Financial Advisory & Intermediaries Services Act (FAIS), but the industry does not function under any purpose-built legislation. This will change somewhat when the Conduct of Financial Institutions (COFI) Act is introduced, expected in 2024. The Bill covers "alternative investment funds" which, as it is currently drafted, would include private equity. The precise treatment of private equity fund managers still needs to be assessed as some elements of the Bill are unclear (Amardien & Gillmer, 2023). In contrast, markets such as Mauritius have developed legislation specifically for private equity funds, providing effective legal vehicles to manage and operate funds, however COFI will provide a coherent approach for private equity in SA. Currently, most private equity funds in South Africa operate as partnerships, a common law structure used internationally that many investors are familiar with, but which faces some legal uncertainty. Alternative structures are sometimes used including companies and trusts, and potentially future structures such as patient capital funds could be used too.

**The industry welcomes the introduction of an appropriate regulatory framework.** This will support the ongoing development of the industry and reduce both prudential and conduct risks. Indeed, this report proposes that the process is accelerated even prior to the introduction of COFI, by designating the alternative investment funds as a product under section 2 of the Financial Sector Regulation Act.

This report outlines how private equity and venture capital helps to deliver on South Africa's policy objectives. It also sets out the constraints that currently bind the industry, constraints which could be addressed to support its growth.

## Common questions about private equity

### **Are private equity firms asset builders or asset strippers?**

There is a stereotype aided by popular media of the corporate raider, firms who buy companies to take them apart, selling assets and letting go of employees.

The reality is very different, especially in a country like South Africa. Most private equity firms aim to generate returns from growing the companies they invest in, improving governance and access to markets of those businesses. South Africa's corporate environment is quite different to established developed markets, with the opportunity set biased toward newer growing companies.

There is a specialist activity in the industry which consists of turnarounds, taking over distressed assets that are underperforming and at risk of collapse. These can be listed companies. In such cases, firms may sell assets and reduce headcount as a way of restoring the sustainability of those businesses. Private equity allows for a rapid turnaround of businesses, which often then return to the public capital markets. In such cases, private equity saves jobs.

# Introduction

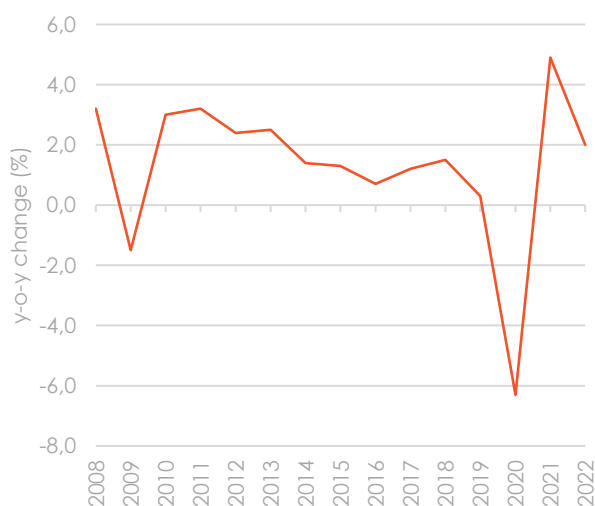
In this report we aim to provide the public and national policymakers with an understanding of the role private equity and venture capital play in the economy and in delivering on the objectives of the National Development Plan. We take these to include eliminating poverty and reducing inequality, by bringing about rapid economic growth and increased employment (NPC, 2012). This overarching policy objective guides policies developed by the government. Many of these policies have a bearing on the private equity and venture capital industry, from supporting the growth of small- and medium sized enterprises (SMEs), to conducting research, commercialising innovation, and supporting export competitiveness. These policies all aim to facilitate economic growth and the reduction of poverty.

## South Africa's growth and investment challenge

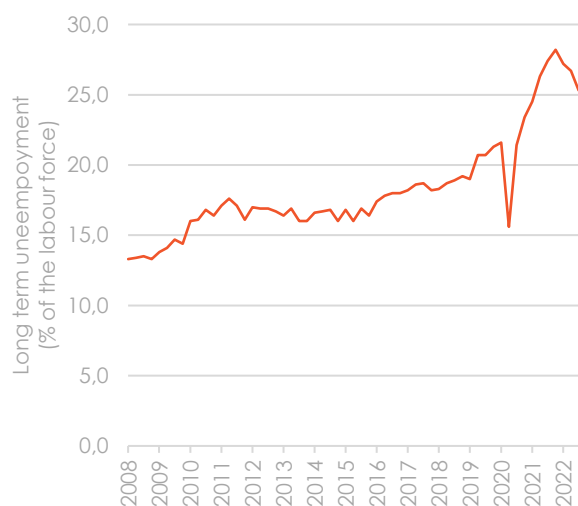
South Africa faces a significant growth and investment challenge. Economic growth has remained flat, and without meaningful economic reform, is unlikely to rise to the rates needed to meaningfully reduce unemployment, poverty and inequality.

**Figure 3: South Africa's economic challenge**

*Economic growth has been slow for a protracted period....*



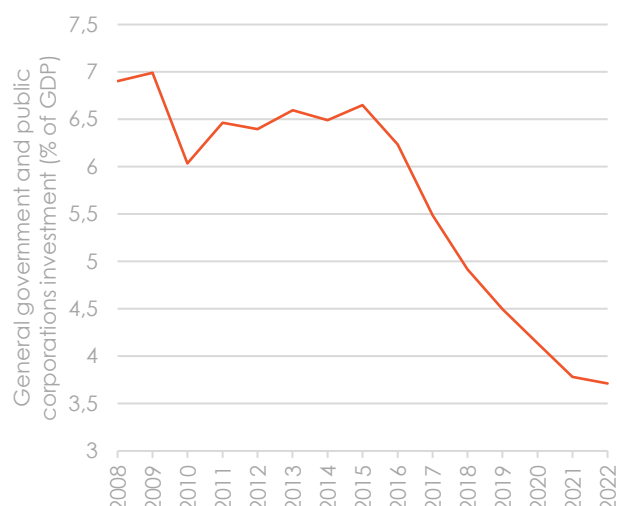
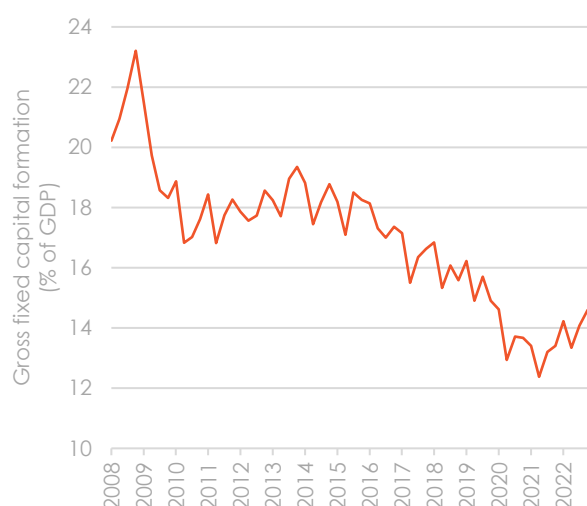
*... with persistently high unemployment, particularly amongst the youth...*



Source: Intellidex, NT

*... and a low investment rate...*

*... and declining government investment in real terms*



South Africa's investment rate has remained persistently weak. Government investment has declined in real terms since 2014/15, and is forecast to only recover slowly. Accelerating investment has become an urgent policy priority.

## The role of venture capital and private equity

**To meet the investment challenge, different players are needed at different parts of the investment ecosystem.** Banks typically lend to relatively low-risk businesses. In contrast, the venture capital industry focuses on the early stage of companies when they are highest risk, enabling start-ups with great potential to rapidly build scale. Typically, venture capital firms will invest in a set of possible winners, with the hope that one of them pays off.

In contrast, the private equity industry focuses on more mature businesses that can benefit from a private equity firm's experience in building scale, management and reporting structures and improving the marketing strength of the firm. In many cases, particularly in South Africa, this involves supporting the firm to access international markets and tap into new sources of demand for its products and services.

Private equity has played an important role in driving infrastructure investment, particularly the renewable energy programme. Several funds have invested in project developers, providing the equity finance that allows them then to raise further funding. Typically, a project will have a debt:equity ratio of 80/20 to 90/10. So private equity enables between five and 10 times the funding it contributes directly. Private equity reduces the risk of projects, enabling investors with a lower risk appetite to finance the project, including banks and pension funds. Infrastructure projects are higher risk during the development and construction phases, risks then dissipate as a project enters operating phase. Typically, the investment exposures will then be passed on to low-risk appetite investors like pension funds and insurance companies.

Figure 4: As a project progresses, risks decrease enabling different kinds of investors

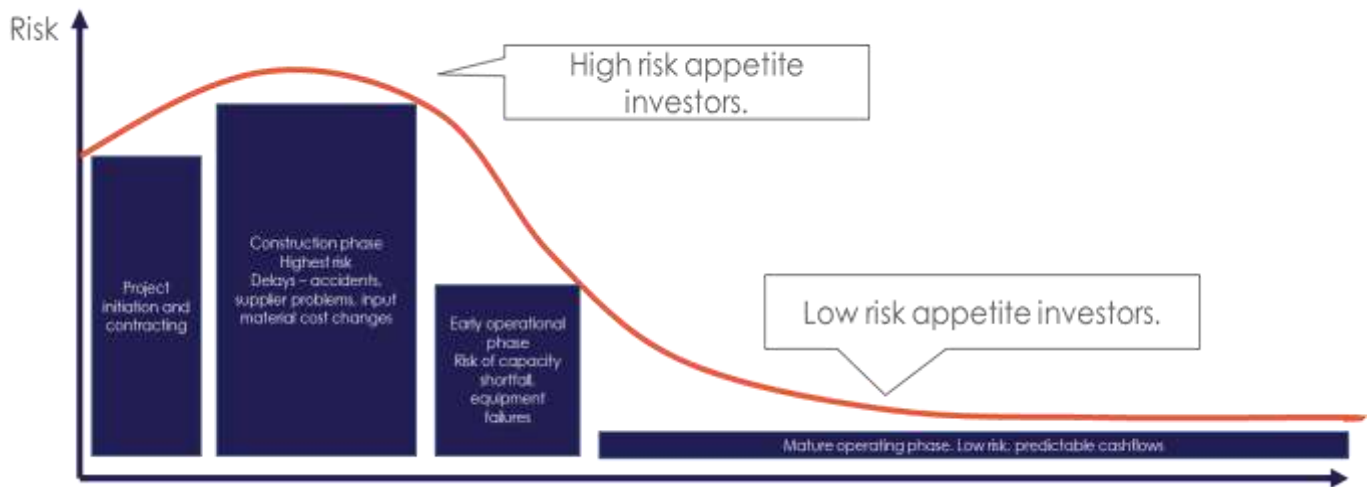
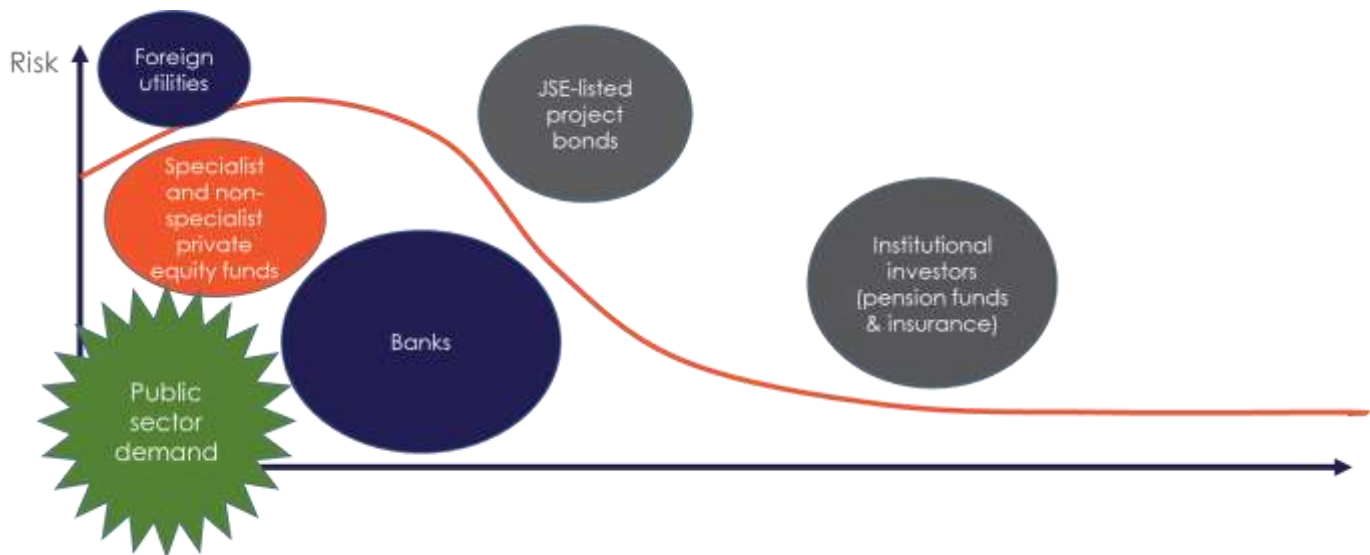
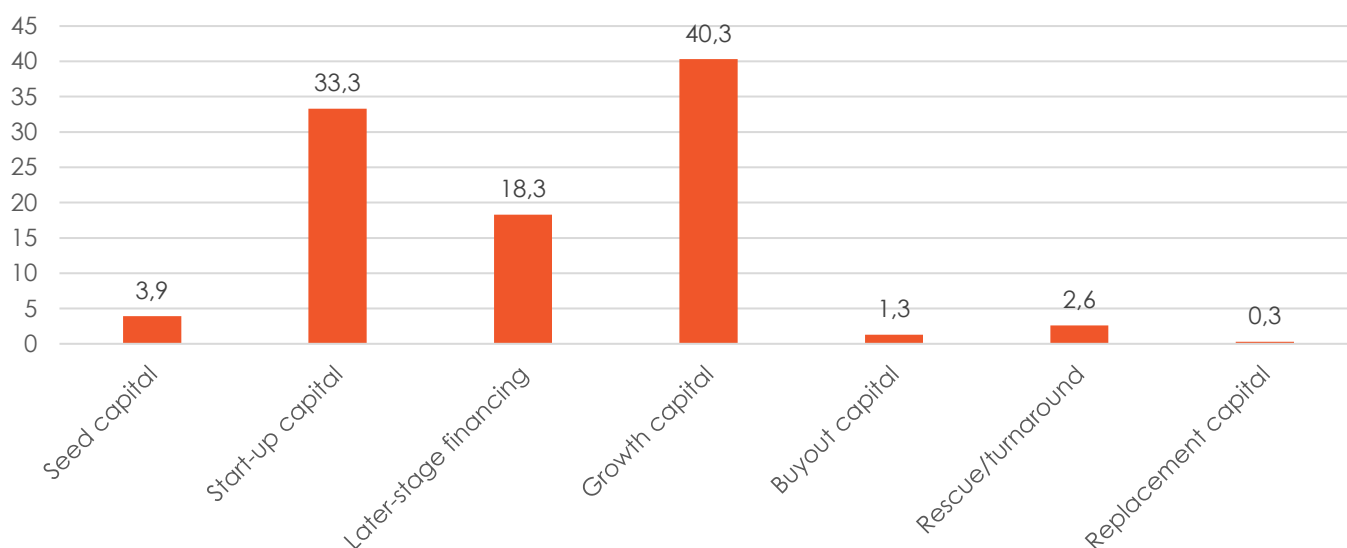


Figure 5: The challenge is that the current demand for finance is focused on early phases of projects, which is where PE funds focus



While the South African government has many policies to guide different parts of its work, we have selected some priority policies and plans in Table 1 where private equity and venture capital play a role.

Figure 6: Venture capital – contribution by stage of the deal; by value of deals, all deals still invested (2022, %)



Source: SAVCA

While the South African government has many policies to guide different parts of its work, we have selected some priority policies and plans in Table 1 where private equity and venture capital play a role.

Table 1: Key policies and role of the private equity and venture capital industries

Policy	Role of private equity and venture capital
<b>Black Economic empowerment (and financial sector transformation)</b>	<ul style="list-style-type: none"> <li>More than half of PE and VC firms are black-owned and aim to improve the BEE ownership features of companies when they invest in them.</li> </ul>
<b>Financial inclusion</b>	<ul style="list-style-type: none"> <li>Some segments of the private equity and venture capital ecosystem target small businesses with funding and know – how to aid their growth.</li> </ul>
<b>Financial sector market conduct</b>	<ul style="list-style-type: none"> <li>With the alternative investment funds category, private equity and venture capital funds will be covered by the Conduct of Financial Institutions Act. Moreover, the majority of fund managers are members of SAVCA and subscribe to an industry code of conduct.</li> </ul>
<b>Sustainable finance</b>	<ul style="list-style-type: none"> <li>The private equity and venture capital industry plays a critical role in providing risk finance and mentorship to support companies and other lenders in building available flows of sustainable finance in South Africa. ESG is a key consideration by PE and VC firms in their investment processes.</li> </ul>
<b>Financial stability</b>	<ul style="list-style-type: none"> <li>Private equity and venture capital provide patient capital that is less vulnerable to economic shocks.</li> <li>Private equity assists companies to trade through difficult economic conditions (the Covid-19 pandemic provided a good example).</li> <li>In some countries, the use of debt by private equity firms has been seen as a potential systemic risk. However, the sector is not sufficiently large in a South African context to pose a systemic risk.</li> </ul>
<b>Integrated National Export Strategy</b>	<ul style="list-style-type: none"> <li>Private equity and venture capital often support investee companies to build capacity and access international markets for their products and services.</li> </ul>
<b>National innovation system</b>	<ul style="list-style-type: none"> <li>Venture capital funds potentially high growth ideas, supporting innovation and commercialisation of intellectual property.</li> </ul>

	<ul style="list-style-type: none"> <li>• Private equity improves research &amp; development capacity of investee companies and the speed to market of new innovation.</li> </ul>
<b>Digital Economy Transformation Plan (and Fourth Industrial Revolution strategy)</b>	<ul style="list-style-type: none"> <li>• The private equity industry has been a significant funder of broadband infrastructure both within South Africa's borders and international connectivity</li> <li>• The venture capital ecosystem is a major driver of the development of 4IR technologies.</li> </ul>
<b>South African Renewable Energy Masterplan</b>	<ul style="list-style-type: none"> <li>• The private equity industry is already involved in developing renewable energy supply chains in South Africa. The SAREM will provide an overarching framework which will support significant investment by the industry from component manufacturing to supporting services.</li> </ul>
<b>National Infrastructure Plan</b>	<ul style="list-style-type: none"> <li>• The NIP envisages significant private sector funding for infrastructure through mechanisms such as public-private partnerships.</li> <li>• Private equity firms are already significant investors in infrastructure assets.</li> </ul>
<b>Green Hydrogen National Programme</b>	<ul style="list-style-type: none"> <li>• Several of the projects identified for the programme have private equity investment backers.</li> </ul>
<b>Just Energy Transition Plan</b>	<ul style="list-style-type: none"> <li>• The JET plan envisages a wholesale shift of the country's energy production from fossil fuels to sustainable sources, with the linking supply chains all supporting development.</li> <li>• The private equity industry is actively invested across renewable energy supply chains, from utility scale projects to supporting services.</li> </ul>

This table shows the extent of the industry's bearing on policy objectives. Given this context, we aim to answer these questions in the report:

- What is the evidence in the literature internationally on private equity's role in addressing these public policy objectives?
- What are the facts about private equity in South Africa and its impact on these objectives?
- What are the potential pitfalls and risks from a public policy perspective?
- How might the growth of the private equity industry help SA achieve its public policy objectives?
- What further regulatory development would stimulate positive outcomes from private equity activity in SA?

We assess these issues in six important policy areas:

- Employment
- Financial inclusion of SMEs
- Innovation
- Competitiveness and exports
- Black empowerment and transformation
- Infrastructure and energy finance

Finally, we consider some pitfalls and risks from a public policy perspective that need to be considered.

We trust this document will support thinking by both the industry and policy makers to better align in achieving South Africa's policy objectives.

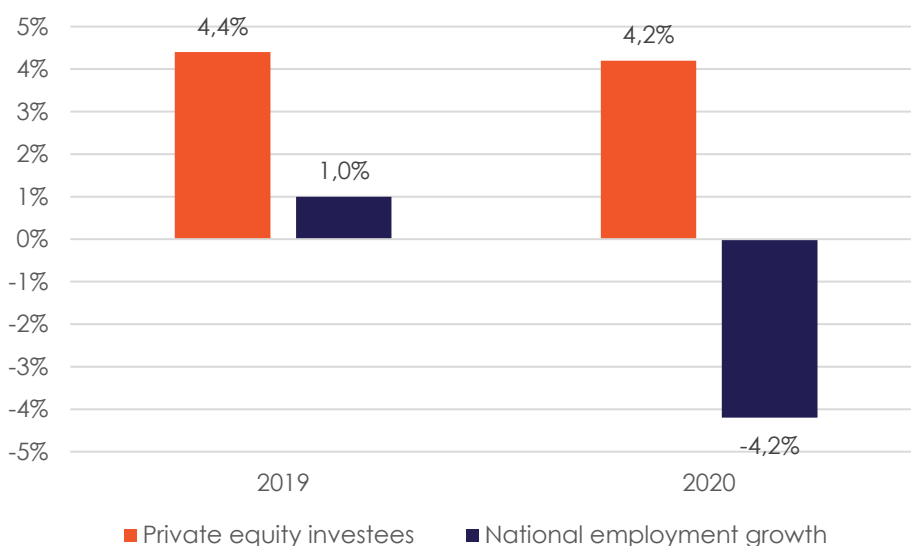
# Employment

South Africa has a devastating unemployment rate, with an official rate of 38.9% and expanded definition, which includes discouraged job seekers, at 43.1% as of the third quarter of 2022 (StatsSA, 2022). The National Development Plan makes clear that growing employment is critical to the ambition of eliminating poverty and reducing inequality.

## Job creation in the private equity industry

Research commissioned by SAVCA shows that investee firms tend to experience employment growth that is significantly higher than the national average (SAVCA, 2021). In the last two years (which is only period for which data is available), employment growth was higher in companies that had private equity investors. This was particularly clear in 2020, when during the Covid pandemic lockdowns, employment fell sharply nationally, yet grew 4.2% among private equity investees, an 8.4 percentage point difference. The Covid experience strongly suggests that private equity investee companies can absorb shocks better than companies in the general economy.

Figure 7: Employment growth of private equity investees vs national employment growth



These employment indicators are consistent with the view that private equity investee companies tend to grow faster on average than the general economy.

## Theoretical perspectives on job creation by private equity and venture capital

Job creation is a function of the growth of businesses. In turn, the employment intensity of that growth will depend on the capital or labour intensiveness of the business. All else being equal, we should expect companies will optimise the mix of labour and capital to be able to produce at least cost.

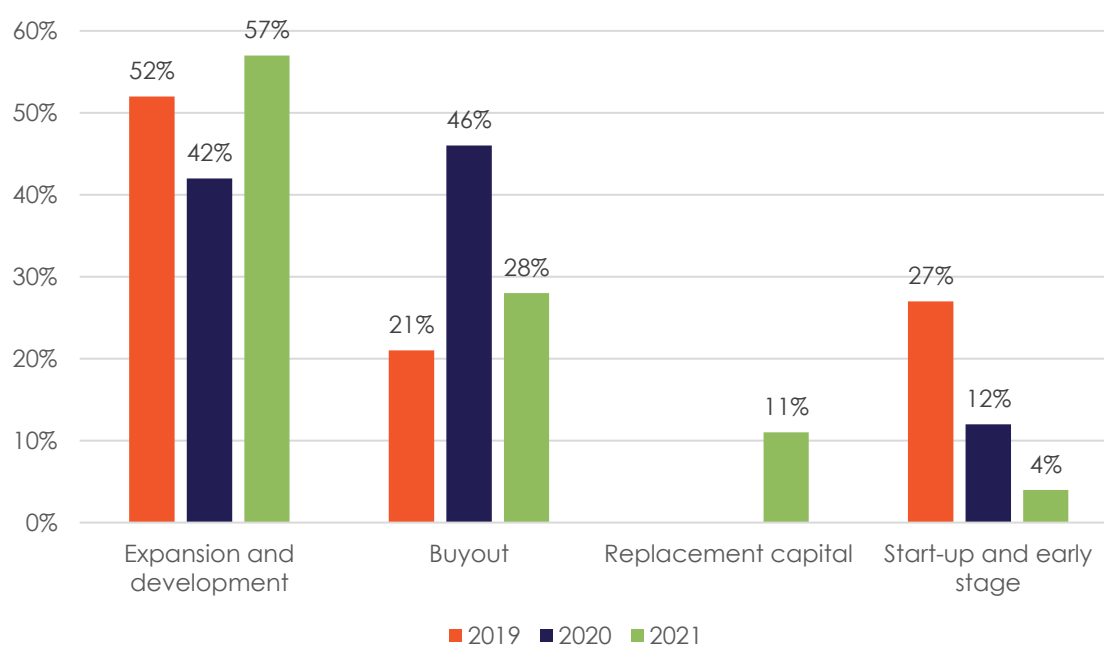
International research shows that private equity has both positive and negative effects on employment levels. On the negative, private equity aims to improve efficiencies at target firms by reducing costs, which may include reductions in headcount. We would expect this trend to be clearer in buy-outs, the transactions that involve taking over large, established companies, often with a recent history of underperformance. One study in the United States found that buyouts tend to see job losses in the first five years following the transaction, on average by 6% (Davis, Haltiwanger, Jarmin, Lerner, & Miranda, 2011). This study found several notable dynamics within firms acquired. The reduction in headcount is focused on parts of firms that are substantially reduced or closed down. However, other parts of target firms tend to grow

faster than a control group comparison. In other words, private equity drives restructuring, reducing activities in some areas but then also growing activities in other areas. It also found that target firms tend to start more greenfields operations than the control. In other words, target firms open new establishments (such as new branches) and obviously generate employment in doing so. When all these effects are consolidated, the study found that target firms have a net decline in employment of just 1% two years after the transaction. While the study did not consider the financial performance of the target firms post transactions, if the restructuring succeeds in improving financial performance, then the sustainability of the jobs in the companies are more assured.

Other studies have found different effects of private equity. A study of buy-outs in France, for example, found that employment increased post transaction (Boucly, Sraer, & Thesmar, 2009). This was attributed to improvements in the firms' access to finance post the transaction. Studies have also found that private equity-backed firms are much more able to protect employment during times of crisis. A study in the UK found that there is generally a fall in employment immediately post buy-outs, but then a significant increase (Wilson, Wright, Siegal, & Scholes, 2012). These studies are all consistent in finding that buyouts can have a negative effect on employment in the short run, but also lead to employment growth in the long run, often with a net positive outcome. Given buyouts focus on large, mature companies in which there may be considerable inefficiencies, one consistent interpretation is that private equity firms start by improving efficiencies and then shift to focus on growth of the businesses. Such activity should be positive for the overall competitiveness of the economy.

The buy-out end of the market focuses on mature companies, however this has not been the main focus for the South African industry, particularly since the global financial crisis. A SAVCA survey of members (SAVCA, 2022) found that buyouts range between 21% and 46% of transactions over the last three years (see Figure 8).

Figure 8: Stage of investment 2019-2021 (% of total value invested)



The impact of private equity in expansion and early stages is much clearer. These tend to be smaller businesses where the investment thesis for the private equity or venture capital investors is to drive growth to generate returns. As Figure 8 shows, expansion and start-up funding makes up over 50% of investments in each of the last three years. This would naturally accelerate employment growth. The evidence supports this conclusion. Paglia and Harjoto (2014) find in a study in the US that both private equity and venture capital accelerate sales and employment in investee companies. These effects are more pronounced in venture capital investments, which tend to be early stage and start-ups, than private equity, however private equity

investment had a longer lasting impact than venture capital. However, some more narrowly focused studies (Engberg, Tingvall, & Halvarsson, 2021) find no employment impact.

On the whole, the theoretical literature is consistent with the view that private equity and venture capital can create more employment than the economy in general. The data reported by SAVCA show this to be true in South Africa. We speculate that the reason for the clearer performance in South Africa is because of the different opportunity set – there are fewer mature, large companies and more mid-size and start-up companies in which the primary strategy is expansion.

## Financial inclusion of SMEs

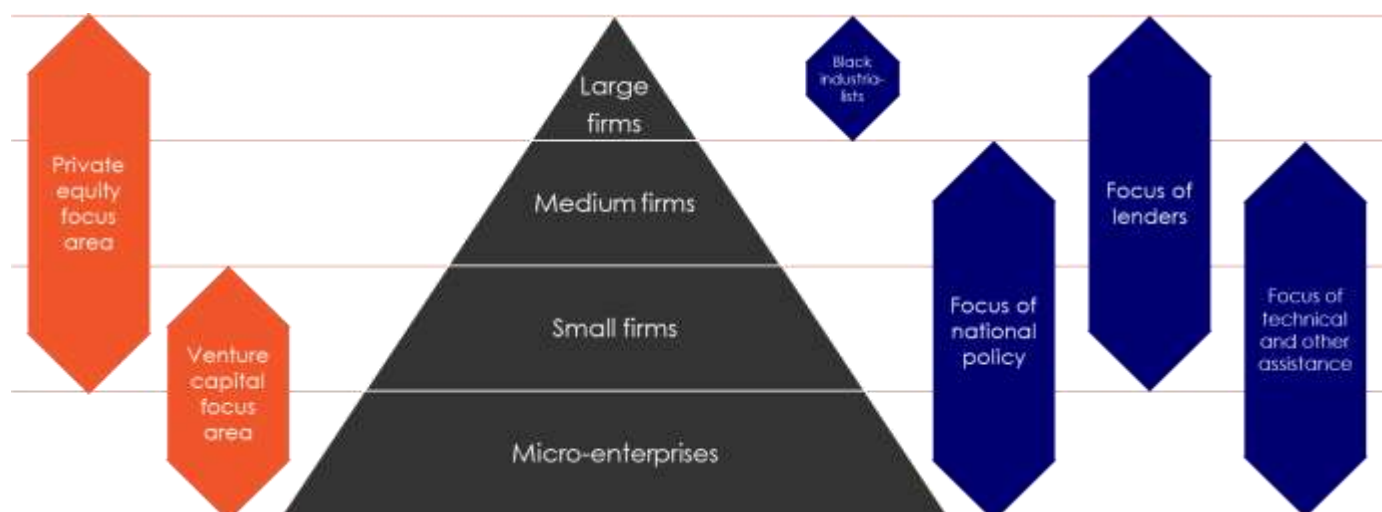
*Financial inclusion of the SME sector has been a policy priority for the South African government since 1994. It has taken the form of a plethora of financial and developmental support schemes. Given South Africa's history, a core focus of these schemes has been the promotion of black- and women-owned business. Recently the emphasis has also included black industrialists.*

Of the estimated 2.6-million SMEs in South Africa only about 37% are considered formal (OECD, 2022). About 34% use formal financial accounts in the business's name. Total lending to SMEs at the end of 2020 was R631bn, accounting for about 25% of business loans in the banking sector.

Bank lending is the most common source of finance for SMEs, which are often reliant on debt to meet their start-up, cash flow and investment needs. Debt is a riskier form of finance from the companies' perspective as the interest and capital must be paid irrespective of the performance of the company. In contrast, equity finance is lower risk as the returns depend on how the company performs. Debt is difficult for SMEs to access, but equity finance is even more difficult for a typical SME. Debt typically requires collateral, which few start-ups can provide, particularly technology businesses.

Given high levels of informality among SMEs, the venture capital and private equity industry can only focus on a small part of the SME sector. Yet this subset could potentially deliver the greatest benefits in terms of policy objectives, as this subset will include the fastest growing small businesses, which can be scaled up through private equity and venture capital. Private equity and venture capital investors aim to identify investments with high growth potential in which they can support development. From a national policy point of view, the sweet spot is for private equity and venture capital to be able to deliver positive social and environmental benefits in addition to good investment returns, consistent with practices such as sustainable investing and ESG investing.

Figure 9: Private equity's role in financing and supporting SMEs



The definition of SMEs varies across jurisdictions. The most commonly used criteria are the number of employees, followed by turnover and assets. In South Africa the National Small Enterprise Act uses:

- Annual turnover within industry sectors: depending on the industry sector, microenterprises have an annual turnover ranging from R7 million to R20 million; small between R17 million and R80 million and medium between R35 million and R220 million
- Employees: microenterprises are delineated as having zero to ten employees, small 11 to 50 and medium 51 to 250.

As Figure 9 illustrates, the private equity industry focuses on all size segments apart from microenterprises. However, venture capital funds will often back companies that fit the definitions of microenterprises, but have the potential to scale up significantly. These can be contrasted with microenterprises that provide lifestyle or survivalist support to their proprietors, which are unlikely to be funded by venture capital or private equity investors.

Most SMEs aspire to grow into substantial businesses. To an extent the Department of Trade, Industry and Competition recognised this when introducing its “black industrialists policy” (DTIC, 2020) targeting high-growth black-owned firms with industrial potential. Internationally, the remarkable success of several well-known new enterprises in the technological field – so-called “big tech” – which in a couple of decades moved from start-ups to major international businesses such as Facebook and Google, points to technological innovation as a key factor in the high growth of firms. High-growth companies often drive innovation, job creation and economic growth. The growth and ability of financial technology firms (fintechs) to attract capital has not slowed. According to research company Forrester, fintech funding increased by more than 200% in 2021 (Macknight, 2022). These are the kinds of companies that venture capital investors seek out. There is therefore considerable overlap between government policy and private equity industry activity in this area.

In February 2022 the IMF released a financial system stability assessment based on the Financial Sector Assessment Program (FSAP) that was conducted during February 2020 and July 2021 (IMF, 2022). The assessment indicated that progress to further increase financial inclusion and access to finance has slowed in recent years, as micro-, small-, and medium-sized enterprises (MSMEs) experience challenges in obtaining financing. The report recommends that enhanced credit information systems be prioritised as a part of the solution. But there is also merit in considering how the venture capital and private equity industry could widen the scope of its activities to support SMEs further.

## Department of Trade, Industry and Competition

The DTIC acknowledged in its National Industrial Policy Framework that small enterprise financing and support services have not been functioning as effectively as they should be (DTI, 2007). Many of its small business financing and support functions were transferred to the Department of Small Business Development in 2014.

## Department of Small Business Development

The Ministry of Small Business Development was established in 2014 to facilitate the development and growth of small businesses and cooperatives.

The Department of Small Business Development aims to give expression to the vision of the NDP and accordingly focuses on developing, evaluating and reviewing strategies and legislation for small enterprises and cooperatives; increasing support for small enterprises; and developing and supporting cooperatives.

Entities reporting to the Minister of Small Business Development are the Small Enterprise Development Agency (SEDA) and the Small Enterprise Finance Agency (SEFA).

## Financing SMEs

Private equity funds are different from other institutional investors as they usually invest in illiquid assets. Private equity funds become strategic investors in companies that may benefit from a strategic redirection, injection of capital, and often new management. Typically, after five to seven years, private equity funds seek to liquidate and realise profits on these investments through trade sales or sale to another investor, and sometimes through a stock exchange listing.

Thus, private equity typically has a long lock-in period, which aligns well with the need of SME start-ups to secure investment for an extended formation period. Private equity funds routinely impose variable, sometimes multi-year, lock-up periods on investors.

## Developing SMEs

Private equity and venture capital bring technical knowledge and expertise as well as industry relationships and management skills to the SMEs in which they invest. Through active participation on the board of directors or in partnership/mentorship with management, private equity provides companies with critical improvements in governance, financial accounting, access to markets, technology, and other drivers of business success.

## Data on SME finance by private equity and venture capital

According to the OECD Scorecard (OECD, 2020) and SAVCA survey on private equity funds under management (FUM) (SAVCA, 2021), the financing of businesses including SMEs in South Africa is shown in Table 2.

Table 2: Financing of SMEs in South Africa

Instrument	2016	2017	2016-2017	
	Rbn	Rbn	% of total	% change
<b>Debt</b>	638.53	617.85	78.38	-3.24
<b>Government guarantees</b>	0.24	0.3	0.04	25.00
<b>Direct government loans</b>	10.9	11.48	1.46	5.32
<b>Private equity (FUM)</b>	171.8	158.6	20.12	-7.68
<b>Total</b>	821.47	788.23	100.00	-4.05

Table 3: New funds invested by fund managers in 2021 (SAVCA, 2022)

	Amount invested (Rbn)	Number of Investee companies
Private equity	14.9	135
Venture capital (early stage)	1.31	129

Early-stage funding is required by SMEs at the beginning of their lifecycle. Private equity, venture capital and angel investors are a critical source of early-stage financing. Although South Africa has a well-developed private equity / venture capital market, the majority of funds are channelled into late-stage investments. In 2021, 4% of new private equity investments went to early-stage investments. Although this varies considerably by year, in 2019 it was 27% of new investments (see Figure 8). When it comes to venture capital in particular, a larger portion of investments are focused on early stages, with 68% of deals in 2021 focused on early stages (SAVCA, 2022b). This is unsurprising as VC has more of an early stage mandate and focus, hence the higher allocation early stage investments. PE firms do not, so would only have a small allocation to early stage. However, both PE and VC would remain invested for the long term, with commitments of several years.

As the discussion in this section makes clear, the private equity and venture capital industry plays an important role in providing long term risk capital to the South African economy. This is in line with several policy priorities.

## Innovation

*Several policies aim to promote South Africa's innovation and competitiveness. South Africa has aimed to develop a national system of innovation since 1996 when the first white paper on science, technology and innovation was published. In 2019 a revised white paper was published (Department of Science and Technology, 2019), setting a policy of partnership between public and private sectors as part of the national system of innovation. The white paper supports increasing commercial funding for innovation and notes the need for public funding to leverage co-investment by the private sector.*

Such partnerships have already worked successfully. The Technology Innovation Agency (TIA), for example, operates an industry matching fund programme (TIA, 2020). The TIA partnered with the SA SME Fund on the Savant Venture Fund, with the TIA contributing R1.5m and the SA SME Fund R110m. The Savant Fund now supports incubation and venture capital investment to support technology businesses to develop and scale new innovations. The TIA has also partnered with biotech funds and angel investors. The TIA is now working toward establishing the Innovation Fund recommended in the white paper, to crowd in private funding and drive the innovation ecosystem (TIA, 2020).

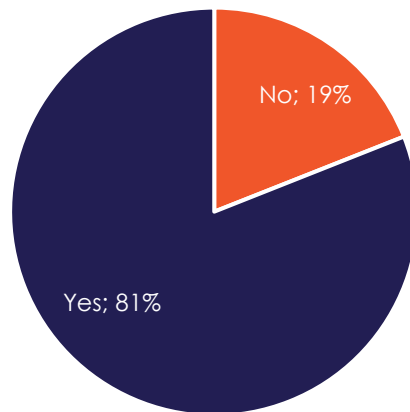
### Impact of private equity and venture capital on innovation

SA inherently has this important asset of entrepreneurs with world-class ideas. There is therefore a risk of losing this talent, which can go anywhere else in the world with their great ideas, and the role that capital from PE and VC plays in supporting them and evolution of IP that sits in the country.

A study commissioned by SAVCA (SAVCA, 2020) assessed a sample of investee companies to determine the impact of private equity investment had on their performance and operations. While the sample was not necessarily representative, it does make some indicative findings regarding the performance of

companies post investment. One finding was that 81% of investee companies introduce new products and services post the investment. While there are no baseline figures to compare this to, it does indicate a high rate of innovation post investment.

Figure 10: Firms answers to whether they had introduced new products and services post private equity investment



A related measure of the innovativeness of companies is derived from global manufacturing company 3M's principle for internal innovation: that 30% of each division's revenue should come from products introduced in the last four years, which it called the New Product Vitality Index. The 2020 study (ibid) found that 32% of investee companies met this threshold, while some had far higher ratios of new products. There are no baseline comparisons for this ratio, though 3M, which is globally respected for its high rates of innovation, had an NPVI of 39% by 2013, having grown steadily from 2005 when it was recorded at 21% (Corporate Innovation Online, 2018). Many private equity investee companies in South Africa show higher ratios than this which is suggestive though not conclusive of the performance of private equity firms in driving innovation. The anecdotal evidence is suggestive that private equity and venture capital in South Africa does support rapid acceleration of innovation. This is consistent with international findings, though more research is needed in a South African context.

## International research on innovation by private equity and venture capital investees

The international evidence tends to strongly support the view that private equity and venture capital-backed companies are more innovative than companies in the rest of the economy. They also tend to be more efficient innovators, with costs of innovation on average lower than for other companies.

Studies tend methodologically to focus on the number of registered patents achieved by target companies. One study of 21 countries across Europe found that private equity investment accounts for 8% of aggregate research & development spending, but 12% of industrial innovation, suggesting highly efficient innovation (Popov & Roosenboom, 2009). The study controlled for the natural bias that emerges from the fact that venture capital investment tends to target highly innovative firms in the first place. Another study found that firms tend to increase the effectiveness of innovation, even if not the amount spent on it post investment by private equity. The study found that the patents that firms applied for after the deal received more citations, indicating that they are more influential than the patents applied for before the transactions (Lerner, Sorensen, & Stromberg, 2013). Another study of US firms receiving public research grants found that those firms which also had private equity investors were significantly more able to commercialise their research than those that did not, suggesting that public spending on innovation is more effective in driving economic growth if it is accompanied by private equity investment (Link, Ruhm, & Siegel, 2012). This last finding supports public-private partnerships of the sort pursued by the Technology Innovation Agency in South Africa.

On the whole, the evidence appears clear that the private equity and venture capital industries strongly support innovation by improving the efficiency of innovation, speed of innovation, and ability to commercialise that innovation.

## Competitiveness and exports

*Several South African policies aim to boost the competitiveness and exports of the country. The National Development Plan singles out boosting private investment in competitiveness and exports as a critical action. Competitiveness and export growth have been central to several other growth policies including Accelerated Shared Growth Initiative for South Africa (Asgisa). A key question is therefore whether private equity and venture capital supports the achievement of these goals.*

### Impact of private equity and venture capital

While there have not been systematic studies (that we are aware of) on the impact of private equity and venture capital on South African export competitiveness, there is clear anecdotal support for the notion that private equity enables improved access to markets and improved competitiveness of investee companies. Several case studies of private equity and venture capital investment show how the investors enabled competitiveness, such as GoMetro, which took its technology from Cape Town to several other African markets, and Aerobotics, which developed technology in South Africa, and is now commercialising in the United States, Europe and South America with the support of private equity and venture capital investors.

### Evidence from the literature

The anecdotal evidence is in line with the findings of researchers around the world. An OECD study of 22 developed markets found clear evidence that private equity positively affects companies' share of total exports as well as the intensity of exports (the ratio of exports to total sales) (Hernan Herrera-Echeverri & Nandy, 2022). A UK study of a large dataset of companies between 1998-2013 found that private equity-backed firms are more likely to engage in exporting (export propensity) and be internationalised post-buyout than a control sample and that the effect is larger than for listed companies (Wilson, Uddin, & Wright, 2021). The same study also found improved export intensity. This is strong evidence that, in developed markets at least, private equity investment boosts exports and competitiveness. There is less evidence specifically regarding developing markets, but what there is supports the same conclusion. For example, one qualitative study of businesses in Poland reported that managers cited improved export competitiveness as a result of private equity investment (Falat-Kilijanska & Luty, 2019).

The reasons for this clear improvement are several. One is the access to increased finance – private equity-backed firms are able to invest to expand output to meet export demands. Another reason is improved efficiency, that private equity-backed firms are able to produce at lower cost and therefore are able to compete in global markets (Lavery & Wilson, 2022).

Overall, the evidence on competitiveness and both the export intensity and export propensity of private equity and venture capital is compelling. There is every reason to believe that this is true in the South African market too, providing a clear alignment of the industry's activities with policy objectives.

# Black empowerment and sustainability

*Redress of South Africa's racial legacy in the distribution of economic resources has been a key policy since democracy. The private equity and venture capital industry can potentially contribute to transformation through two mechanisms: the influence they exercise in companies into which they are invested, and the transformation of the private equity industry itself.*

The guiding policy is reflected most clearly in the Broad-Based Black Economic Empowerment Act and the associated charters that drive transformation in various industries. The financial sector is one such industry, and private equity firms have a specific dispensation.

## Financial Sector policy and financial sector transformation

National Treasury is of the view that the financial sector needs higher standards for transformation than the generic B-BBEE legislation (and Financial Sector Code) requires and should be aligned with financial sector policy objectives (see Figure 11) (National Treasury, 2019)

Figure 11: National Treasury's multi-pronged approach to transformation



In recognition of this, the Financial Sector Regulation (FSR) Act, 2017 (Act No. 9 of 2017) includes as an object of the Act the promotion of transformation of the financial sector. The Conduct of Financial Institutions Bill, expected to be tabled in Parliament in 2023, includes key proposals to further strengthen the powers of the FSCA in relation to financial sector transformation.

The Financial Sector Conduct Authority (FSCA) has published its strategy for promoting transformation of the financial sector in South Africa (FSCA, 2022). FSCA will take actions such as minimising regulatory barriers to entry for small, black-owned entities in the financial sector, and supporting small black businesses with suitably enabling regulatory compliance requirements.

## Financial sector transformation

Financial sector transformation has several aims, including the financial inclusion of SMEs. The private equity industry is covered by the financial sector charter, providing an important set of regulatory drivers for the industry to support transformation.

There are several criteria that must be met by a private equity firm before its ownership of an investee company is seen as being held by black people. The criteria are:

- At least 51% of the private equity firm's exercisable voting rights associated with the equity instruments through which the private equity fund holds rights of ownership, must be held by black people;
- At least 51% of the private equity firm's executive management and senior management must be black people;
- At least 51% of the profits made by the private equity fund manager, after realising any investment made by it, must accrue to black people;
- The private equity firm must be a B-BBEE owned company, which is defined as a juristic person having shareholding, or similar members interest, that is B-BBEE controlled. The flow-through principle applies;
- The private equity fund manager must seek to invest at least 51% of the value of funds under management in companies that have at least a 25% direct shareholding using the flow-through principle.

Secondly, if a private equity fund meets the criteria above then the fund and its investee companies can claim B-BBEE ownership points determined as follows:

<b>Year of investment</b>	<b>Percentage of the value of funds invested by the private equity fund that must be invested in enterprises that have at least 25% direct black shareholding</b>
<b>1</b>	More than 5%
<b>2</b>	More than 10%
<b>3 to 4</b>	More than 20%
<b>5 to 6</b>	More than 30%
<b>7 to 8</b>	More than 40%
<b>9 and beyond</b>	51%

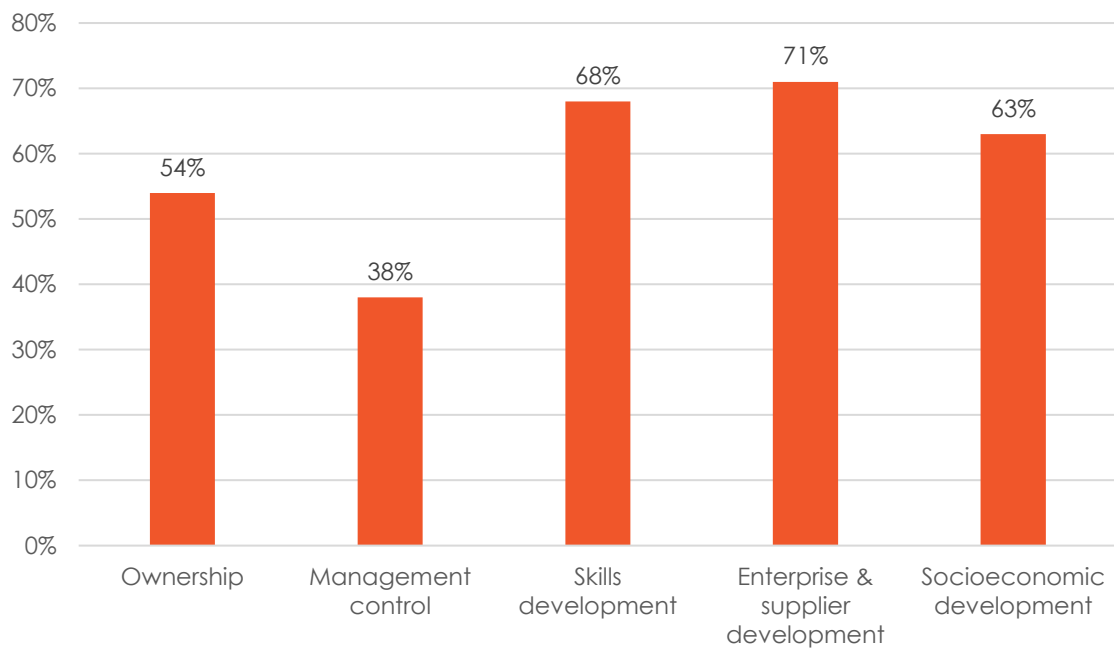
These requirements create incentives both for private equity firms to improve their black ownership and leadership, and for private equity firms to coinvest with black owners of companies. This gives private equity firms a material role in promoting black empowerment in the economy.

According to the 2022 SAVCA survey (SAVCA 2022), a third of fund managers were level 1 firms, which collectively managed a fifth of private equity funds under management, double the amount of 2020. Just over half of survey respondents had black ownership of more than 50% and 65% had black management of more than half.

## Impact on private equity investee companies

Evidence gathered by SAVCA indicates that private equity and venture capital firms have a significant impact on improving the BEE performance of companies within their portfolios. A survey of investee companies showed improvements in the BEE scores of companies post investment, with 65% of companies non-compliant pre investment and 42% post investment (SAVCA, 2022). In a survey that unpacked transformation activity against the BEE scorecard, companies reported significant improvements in several factors, namely (SAVCA, 2020):

Figure 12: Percentage of respondents who reported an improvement in the respective BEE scorecard element



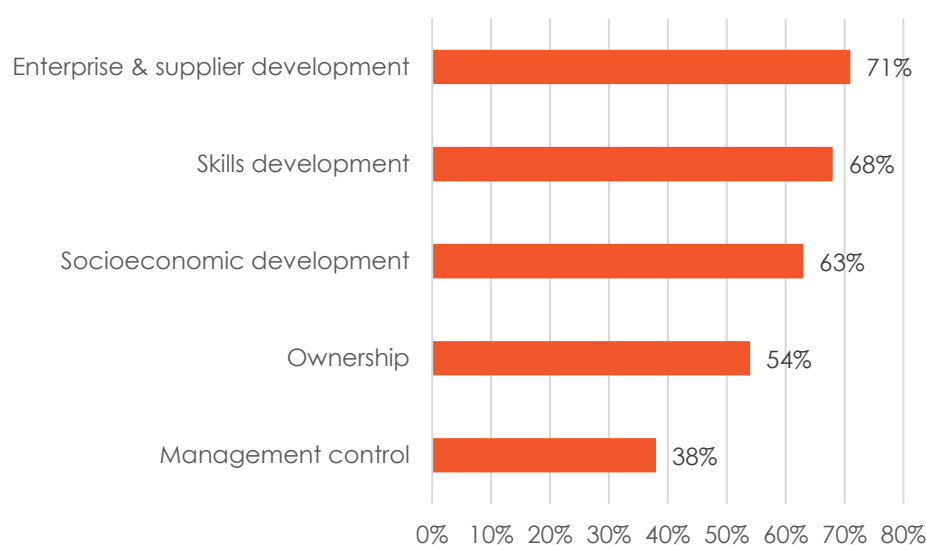
## Sustainability

Private equity and venture capital firms often see BEE as part of their wider sustainability commitments. With respect to sustainable finance, SAVCA report that:

- 96% of private equity firms consider ESG when making an investment decision.
- 59% of private equity firms that do not have a specific impact investing mandate are likely to consider such a mandate in the next five years.
- 72% of private equity firms intend to escalate efforts to manage and track the ESG performance of investee companies over the next 12 months.
- 56% of private equity firms noted that ESG risks and opportunities are considered “very seriously”, as the local market have mature ESG policies and processes.

The commitment of private equity firms to sustainable finance is sensible given the focus on sustainable finance by policymakers as evidenced in National Treasury's technical paper “Financing a sustainable economy” (National Treasury, 2020).

Figure 13: Percent of investee respondents who reported an improvement in BEE element post private equity investment



In addition to private equity firms influencing transformation in investee companies, 30% of firms interviewed by SAVCA stated that increasing gender representation is a top priority when onboarding talent (SAVCA, 2020).

## Infrastructure and energy finance

*The private equity industry has long been a key investor in public infrastructure, beginning with the first such projects post democracy like the N4 Toll Road and Albert Luthuli Hospital. It has long been a channel for pension funds and insurance companies to invest in infrastructure, particularly for equity investment. Several policy documents advocate for development of infrastructure. The National Infrastructure Plan prioritises the mobilisation of private capital to support investment in public infrastructure. The Plan notes that “The private equity industry is a key catalyst in infrastructure projects by providing equity and absorbing the most risk” (DPWI, 2022). This was clear in the Renewable Energy Independent Power Producers Programme, with private equity funds providing a significant amount of the equity needed by projects to enable them to then access debt finance. The private equity industry includes several dedicated infrastructure funds as well as general funds that take infrastructure exposure.*

### Understanding infrastructure investment by private equity

Infrastructure takes different forms. **Economic infrastructure** is that which supports economic activity and creates economic value. This includes roads, ports, railways and electricity plants. Generally, these can be funded by a “user pay” models – i.e. those who use them, and derive the economic benefit, pay for their creation and maintenance. Sometimes there is a blended finance approach, with guarantees or other forms of funding from the government in order to ensure that the project is viable for funding from the private sector. Projects like the Gautrain and Renewable Energy Independent Power Producers Programme are examples of economic infrastructure, which are funded by the private sector but have risk mitigation elements from the state (including guarantees). Private equity often participates in public-private partnerships, providing risk capital that is essential to enabling these projects.

**Social infrastructure** provides services to the public but is usually of a public good form and does not generate fees or other revenue from users. Examples include schools, courts, untolled roads, parks and hospitals. These can also be structured as public private partnerships, with the funding supported by

payments from government. Often, they can be efficient where “mixed use” projects are developed, for example, hospitals that also provide some privately paid services and have retail and other economic activities as part of the same development. Typically, either local or national government would commit to a long-term contract to pay for the availability of social infrastructure, or to pay for the services actually provided. Such models can be efficient where the private sector takes on all operational risks from the project.

**Private infrastructure** is that funded entirely by the private sector, but note that this can be enabled by regulation. For example, much broadband infrastructure across the country has been entirely funded by private investors, including extensive funding from private equity, as a result of national policy that has enabled private sector licensing for broadband distribution. More recently, amendments to the Electricity Regulation Act allowing private sector generation without a license has led to a significant increase in new projects that will be crucial to ending load shedding and in which private equity is widely invested.

As shown above in Figure 4 and Figure 5, private equity is particularly important at the early stages of projects when the risks are highest. This is also the most important stage from a public policy perspective – the need to fund new greenfields infrastructure, from hospitals to energy plants. The role of infrastructure specialists in the private equity industry is critical to arranging projects and ensuring their bankability. We believe there is significant capacity in the industry that could accelerate infrastructure development if the appropriate pipeline is enabled through government policy.

There is significant funding available for this form of investment. The increased allocation for private equity investment by pension funds, in terms of Regulation 28 of the Pension Funds Act (discussed further below) means pension funds can allocated significant amounts of investment to infrastructure through the private equity channel.

## Financing a sustainable economy

South Africa's electricity crisis is driven by a historic underinvestment in electricity generation and transmission infrastructure. There are now several urgent interventions to address the resulting shortage of electricity. Private equity has an important role to play in funding new generating infrastructure.

National Treasury's technical paper “Financing a Sustainable Economy” is a first step aimed at encouraging more long-term investments in sustainable economic assets, activities and projects (National Treasury, 2021b). The paper makes recommendations for the financial sector, including the private equity sector, to establish minimum practice and standards to address environmental and social risks.

The paper highlights that a key barrier hindering the growth of sustainable finance in South Africa includes the shortages of early stage funding, low availability of venture capital and a scarcity of private equity.

The technical paper's recommendations for the private equity sector are to:

- Request academics and professional bodies to analyse accounting rules for long-term investments and identify any potential barriers to sustainable finance practices;
- Promote the clarification and standardisation of terminology and methodologies for determining sustainability, which the sector believes hampers further investment;
- Disseminate case studies and best practice, such as those published by SAVCA, the International Finance Corporation and other development finance institutions.

## Pension Funds Act

Regulation 28 of the Pension Funds Act allows pension funds to hold private equity assets up to 15% of their total assets, subject to diversification and valuation requirements (National Treasury, 2021). This ceiling took effect in January 2023, materially increasing the allowed pension fund exposure from 10% (shared with hedge funds). The changes are in line with international initiatives around “patient capital” – private capital invested in innovative and high growth business for many years, particularly through the J-curve i.e. an initial loss followed by exponential growth. For example, Australian superannuation funds allocate around 23% of

defined contribution (DC) plan assets to alternative investments (including property, infrastructure, and private equity). Around 87% of Australian pension fund assets are in DC schemes (Rosov, 2020).

The amended Regulation 28 has also created a ceiling for South African infrastructure exposure, with a limit of 45%. While in theory the creation of this limit actually reduces the potential exposure of pension funds to infrastructure, in practice it creates a category that pension funds must then report on, which can enable further policy measures to support greater exposure. The infrastructure limit is additional to other asset class limits, so infrastructure assets held via private equity firms will need to be within both the private equity and infrastructure ceilings.

Ongoing engagement is taking place between the regulators and the industry on the definition of infrastructure, which is unclear and may not result in the increased allocation hoped for. Further clarity will support the implementation of Regulation 28 and assist the industry significantly.

## Pitfalls and risks from a public policy objective

### Financial stability

Regulators internationally are concerned that excess concentrations of leverage used by private equity may give rise to financial stability issues. Private equity firms can have a countercyclical effect when they use excess liquidity or dry powder to provide financing for investee companies during downturns or times of crisis. But negative impact on financial stability may arise from:

- Higher financial leverage amplifying recessions if it leads to lower investments in the downturn;
- Higher financial leverage increasing the probability of default and decreasing recovery rates;
- These risks being worsened by the high concentration of private equity ownership in the hands of a few large and global firms.

Leveraged loans issued by private equity buyout companies are estimated to account for about 80% of the European leveraged loan market and half of the US market (European Central Bank, 2020).

A study by the Federal Deposit Insurance Corporation in the US into the role of private equity in the resolution of failed banks after the 2007/2008 financial crisis, found that underperforming and riskier failed banks acquired by private equity investors performed better ex-post with positive real effects for the economy. The study found that the involvement of private equity investors in failed bank resolution played a positive role in stabilising the financial system in the crisis (FDIC, 2021).

In its Financial Stability in Focus report of October 2021 the Bank of England (BoE) reported that UK leveraged lending flows have in part been driven by a surge in private equity investment in UK businesses: 2021 private equity investment looks as if it will exceed its 2019 level, itself a strong year. The BoE identified increased risk to end-investors as looser underwriting standards in leveraged loan markets continued. The ECB in its Financial Stability Review of May 2020 suggests that private-equity-controlled companies issuing leveraged loans had been driving corporate leverage higher and investor protection lower both in the US and Europe. Higher leverage increases corporates' probability of default and will likely lead to lower recovery rates. Thus, while private-equity funding can provide corporates with a diversified source of financing, but it can also increase some financial stability vulnerabilities.

According to the SARB's Financial Stability Review, the trends in South African debt have been different. While government debt has trended higher, the debt of the private sector has remained relatively stable overall. The case of Edcon (discussed below) has been the starkest example of where high leverage

destabilised the operating performance of a large South African company, though this stands out as unusual. Post the financial crisis, there has been considerably less use made of offshore debt in private equity transactions. As discussed in this report, the South African opportunity set for private equity is biased towards smaller and mid-sized companies where the use of debt is unlikely to pose any systemic risks. While the use of debt should be monitored, we see less systemic risk from the South African private equity industry than in some foreign markets.

## Market conduct and investor protection

### Retail investors

Globally retail investors could be indirectly significantly invested in private equity, for example where pension funds invest the retirement savings of their beneficiaries in private equity funds. In addition, other institutional investors such as insurers and banks have increased their investments in private equity funds, often on behalf of retail customers. If a private equity firm defrauds a private equity fund, the underlying victims frequently include retail investors, who in many cases are not able to protect themselves. In addition, while the managers of these pension funds and other institutional investors who invest in private equity can be sophisticated, even experienced investors can be defrauded if they lack insight into the various fees, expenses, and practices.

In South Africa most private sector pension funds are defined contribution (DC) rather than defined benefit (DB) funds. One of the main differences between DB and DC funds is the allocation of financial risk. In a DB scheme the risk is borne by the provider of the pension plan, whereas in a DC scheme, the risk is carried by the member i.e., the retail investor. As a result, DC pension funds are subject to strict regulatory and operational constraints which can hinder funds' ability to allocate capital into investments other than traditional assets (public equity and fixed income). Even if the regulatory constraints are eased, barriers must be overcome for DC funds to invest in private equity (PLSA, 2018) (Rosov, 2020). These include:

- The perception that investments DC funds make must be priced and traded daily to be compatible with DC funds' terms and conditions. Daily pricing and trading is not an explicit regulatory requirement in most jurisdictions;
- A lack of suitable scale for many DC funds. Only larger funds can tolerate more illiquidity as it is easier to match cashflows in and out;
- Caution among trustees regarding member protection while investing in illiquid assets;
- DC schemes use of investment platforms that provide a limited range of permitted options to members;
- Diversification of the idiosyncratic risk of the underlying private equity exposures particularly given the J-curve, which is the tendency of private equity funds to deliver negative returns and cash flows in the initial years of the fund's life. This initial period is intended to be followed by positive cash flows and investment gains as the fund's investments mature;
- High fees and value for money;
- Reluctance to invest in private equity due to DC funds' culture, which is typically conservative and risk averse.

South Africa's pension funds system has changed over the last few decades, shifting to a large extent from DB to DC. This has meant in general that pension funds find it more difficult to invest in private equity, an unintended outcomes that should be considered in respect of pension funds regulation.

### Investor protection

Private equity and venture capital have strong and unique investor protection mechanisms. For example:

- strong continuous monitoring and contractual mechanisms to guard against information asymmetry. For instance, staged financing is often used to close information gaps. Knowing that the next round

of financing will only be released if key objectives in the business plan are met, SMEs have an incentive to get an accurate valuation of their projects and work hard to achieve business plan objectives;

- an implicit reputation mechanism in that other investors would find an investment unattractive if existing investors ceased to provide funding in subsequent rounds;
- due to having more control in the investee companies, the influence private equity firms have over decision-making is often disproportionately larger than the voting rights associated with their equity holdings;
- direct involvement in the corporate governance of investee companies;
- contractual mechanisms designed for investor protection, such as drag along rights, tag along rights, and right of first refusal.

However, in many countries there have been instances where fund managers have exploited the lack of regulatory oversight. These scandals illustrate how a lack of regulation leads to serious problems of non-transparency and non-disclosure in the management of a fund, deficits in investor confidence, and serious threats to economic growth and stability (see pitfalls and risks above).

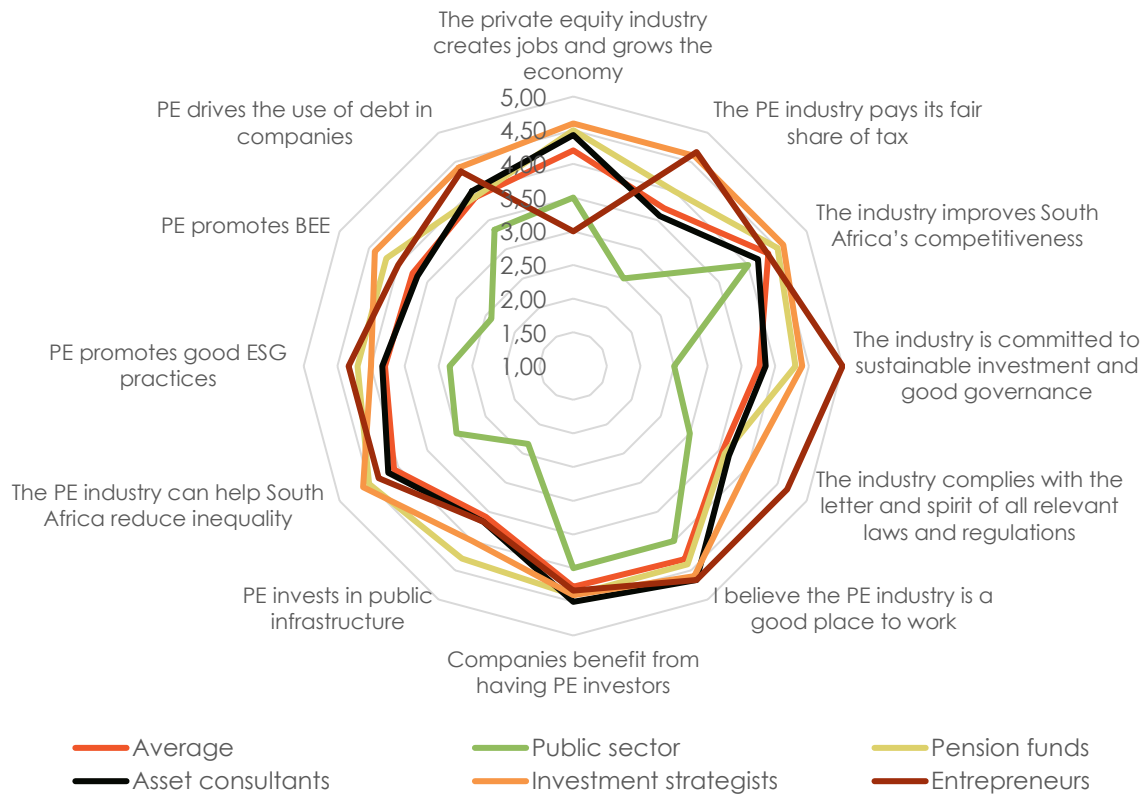
Good practice and conduct standards developed by industry associations such as SAVCA, the African Venture Capital Association and British Venture Capital Association, align the interests of private equity firms and investors and promote transparency for investors, particularly in respect of conflicts of interest, fees and performance measures.

## Reputation

A survey conducted by Intellidex on behalf of SAVCA has highlighted reputational concerns from the public sector, which holds a substantially more negative view of the industry compared to other stakeholders (pension funds, asset consultants, investment strategists, entrepreneurs and pension funds).

The public sector interviewees could see the potential benefits in directing capital particularly to development-oriented objectives (renewables was most mentioned), but there was concern about negative effects such as downsizing and reducing job headcount in the pursuit of efficiencies. They do not believe there is reliable research on the net effect on jobs or growth.

*Figure 14 Qualitative views of different constituencies from dipstick study (5 = strongly agree; 1 = strongly disagree)*



The following issues came out in the interviews:

- There is considerable concern about the **impact on the tax base from potential profit shifting offshore**, both by firms that domicile offshore and through the use of offshore debt. The Section 12J experience as well as legacy transactions such as Edcon are cited by interviewees when pushed on this point.
- The size of the industry: There is reticence about just how much policy development attention is appropriate for the industry given its size relative to other parts of the financial sector.
- It is not clear to our interviewees that regulation would benefit the industry or the public at large, though **there is an expectation that COFI and the alternative assets category will improve conduct risk**. From a conduct perspective, the assumption is that COFI (and consequent amendments to FSR) is sufficient – no further development is needed. From a macroprudential perspective, the assumption is that private equity is not systemically consequential (though there is some hesitance on this point) so does not really need much attention.
- And from a wider developmental perspective, there is uncertainty on whether private equity and venture capital really are net positive.

On job creation, interviewees are most undecided. Some believe it is positive, but others were unconvinced. There is concern that some deals focus on efficiencies rather than growth, reducing headcount where necessary.

The industry is **generally seen as positive for important policy objectives like infrastructure investment**, though this was not as robust as we had expected. It is seen as positive, particularly from a private debt perspective, but the role of equity in projects was not generally recognised. Our interviewees did not spontaneously refer to ESG or impact investing as a feature of private equity.

## What about Edcon?

In February 2007, at the height of the pre-financial crisis bull market, foreign private equity firm Bain Capital made a R27bn bid for clothing retailer Edcon. The offer was a 61% premium to the share price Edcon had been trading at, netting shareholders a windfall and injecting a substantial amount of foreign currency into SA.

To finance the deal, Bain Capital and Edcon raised a large amount of debt on international markets. In particular, it issued €1.83-billion in European debt markets, taking advantage of low rates at the time.

Shortly after, the financial crisis struck, triggering a recession in South Africa. The operating performance of Edcon suffered, while the Euro-denominated debt became more onerous due to the sharply weaker rand.

The deal was seen negatively in the media, and criticised for the amount of leverage that was used and therefore the riskiness of its funding just as a recession struck. It was also criticised as a negative for tax collections, as the interest payments on the debt were to offshore lenders and therefore outside of the South African tax net. The cost of servicing this debt absorbed a significant portion of its taxable profits.

That deal has not had a happy end. In 2016 Edcon's debt was restructured and lenders agreed to reschedule debt and take an interest holiday. At the time Bain exited the deal, effectively writing off its investment. This, and subsequent restructurings, were not ultimately successful and the business was placed in business rescue in April 2020 after the start of Covid lockdowns, resulting in significant losses to lenders and other creditors. Six months later, the business rescue practitioners were able to dispose of a substantial part of the group to a consortium backed by private equity, which saved 5,200 jobs and 120 Edgars stores. Today those assets trade well.

The Edcon story stands as a lesson on the overuse of debt in private equity transactions, which was possible at the height of the hubris before the financial crisis. Such offshore funding has not been possible since. Also, tax rules have been amended so the tax deductibility interest to offshore lenders is more tightly controlled. Ultimately, though, private equity has been able to play a key part in rescuing significant parts of the business and returning them to health.

Respondents generally did not see much difference between private equity and venture capital, with the two asset classes largely overlapping. However, private debt is seen quite differently, particularly from a base erosion risk perspective, but also in that private debt could be a substantial source of developmental capital and business finance in general.

The poor reputation in the South African public sector is not far removed from reputational concerns in other jurisdictions, e.g. the United States. The Senate Oversight Committee, for example, noted that "Private equity's business model involves buying companies, saddling them with mountains of debt, and then squeezing them like oranges for every dollar" (Oversight Subcommittee, 2021).

In March 2020, the Committee on Ways and Means in the US Congress examined the role that private equity plays in the Medicare program. Supporters of private-equity investment in healthcare argue that private equity firms improve the performance of the companies they acquire, generate better returns than other types of investments, and provide a way for health care companies to obtain capital. Opponents contend that private equity firms weaken the long-term health of the companies they acquire by weighing them down with debt, increase health care costs by using market power to obtain higher payment rates, and do little to improve the quality of healthcare.

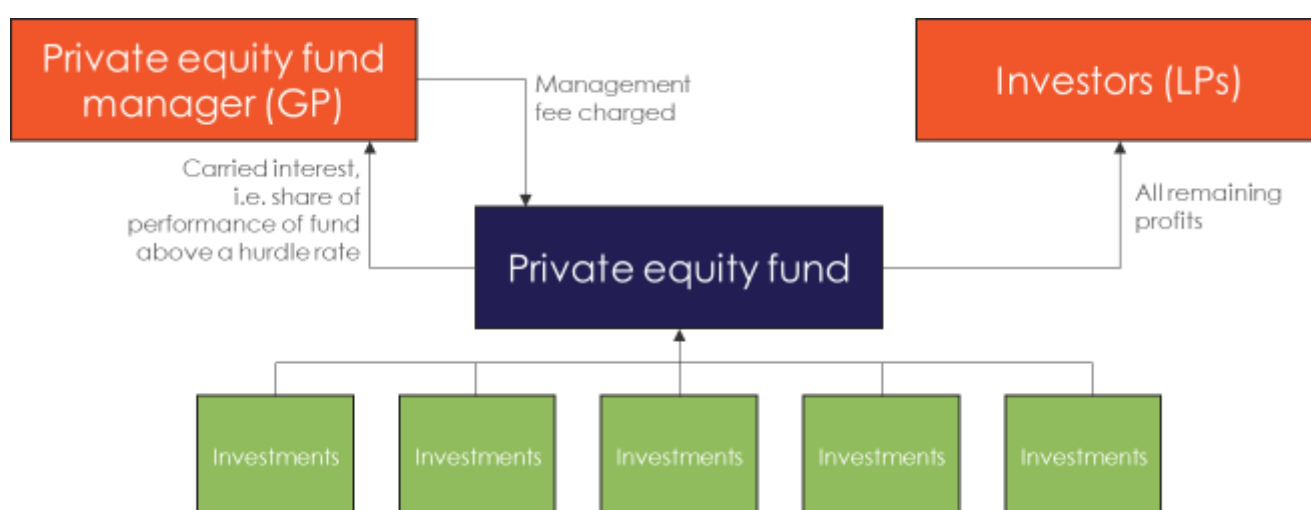
During Covid-19 private equity firms and other institutional investors acquired residential property. As their ownership share of the residential-property market grew, so did negative reaction and criticism. Big landlords are being accused of exploiting the crisis for profit through ever-increasing rents. Policymakers in

various jurisdiction responded quickly: the US wants to restrict the types of properties that large investors are allowed to buy. New Zealand has scrapped tax breaks for property investors, and Ireland imposed a 10% tax on the bulk-buying of houses. The reaction may be overdone as the market share of institutional investors and private equity is small e.g., in the US investors own 2% of rental homes (The Economist, 2021).

## Fees

Private funds have multiple levels of fees — among others, management fees, performance fees and for many private equity funds, portfolio company fees. Most of the fees earned are subject to performance and the returns generated for investors and are often negotiated and structured to fit investors' needs. Private equity is considered worth its high fees because it reliably outperforms public markets over long periods. Yet recent evidence (Steven J. Davis, 2021) shows that in the US, private equity's biggest market, it has performed only slightly better than public markets during the past decade, and that returns are on a downward trend. In South Africa this has also been the case, with performance over the last decade lagging listed markets (Riscura 2022) in line with the wider performance of the South African economy.

Figure 15: Typical private equity fund fee structure



Typically, the management fee charged by the general partner (GP) covers the costs of managing the fund. The upside for the GP is in the form of carried interest – a participation in the capital gains generated in the fund. Often this is specified by reference to a minimum return that the fund must yield before any carried interest can be charged by the GP. The GP may also be an investor with its own capital in the fund. The use of carried interest means that GP is aligned with the investors (limited partners) and usually only participates in the upside after investors have received their capital plus the hurdle rate of return.

## Conflicts of interest

Private equity firms could have interests that conflict with the funds they manage. Private equity firms may be managing multiple private equity funds as well as several investee companies. The funds typically pay the private equity firm for advisory services and for services such as managing and monitoring the investee companies. Affiliates of the private equity firm may also play a role as service providers to the funds or the investee companies. Advisers must make full disclosure of all conflicts of interest between themselves and the funds they manage. This is usually governed by the partnership agreements that set up the fund which aim to manage any conflicts.

There could also be a conflict of interest between private equity investors that aim to maximise their returns on equity, and debt-holders that want repayment of their debt. Private equity investors are likely to have fewer incentives than debt-holders to support investee companies in difficult times and are also likely to extract higher concessions from debt-holders when providing support to their investee companies.

# Conclusion: Regulatory developments to stimulate good outcomes

## Recommendations

### *Recommendation 1: Work with the Financial Sector Conduct Authority to develop an appropriate regulatory framework for venture capital and private equity*

An appropriate regulatory framework will sustainably grow the industry, and unlock the potential (e.g., investments through Regulation 28 while mitigating risks). The industry should be brought into the Twin Peaks regulatory framework. This will reduce both prudential and conduct risks. Indeed, this report proposes that the process is accelerated even prior to the introduction of COFI, by designating alternative investment funds as a financial product under section 2(2) of the Financial Sector Regulation Act.<sup>1</sup>

With a long investment horizon, limited liquidity and the transparency challenges that are particular to private equity investments, conduct of business standards introduced under COFI to protect investors should at least include:

- the valuation of fund investments be functionally independent from the portfolio management and implementation of measures to mitigate conflicts of interest;
- asset stripping restrictions;
- notification of acquisition of significant interests and of acquisition of control;
- the provision of sufficient information to investors at the outset and over the course of their investment. A certain minimum level of information should be made available, including disclosure of remuneration paid by the private equity firm to its staff;
- transparency around allocation of expenses, hidden fees, issues concerning marketing and valuation, the appropriateness of certain fees and the rightful beneficiaries of those fees (in line with SAVCA's template guidance);
- that it is the role and responsibility of individuals in positions of significant influence to be vigilant to ensure that the best interests of investors are being protected;
- fitness and probity regime.

### *Recommendation 2: Promote adherence to the Code of Conduct*

**Promote adherence to the SAVCA Code of Conduct** as a key differentiator between firms that are committed to ethical conduct and the reputation of private equity and venture capital funds. Emphasise too the Code's commitment to "building the value of investee companies" and the prevention of conflicts of interest between firms and investees.

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<sup>1</sup> Section 2(2) states: "The Regulations may designate as a financial product any facility or arrangement that is not regulated in terms of a specific financial sector law if— (a) doing so will further the object of this Act set out in section 7; and (b) the facility or arrangement is one through which, or through the acquisition of which, a person conducts one or more of the following activities: (i) Lending; (ii) making a financial investment; and (iii) managing financial risk."

**In particular, the industry should adopt a code regarding accepting of state funds.** State participation in private equity funds is based on considerations that go beyond pure financial gains, namely on national policy objectives such as creating employment and economic growth. Thus, government participation in private equity markets should in theory be driven by the fact that through meeting the equity capital funding needs of promising, young and innovative companies, a socially desirable outcome is achieved. Indeed, through blended finance structures, government can derisk projects and crowd in private investors to mobilise greater investment.

That said, there is **significant** reputational risk to the private equity industry arising from state funds being invested in private equity schemes. We recommend that the industry consider a code of conduct for accepting state funds, with the understanding that this may unlock capital.

### *Recommendation 3: Appropriately incentivise the industry*

**Engage with the Government on extending the Loan Guarantee Scheme to include venture capital.** The South African government has several schemes to assist SMEs to obtain financing. However, these are not designed to supplement and build on private sector provision. Rather they are delivered directly by government and not through intermediaries such as private equity and venture capital funds.

International jurisdictions such as US, UK and Europe recognise that private equity and venture capital are major investors in SMEs, which in turn is a key driver of economic growth and employment.<sup>2</sup>

### *Recommendation 4: Engage with government on an appropriate tax regime focused on simplification*

There are two aspects that require policy consideration:

- *Simplify and lessen the taxation regime for SMEs:* South African authorities have recognised that the uniform application to firms of all sizes of basic tax provisions i.e., non-targeted, generally-applicable tax policies and tax administration rules and procedures – may result in a disproportionate tax and compliance burden on SMEs, and thereby discourage SME creation and growth. Seven tax products / types currently may apply to SMEs: company income tax, personal income tax for self-employed individuals, VAT, PAYE, provisional tax, turnover tax and employer reconciliation;
- *Use of tax incentives to encourage investment in SMEs:* Section 12J of the Income Tax Act was introduced in 2008 to encourage investments in SMEs that can help to create jobs and economic growth. The tax incentive expired on 30 June 2021. Expectations were that it would be extended, however it was scrapped by National Treasury in its Budget 2021 statement because the incentive had not “sufficiently” achieved its objectives of developing small business, generating economic activity, and creating jobs. It has been suggested that funds were concentrated in new property development rather than employment-creating new enterprises. National Treasury found that R11bn was invested in 360 Section 12 J companies but only 37% created new jobs and most of the investments were in property development (Wasserman, 2021). No alternative has been put forward. The industry could propose a design of an incentive that does not include property development – e.g., into energy or infrastructure.

### *Recommendation 5: Engage with the South African Reserve Bank on the treatment of intellectual property*

Apart from amendments to Regulation 28, there are no current initiatives in South Africa to stimulate equity investment into SMEs by the private sector. Policy development and public spending needs to consider supporting private equity and venture capital, especially in relation to sustainable and new-technology investments. This could take the form of revised tax incentives to encourage angel investing in SMEs, revised exchange control regulations that make it easier to (i) raise capital from foreign investors and (ii) allow

<sup>2</sup> <https://www.businesslive.co.za/bd/national/2022-06-15-pic-plans-to-ramp-up-its-unlisted-investment-portfolio-to-25/>

foreign investors to exit their investments, and the creation of a central government fund that supplies funding to private equity and venture capital funds.

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