Obstacles to Venture Capital Funding: the South African Entrepreneurs' Perspective

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Abstract: The primary objective of this qualitative study was to explore the challenges faced by entrepreneurs in acquiring funding from venture capitalist companies in South Africa. A purposive snowball sampling technique was adopted to collect data from ten entrepreneurs and ten venture capitalist companies using semi-structured face-to-face interviews. Thematic analysis of the data revealed a number of prominent themes. Findings indicated that venture capitalist investors consider personal qualities of the entrepreneur as a key indicator of a viable business opportunity when making investment decisions. It was further revealed that the investment evaluation process is both lengthy and costly. In South Africa, the economic and political environments are unstable and risky. This plays an influential role to venture capitalist investors when making investment decisions. The study contributes to the existing body of knowledge and points to issues that can be further investigated. The study also has managerial implications in that it provides guidelines to entrepreneurs on how to approach venture capitalist investors for investment. The study has some limitations in that the use of a non-probability sampling techniques implies that findings cannot be generalised widely. Furthermore, the study was conducted only in South Africa and findings therefore cannot be generalised across other markets.

Keywords: Venture Capitalist; Venture Capital Funding; Entrepreneurship; South Africa

JEL Classification: M10

1. Introduction and Background to the Study

In 2018, the South African economy experienced a recession, which the country last encountered in 2008 (Central Intelligence Agency, 2018; Statistics South Africa, 2018). In order to revive an economy, entrepreneurship is generally regarded as a viable mechanism to address unemployment and poverty (Herrington & Kew, 2016). However, access to funding is one of the restraints for entrepreneurial activity in South Africa (Herrington et al., 2017). As an alternative to traditional forms of funding, studies have highlighted the importance of venture capital (VC) funding for entrepreneurs in South Africa (Park & Steensma, 2013; Zachary & Mishra, 2013). According to Portmann and Mlambo (2013) and Jones and Mlambo (2013), it is challenging for South African entrepreneurs to raise funds from potential VC investors due to various factors such as the perceived lack of managerial and business skills among entrepreneurs. Furthermore, the South African Venture Capital and Private Equity Association (SAVCA) established that between 2009 and 2014, a significant number of South

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African VC companies did not invest in entrepreneurial ventures as they were in the growth phase of the investment cycle. This situation was exacerbated by the sluggish economic growth attributed to the global financial crisis (SAVCA, 2015). Based on this background, the purpose of this study is to investigate the possible reasons prohibiting South African entrepreneurs from accessing funding from VC investors.

2. Literature Review

This section focuses on entrepreneurship in South Africa, as well as Venture Capitalism and related concepts in the context of South Africa.

2.1. Entrepreneurship in South Africa

Nieuwenhuizen and Oosthuizen (2014, p. 48) define an entrepreneur as a person who "identifies an opportunity or a gap in the market and evaluates the risk related to the establishment of the business and who is prepared to take the associated risk to start the business in the quest for making profit". According to Mbhele (2012, p. 94), entrepreneurship is "an activity that involves the discovery, evaluation and exploitation of opportunities to introduce new goods and services, ways of organising, markets, processes and raw materials through organising efforts that previously had not existed". Herrington and Kew (2018) exclaim that, compared to other developing and emerging countries such as Egypt, Morocco, Indonesia to mention a few, the entrepreneurial activity in South Africa is regarded as average. Factors attributed to this average entrepreneurial activity include rigid government policies and labour laws, access to funding or lack thereof, lack of training and education, and slow economic growth. In terms of funding, which is the focal point of this study, the limited financial support for entrepreneurs is detrimental to the emergence of entrepreneurs in South Africa (Mbonyane & Ladzani, 2011).

2.2. Venture Capital Funding in South Africa

VC is defined as the equity funding used to fund new entrepreneurial ventures (Correia, Flynn, Uliana, & Wormald, 2011; Els, Erasmus & Viviers, 2014; Mbhele, 2012; Ojah, 2011; Portmann & Mlambo, 2013; SAVCA, 2015). VC funding is a fundamental factor for entrepreneurs, who in turn, grow the economy through innovative products and services and ultimately create employment opportunities. VC funding can be divided into seed capital, start-up capital, later-stage financing, growth capital, buyout capital, rescue capital, and replacement capital (SAVCA, 2019). The role of VC is not confined to funding. According to Le Roux and Pretorius (2015), VC investors play a pivotal support role in terms of business strategy, marketing, networking, training, and identification and selection of suppliers. In order to encourage VC investors to fund potential entrepreneurs, the South African government has tax incentives aimed at encouraging VC investors to fund local entrepreneurs (SAVCA, 2015). Herrington and Kew (2016) confirm that a critical restriction to enhancing entrepreneurial activity in the South African economy is a lack of access to funding. Small and Medium-sized business owners struggle to obtain the requisite funding to grow their businesses, while also facing serious constraints as a result of poor cash flow and poor credit records, with many entrepreneurs suffering from lack of management experience and business training (Herrington et al, 2017). While the government has made great strides in the provisioning of financial programs, the aforementioned challenges result in businesses struggling and not growing to maturity (Mbonyane & Ladzani, 2011). While there exist a substantial number of sources from which companies can find capital (Els et al., 2014), entrepreneurs continue to find it difficult to secure funding from many of the available sources (Herrington & Kew, 2016). Entrepreneurs often attempt to source VC funding owing to a lack of other funding sources for start-up capital, while at the same time VC investors often provide helpful support and business advice in the areas of strategy, financing, operations, management, marketing and networking (Nanda & Rhodes-Kropf, 2013; Spinelli & Adams, 2016).

2.3. Problem Statement

In the past ten years, the South African economy has not performed well when compared to other emerging markets. Entrepreneurship is regarded as a one of the solutions due to its potential to stimulate the economy and create job opportunities. Nonetheless, lack of funding makes it difficult for aspiring entrepreneurs to be involved in entrepreneurship. Other than traditional sources of funding, such as bank loans, VC funding is a further option being explored by entrepreneurs with feasible and viable businesses. Despite VC investors investing sizeable capital in entrepreneurial ventures in the last ten years (SAVCA, 2015), entrepreneurial activity remains relatively low and not significant to stimulate South Africa's declining economy. Therefore, this study was conducted to determine the possible reasons that hinder entrepreneurs from sourcing funding from VC investors.

3. Methodology

This study employed a descriptive research approach and was guided by an interpretevist philosophy, as the intention was to develop a meaningful understanding of the VC industry from the perspective of both Venture Capitalists and entrepreneurs. The study employed a qualitative research design in the form of semi-structured interviews with participants from the VC industry, as well as with entrepreneurs. Interviews were guided by means of an interview guide that made provision for probing questions. When conducting semi-structured or in-depth interviews, five to twenty-five participants are deemed adequate (Saunders et al., 2016; McDaniel & Gates, 2013), or until saturation is reached. For this study, interviews were conducted with twenty participants, with ten participants emanating from the VC industry and ten participants who were entrepreneurs. A non-probability sampling approach in the form of judgmental and snowball sampling was employed, as the specific focus of the study necessitated this approach. Participants were also asked to refer other possible participants. Participants from the VC sector were identified from the SAVCA members' directory, similar to other studies conducted in the VC industry (Van Deventer & Mlambo, 2009; Jones & Mlambo, 2013).

A cross-sectional research approach was followed, with interviews taking place between April-November 2019. Data were analysed by means of thematic content analysis, with codes being allocated in the first stage, where after themes began to emerge. Ethical clearance for the study was obtained from the relevant departmental ethics committee at the University of Johannesburg. The study followed institutional ethical guidelines, with participants signing a consent form and being informed that participation was voluntary. The principle of informed consent was followed and responses were anonymised to protect participant confidentiality.

3. Findings and Discussion

A total of twenty interviews were conducted, split equally between participants from the VC industry and entrepreneurs. In terms of the participants from the VC industry, most participants (50%) were involved in their respective businesses between one and five years, 40% for ten years or more and 10% for less than one year. Most participants (40%) were in senior management, 20% were majority shareholders, 20% were minority shareholders and 20% were employees. In terms of industries invested in, five of the companies were invested in manufacturing, four in consumer products and services, food and beverages, securities and software. Three of the VC companies primarily invested capital in business products and services, healthcare, medical devices and equipment and telecoms. Two of the VC companies made investments in agriculture, electronics and instrumentation, energy, financial services and financial technology. In terms of the participating entrepreneurs, all were owners of their businesses, in which 60% were involved between one and five years, 20% of the participants between six and ten years and 20% of the participants for ten years or more. The entrepreneurs operated in a diversity of industries, such as electronics, software, e-commerce and financial services.

After completion of coding, five distinct themes emerged, namely the quality of the entrepreneur, the evaluation process, information required, business model of the VC industry, as well as the economic and political environment in South Africa. One of the most distinct themes to emerge were the *quality of the entrepreneur*. Participating VC companies take the abilities and character of the entrepreneur into account when evaluating investment opportunities. Specific character traits such as passion for business, high levels of motivation and commitment, prior industry experience, strategic foresight, honesty and preparation for the investment pitch emerged as desired character traits. This finding agrees with studies by Snyman et al. (2014), Van Deventer and Mlambo (2009), as well as Portmann and Mlambo (2013). In terms of the *evaluation process*, it is noteworthy that while VC companies follow a structured investment process, the process to evaluate the entrepreneur is unstructured. The investment process emerged as highly structured, lasts between three to seven months, can be in excess of twenty meeting. Success is mainly determined by the level of preparation on the part of the entrepreneur and quality of documentation received. As the costs of the due diligence process can be substantial, between 1.5-5% of the size of the transaction, some VC companies will expect the entrepreneur to pay the transaction costs, thereby excluding some entrepreneurs lacking this capital. In terms of the *information required*, the quality of the summary document, known as the ‘pitch deck’, greatly influences decision making by the VC company. Participants indicated that working with VC companies can be demanding, with some demands being unachievable for entrepreneurs. The information provided by the entrepreneur must create a logical coherent picture of the opportunity being presented, focusing on risks and risk mitigation measures. Alignment of the needs of the VC company and information provided is of critical importance, as information needs to be tailored to each investor and must be substantial, correct and logical. In the full proposal, critical information needs to include a financial plan and financial model, background on the business and founders, strategy, valuation, competitive advantage and industry analysis. This broadly agrees with findings of other studies (Van Deventer & Mlambo, 2009; Portmann & Mlambo, 2013; Spinelli & Adams, 2016; SAVCA, 2018). In terms of the *business model of the VC industry*, VC companies follow the investment cycle (Spinelli & Adams, 2016), with each cycle lasting 10-12 years. The first few years are spent setting up the investment fund, followed by the investment period, return generation period and lastly divestment period. The only time when this cycle is not followed is when Venture

Capitalists utilise their own capital and are awaiting a specific return, such as when an investment is made in a Section 12J fund. Investment usually takes the form of setting up a private company and offering shares to potential investors by issuing a prospectus or a private placement offer, with revenue generated for the VC Company by means of a management fee. An ideal investment is regarded as one where the rate of return is 16-38%, with an internal rate of return of 25-35%. Lastly, in terms of the South African economic and political environment, the VC industry invests capital in return for equity in less mature businesses showing high growth potential and without collateral (Atrill & McLaney, 2015; Els et al., 2014). This has also resulted in a shift in focus to growth capital and later-stage capital investments into more mature companies. Provision of seed capital has come to an almost complete halt (SAVCA, 2018).

4. Conclusion and Recommendations

The purpose of this study was to establish the possible reasons that prevent entrepreneurs from sourcing capital from the VC industry. Findings revealed that Venture Capitalists consider the personal qualities of the entrepreneur as one of the key elements of a good opportunity and strongly consider the abilities and character of the entrepreneur when making investment decisions. A lack of faith in the abilities of the entrepreneur would convince a VC not to invest in a given opportunity, despite the attractiveness of it. A number of personal qualities were outlined as important, such as passion and motivation, prior experience, future planning and networking abilities. Further, investment evaluation process is both lengthy and costly, and aims to evaluate potential success and exponential growth of the opportunity. Also, findings indicated the economic and political environment in South Africa, and associated riskiness, to play a key role when making investment decisions.

The study adds to the existing body of knowledge by providing novel insights into the VC investment landscape and decision-making process of Venture Capitalists. While the study confirms certain findings from prior studies, it also highlights aspects previously not uncovered in other studies, such as the strict application of the investment cycle. The study also holds several managerial implications. Firstly, the results can provide the basis for crafting of an effective tool to prepare entrepreneurs prior to approaching the VC industry for investment, potentially reducing the time and cost of the investment life cycle. This can result in entrepreneurs packaging information more appropriate to the needs of VC funders, thereby ensuring better preparation and enhanced chances of investment success. The study however also faced some limitation, most prominently the non-probability sampling approach, thereby limiting the potential for findings to be generalised. Participants were only from South Africa, thereby limiting the ability to generalise findings across the emerging market landscape. Future studies could make use of multiple case studies and a longitudinal approach in order to accurately map the relationship between a VC company and the investee for the duration of the investment period. A longitudinal study might also provide additional insights into how entrepreneurs have approached the VC industry for funding, how many have succeeded in finding capital and how many have failed, which will provide valuable data to both SAVCA and the Global Entrepreneurship Monitor. Future studies could also measure impact of the Section 12J tax incentive scheme.

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