TRADE & INDUSTRIAL POLICY STRATEGIES

# POLICY BRIEF: 1/2024

# Growing the start-up economy in South Africa: Accelerating local and foreign investment

## OVERVIEW

This policy brief identifies the key constraints that currently curtail the rate of growth of the South African start-up sector, and outlines the measures that could address these constraints. It follows a November 2023 TIPS workshop, Growing the Start-Up Economy: Accelerating Local and Foreign Investment. *Inter alia,* the policy brief draws on the presentations and discussion at the workshop.

**Trade & Industrial Policy Strategies (TIPS) supports policy development through research and dialogue. Its two areas of focus are trade and inclusive industrial policy; and sustainable development.**

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## INTRODUCTION

South Africa is an open economy, integrally linked to the global economy. It has strong universities and technological know-how. It is a democratic society. These are the key ingredients that underpin creativity and experimentation. One manifestation of this has been the development of a dynamic start-up sector.

Start-ups are largely independent of the constraints that significantly curtail growth in other areas of the South African economy – electricity and transport. They are not significantly impacted by crime and corruption. As a result, the South African start-up sector has experienced significant growth over the past decade. However, the growth of start-ups in South Africa is still far from its potential.

Growth elsewhere in Africa has, in recent years, been far more rapid. Once the leading country in Africa for investment in start-ups, South Africa has been overtaken by Nigeria while other African countries, such as Egypt and Kenya, have been growing more rapidly than South Africa.

## CURRENT STATE OF THE START-UP SECTOR IN SOUTH AFRICA

South African start-ups are working in a broad range of economic activities. In 2022, ICT (Fintech), Food and Beverage, Manufacturing, ICT (Software) and Consumer Products and Services were the leading sectors by value, accounting for almost half (48.5%) of venture capital (VC) investments. These sectors, together with Business Products and Services (9.8%) accounted for over half (50.9%) of the number of deals. (See Table on page 2)

South African VC investments are highly concentrated in the Western Cape and Gauteng. Indeed, there is very little VC activity outside of these two regions. In 2022, the Western Cape had the highest share by value (53.7%) and by number of deals (54.3%). (See Table below).

Over the past decade, the value of VC investments in South Africa has increased steadily, and in the number of deals, with the rate of growth rising most rapidly after 2015.

**Business location of all deals still invested, by value and number of deals, 2022**

| | NUMBER OF DEALS % | VALUE OF DEALS % |
|---|---|---|
| Western Cape | 54.3 | 53.7 |
| Gauteng | 34.8 | 33.6 |
| KwaZulu-Natal | 2.3 | 1.5 |
| Rest of South Africa | 3.8 | 4.4 |
| Non South African | 4.8 | 6.8 |

*Source: SAVCA*, 2023. Venture Capital Industry Survey. Covering the 2022 Calendar Year.

MARCH 2024

**Venture capital investment by sector as a % of deal value and % of number of deals, for all deals still invested, 2022**

| | BY VALUE % | BY NO OF DEALS % |
|---|---|---|
| ICT (Fintech) | 12.3 | 12.6 |
| Food and Beverage | 10.7 | 5.1 |
| Manufacturing | 9.3 | 6.4 |
| ICT (Software) | 8.9 | 10.1 |
| Consumer Products and Services | 7.3 | 6.9 |
| Healthcare (Medical Devices) | 6.6 | 5.2 |
| Healthcare (Other) | 5.7 | 5.7 |
| Business Products and Services | 5.1 | 9.8 |
| Energy | 5.0 | 3.0 |
| ICT (Telecommunications) | 4.0 | 3.2 |
| ICT (AgriTech.) | 3.9 | 2.4 |
| Agriculture (not AgriTech) | 3.1 | 3.3 |
| Health Care (Biotechnology) | 2.7 | 3.1 |
| ICT (Electronics) | 2.3 | 2.8 |
| ICT (Media) | 2.2 | 1.1 |
| ICT (Other) | 1.9 | 2.1 |
| ICT (Security) | 1.4 | 2.2 |
| ICT (online Markets) | 1.3 | 1.6 |
| ICT (eCommerce) | 1.3 | 2.4 |
| Distribution and Logistics | 1.3 | 2.6 |
| Financial Servies (non-Fintech) | 1.1 | 2.8 |
| ICT (Ed Tech) | 0.8 | 2.2 |
| ICT (Edtech) | 0.9 | 1.7 |
| Materials and Resources | 0.7 | 0.9 |
| Mining. minerals and chemicals | 0.4 | 1.1 |
| ICT (Hardware) | 0.3 | 0.7 |
| Healthcare (Life Sciences) | 0.3 | 0.1 |
| Retail | 0.1 | 0.3 |

*Source:* SAVCA, 2023. Venture Capital Industry Survey. Covering the 2022 Calendar Year.

However, the rate of growth slowed in 2020. Thereafter, the value of investments declined by 5.8% in 2021 and by a further 4.4% in 2022. The number of deals continued to rise, but at a slower rate after 2019. (See Table below).

The year that currently active start-ups were founded provides a further index of the slowdown. "The peak year for launches of currently active ventures was 2016, with start-ups being founded at a generally slower rate each year since 2018." (Disrupt Africa, 2022:11).

VC activity on the African continent has been growing rapidly, and recently far more rapidly than in South Africa.[1]

[1] *The next few paragraphs draw on NACI, 2023:31-34.*

In contrast with South Africa, there was a sizeable increase in value invested elsewhere in Africa in 2021. The value of deals increased almost five-fold, from US1.1 billion in 2020 to US$5.2 billion in the period 2014-2020, while the number of deals more than doubled, from 319 in 2020 to 650 in 2021. (AVCA, 2022:7-8).

In the period 2014-2020, over one-fifth (21%) of the number of VC deals on the African continent were in South Africa. In 2021, South Africa's share of the number of VC deals on the African content fell to 17%. In 2021, Nigeria was the top country destination for the number of deals (23%). Egypt (15%) and Kenya (13%) also increased their share. Nigeria was the tope country for VC deal value in 2021 (22%).

**Venture capital investments per annum – value and number of deals, 2012-2022**

| INVESTMENTS | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Value (R millions) | 288 | 183 | 273 | 372 | 933 | 968 | 1067 | 1225 | 1387 | 1306 | 117 |
| Number of deals | 8 | 19 | 67 | 69 | 116 | 147 | 134 | 162 | 167 | 186 | 195 |

*Source:* SAVCA, 2023. Venture Capital Industry Survey. Covering the 2022 Calendar Year.

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South Africa's share was 15% (AVCA, 2022:15). For the first half of 2022, VC deal value in Egypt, Kenya, Nigeria and Ghana all significantly exceeded South Africa. (AVCA, 2022:8).

There is also a pronounced difference in the success rate of start-ups. Over the past five years, Nigeria has produced five technology unicorns. South Africa has produced none. A significant number of high potential South African start-ups have left South Africa altogether – Gyft, Yola, Yoco and Clickatell, among others.

As VC in the African continent has expanded more rapidly, South African has lost its former dominance. "…South Africa's longstanding position as a titan in the venture capital industry is giving way in the face of increasing competition, entrepreneurial innovation and investment elsewhere in the continent's start up market. Nevertheless, South Africa continues to harbour strong investment activity…" (AVCA, 2022:17)

## THE START-UP ECONOMY AND SOUTH AFRICA'S ECONOMIC AND SOCIAL CHALLENGES

There is widespread misunderstanding of the start-up sector – what it does and who benefits. The popular perception is of a very few technology savvy people becoming rich through producing high technology products that meet the needs of the already wealthy. Some start-ups may have these characteristics. But, overall, and more particularly with South Africa start-ups, the picture is very different.

Indeed, the start-up economy addresses all the major challenges that South Africa currently faces.

### Economic growth

Start-ups are young companies often with little or no revenue. They are in the process of scaling up. Scaling up requires capital investment. Capital investment in turn results in future output. Investment in South Africa and associated growth is far too low. While there are no precise data for the sector as a whole, since 2015 well over US$1 billion has been invested in start-ups. In 2015, 45 start-ups for which data is available raised US$ 50million: in 2021, 89 start-ups for which data is available raised over $330 million. (Disrupt Africa, 2022:18).

### Diversification

South Africa is far too dependent on raw material exports. Start-ups are key to diversifying the economy. Start-ups develop new economic activities. Many of these new activities have considerable export potential. Moreover, start-ups have the potential to attract considerable foreign investment. Enhanced diversification and foreign investment, in turn, spur long-term overall economic growth.

### Employment

While they do indeed generally begin with a core group that is business and technology savvy, as they expand, most start-ups provide employment to far more people who are less skilled – 490 South African start-ups tracked in a recent report, employed more than 11 000 individuals, with the average number of employees at 23 per start-up. Seventy-five percent of these employees are black. (Disrupt Africa, 2022:15)

### Transformation

Start-ups are a "nursery" where many young people acquire their first exposure to business and where they develop deep managerial and technology skills. Twenty-nine percent of start-ups are led by a Black founder. Only one in seven start-ups count a female among its founding team. However, there have been several success stories, and start-ups founded by females have generated many of the jobs created.

### Competition

Start-ups challenge well-established companies and ways of doing business. They do so by introducing novelty. They are the seeds of new entrants and so enhance competition. Many of today's large successful companies began life as start-ups.

### Poverty

Technology based start-ups cover a wide area. A large share of South African start-ups is directed at providing services for the poor: access to finance and insurance, employment, low-cost health and housing, affordable education, and small-scale agriculture. among others. In particular, a significant number of South Africa's successful start-ups are focused on providing access to finance for poorer customers who are not served by established business. South African start-ups are therefore very attractive for investors who place a high value on social impact.

### Fiscal

Start-ups have the potential to generate revenues for the state. Significant revenues will accrue when shares in start-ups are acquired by investors and there is a capital gain. Income tax of employees and VAT are additional sources of revenue.

In contrast with many other areas of economic activity, the further development of the start-up economy does not require any significant government expenditure. What is required are changes in approach and in regulations to encourage higher levels of investment on the part of both local and foreign investors.

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## ENHANCING INVESTMENT

Start-ups are embedded in an ecosystem. *Inter alia* an effective start-up ecosystem requires a supportive business environment, a supply of well-trained people, linkages to universities and other research centres, co-working spaces, incubators and accelerators.

While there is considerable room for improvement in all these aspects, the most significant challenge currently facing high potential start-ups in South Africa is the limited supply of venture funding. This is the binding constraint. If the supply of venture capital (VC) can be increased, the number of start-ups and the rate of expansion of existent start-ups will be similarly enhanced.

There are two sources of funding for start-ups and the VC investors that fund start-ups – local and foreign. Local funding is very limited. The local VC market was only 0.15% of the US$643 billion global VC market in 2021. Foreign funding for South African start-ups is also very limited. Foreign investors are deterred by the more restrictive policy environment in South Africa for start-ups as compared to competitor countries and, in many cases, mandates that preclude investment directly in South African companies (see the *Enhancing foreign investment* section).

The rest of this section examines the current situation and proposes some key measures to enhance investment – both local and foreign.

### Enhancing local investment

South Africa has a large and sophisticated financial sector with an asset to GDP ratio well above that of most emerging markets. There is considerable investment in local companies. Domestic credit to the private sector as a percentage of GDP in South Africa, at 129%, far exceeds other African countries – Nigeria (12%), Egypt (27%), Kenya (33%). Although funding from government and local sources for start-ups has, in some African countries such as Nigeria, been Increasing recently, the bulk of funding for start-ups elsewhere in Africa is from foreign sources. In contrast with other African countries South African start-ups are largely locally funded.

The bulk of the assets of the South African financial sector are in banking, but pension funds and insurers also have large holdings. Of particular note, pension funds have assets of more than R4.6 trillion, one of the highest assets to GDP ratios in the world.

Although South African pension funds have been allowed to invest up to 15% of their assets in private equity alternative investments for the last few years, the uptake has been slow – allocations to private markets in general are below 2%. Almost none of this has been allocated to investments in VC. In contrast, Europe pension funds contribute one-fifth of funds raised by VC. In the United States (US), pension funds contribute two-thirds of the funds raised by VC.

In countries that have well-established VCs, investment in VC is seen as an integral component of a well-diversified portfolio, by pension funds and other investors such as insurance companies, university endowments and private trusts. There are limited signs of change, but the vast majority of South African pension funds and other financial institutions remain uninvested in start-ups.

There is a widespread view that investing in VC is very likely to be unprofitable while, at the same time, such investments will be very risky. While these arguments against investing in VC may have had some validity, particularly in the early stages of the development of VC, and the start-up sector, they are now far less persuasive.

With returns, globally VC and Growth Equity asset classes have substantially outperformed stock markets for several decades. In South Africa, there have been particularly muted returns on established asset classes such as listed equities.

That it is possible to invest in local venture capital in South Africa and have both social impact and excellent returns has been demonstrated recently by the Consolidated Retirement Fund for Local Government (CRF). CRF is the first retirement fund in South Africa to commit to investing in local VC. CRF has seeded and anchored three blended finance funds, backed by National Treasury's Jobs Fund. CRF has also seeded and anchored a blended finance fund launched by the SA SME Fund, which is the first commitment by a retirement fund in the local venture capital space. CRF has outperformed the market on all Indicators, providing significant returns to pensioners. At the same time, CRF investments have grown employment and contributed to a just

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transition in energy – its two social impact objectives (Sukha, 2023).

While, of course, risk remains a factor as with any investment asset class, recent developments have significantly reduced the risk of investing in VC. Investing in a single vehicle that encompasses several VCs allows investors to significantly spread their risks. The so-called Fund of Funds enables investors to gain diversified exposure to start-ups across different sectors, at different stages of investment, and to fund managers with different levels of experience and skills.

Moreover, some Fund of Funds provide concessionary /subordinated capital on a first loss basis. This provision provides considerable downside protection to investors without, in any way, limiting the potential upside gain. The SA SME Fund is an example. The SA SME Fund blends capital from commercial and institutional investors with first loss investors, a combination of corporates, government, and US AID. The Venture Capital Fund of Funds raised by the SA SME Fund has a first loss provision of capital whereby commercial/institutional investors rank senior to first loss investors when capital is returned. This fund has secured capital from South African institutional investors for the first time. (Manning, 2023)

## Enhancing foreign investment

Large numbers of South Africa's most successful start-ups have left or are in the process of leaving. Rather than attracting foreign investment into start-ups, South Africa is experiencing capital flight as high potential start-ups relocate with consequent loss of output, jobs, and revenue.

Successful start-ups will need large sums of capital to scale up, more particularly if they are seeking global markets. The sums available to start-ups in South Africa are woefully insufficient. In 2021, high-growth South African start-ups that are now located abroad raised over R175 billion. Only foreign investors can provide such sums. Moreover, only foreign investors can provide global market access.

Global VCs are very reluctant to invest directly in a South African company. Regulations are more restrictive and uncertain in South Africa, relative to other environments where such VCs are active. Indeed, in many instances, large global VCs located abroad are prohibited altogether from investing in a company whose HQ is in South Africa. Their mandates only allow for them to invest in the US, Europe, the United Kingdom, and a few other countries.

Consequently, if they are to attract foreign investment, South African companies must set up their HQs abroad in one of the countries in which global VCs are active.

This is done by the South African company setting up an offshore holding company (OHC). The OHC acquires the shares of the South African start-up on a share for share basis. As a result, a loop structure is created whereby the OHC and the South African start-up own 100% of each other. The OHC has direct ownership of the Intellectual Property (IP). Foreign investors are now able to invest by purchasing shares or otherwise injecting capital into the OHC, located abroad, rather than in the South African company.

South African firms have, since January 2021, been allowed to set up such loop strictures. However, exchange control restrictions require that a start-up must have prior approval to raise offshore capital. Obtaining such approval is very cumbersome, costly and time-consuming. Time is of the essence for start-ups and rather than face these delays, many South African start-ups choose rather to relocate their entire operation abroad.

Furthermore, South African start-ups must make an application if they wish to transfer their IP to the OHC. Current IP legislation imposes onerous and costly restrictions on companies seeking to transfer their IP abroad. Once again, costs and delays are prohibitive for start-ups. They have limited capital and speed to market is critical to their success.

South African start-ups face a further impediment. Start-ups seeking to raise capital from offshore investors will establish an OHC. This entails the transfer of share in the local South African company to the OHC in return for shares in the OHC, such that shareholders in the South African Company become shareholders in the OHC. Currently, under South African tax law, this would result in a tax event. The resident shareholders of the South African company will be subject to Capital Gains Tax (CGT).

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There is a provision in the Income Tax Act, Section 42 whereby the payment of CGT is deferred until the actual sale of shares in the OHC. However, this deferment only applies in the case of transactions between South African resident companies. As a result, when South African resident shareholders transfer their shares in the South African start-up to the OHC, a non-resident company, the shareholders are regarded as having disposed of their shares and consequently to have incurred a capital gains tax liability.

However, there has been no sale of shares. There has merely been a share swap. As a result, there is no resource from which to pay the deemed CGT, Typically, the South African resident shareholders are cash-poor founders or early-stage investors. Moreover, the South African start-up is typically loss making, and has only "paper value" – a value based on their past investment values and/or the intangible value and/or potential of their intellectual property. The South African resident shareholders are faced with a high tax bill, based on the aspirational value of a high-risk investment, and have no cash to pay the CGT.

The solution is that CGT should only be triggered on the actual sale of shares. The application of the Tax Deferment Provisions, Section 42 of the Income Tax Act, should be extended to include reorganisations involving a non-resident company. This would allow for funds to be invested in growth and consequently a higher sales price for the shares, and thus return more to the South African fiscus than would otherwise be the case.

## CONCLUSION

Currently South Africa is at a disadvantage relative to several African countries. A number of African countries have recently passed start-up Acts to create a start-up friendly environment – Tunisia, Kenya, Nigeria and Morocco. As a result, these countries are now seeing far greater levels of investment, particularly foreign investment, than South Africa and consequently more rapid growth of start-ups.

The more rapid growth of start-ups elsewhere in Africa is the clearest indication that South Africa is performing below its potential. Given its far more developed financial sector, and hence the far greater potential availability of local funds for investment, South Africa has the potential to out-perform other African countries.

Attracting more local and more foreign investment are closely related. Greater investment on the part of local investors will provide some encouragement to foreign investors. Moreover, if South African start-ups can secure greater foreign investment and so expand on the global stage, the prospects of significantly higher returns will, in turn, encourage higher levels of local investment.

The changes required are costless and, as this paper has outlined, are clear and easily implementable. As a recent report concluded "All that is required is a small change in mindset and a few regulatory tweaks." (Lewis, 2023)

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