

Private Equity and the South African Economy

*Delineating the Role and Impact of PE Investment on Small Medium Enterprises
in South Africa for entrepreneurs and policy makers.*

A research proposal submitted by

Richard Manzini

Student number: 302274

Tel: (+27) 82 367 5758

Email: richiemanzini@gmail.com

Supervisor:

Professor. Paul Alagidede

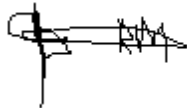
Wits Business School

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Declaration

I, **Makhahlele Richard Manzini**, declare that the research work reported in this dissertation is my own, except where otherwise indicated and acknowledged. It is submitted for the degree of Masters in Business Administration at the University of Witwatersrand Business School (WBS), Johannesburg. This thesis has not, either in whole or in part been submitted for a degree and or diploma to any other university and or publication.

Signature:



Date: 28 February 2018.

ABSTRACT

The private equity (PE) industry in South Africa (SA) has seen continued growth as measured by assets under management over the years, however, in the same token, entrepreneurial activity in the country has been on a decline. This study examined the reasons why (Small and Medium Enterprises) activity in South Africa is on the decline as well as the reasons why they do not seek to access PE investment.

The analysis outlined results in eight thematic areas. Firstly, it finds an indication of the positive impact of private equity in the South African economy. Secondly, it presents evidence that PE industry professionals in SA have no experience with SMEs. It then outlines, given an opportunity, the advice that PE professional would give to SA SME business owners. The study also delineates some qualitative factors leading to the observed SME and PE investment disconnect in the SA context. It then profiled SME business ownership and decision making and then tried to characterise informational asymmetry and the lack of corporatisation of SMEs. Further, it brought out the level of awareness of PE and its product offering among SME business owners and finally identified the factors relating to their fear of the loss of control if they allowed PE investment.

Private equity investment and involvement in the SA economy can lead to growth. It can also play a crucial role in development of SMEs which can result in labour absorption and job creation. However, PE funds in SA target medium to large companies because that is the space they assume to be less risky as they are generally well established companies. Presently therefore, there is a disconnect between PE investment and SMEs in SA.

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Mukutsuri, Hosi ya mina
Wandzi rhandza,
kutlurisa mana wa mina,
Wandzi rhandza,
Mukutsuri, Hosi ya mina, Yeso
Wandzi rhandza,
kutlurisa mana wa mina, Yeso
Wandzi rhandza,

Ri rhandzu ra munhu ra hela,
Ku tsaka ku hatla ku hundza
wena ntsena Xikwembu xanga,
wandzi rhandza

Thank you Lord. Thank you for continuously making sure my life is filled by people whom love and support me; My parents (Makhahlele and Shalati Manzini) and siblings (Lunghile and Gezani Manzini), their continued presence in my life is in itself a blessing; my friends whom continue to provide that needed push towards the ever elusive state of happiness; my colleagues (amongst others, especially Benedict Mongalo), whom have over the years supported my growth and career aspirations. Thank you.

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wena ntsena Xikwembu xanga,
wandzi rhandza

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1 INTRODUCTION

1.1 Purpose of the study

The traditional approach by investors towards growing their wealth is the acquisition of shares in companies and this has led to the term Private Equity (PE). The objective of PE has always been the investment of funds in small and medium enterprises so as to grow the companies and thereafter, to exit and obtain a return on the investments. That PE investments play a role in stimulating a country's economic growth is well-documented. Meyer (2006) found a positive correlation between PE and economic growth in the United Kingdom while Bernstein *et al.* (2016) found that industries financed by PE funds grow faster in terms of productivity and employment indicating a positive impact of PE on other macroeconomic factors. Furthermore, Metrick & Yasuda, (2010) went on to find that PE funds continue to play an increasingly important role as financial intermediaries in providing access to capital that would not be accessible through traditional banking institutions for SME with growth potential.

The overarching aim of this study is to investigate the impact of PE on SMEs, in South Africa. This research is crucial due to the fact that South Africa is currently experiencing low to zero economic growth, as reported by Statistics South Africa for the period 2017, and would benefit from any form of activity (such as PE activity) that could stimulate the SME sector.(STATSSA, 2017) However, although growth is currently on a decline, it South Africa continues to enjoy a reasonably high number of PE investments, new and/or follow-on. (SAVCA & KPMG 2016, Figure 1)

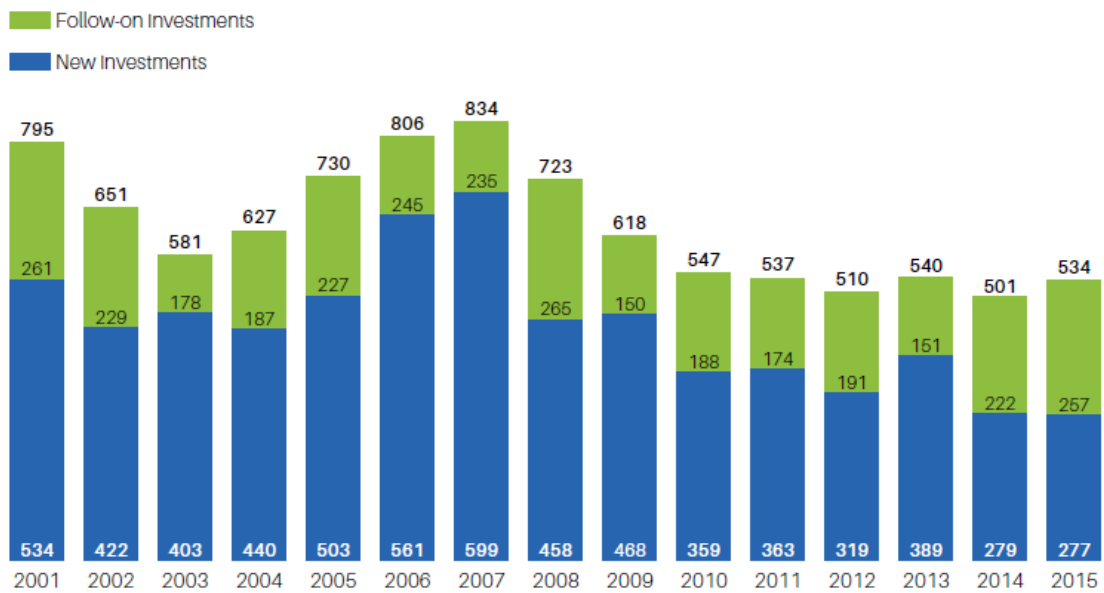


Figure 1 : PE Investments made during the year, analysed by new and follow on investments (SAVCA & KPMG 2016)

The chapter is structured as follows: Section 1.2 presents the context of the study. Section 1.3 discusses the research problem. Section 1.4 outlines the objective of the study. Section 1.5, unpacks gaps in the literature. Section 1.6 expounds on the benefits of the study. Section 1.7 provides for delimitations of the study. Section 1.8, serves to outline the research paper as a whole. Lastly a chapter summary is written to concisely close off Chapter 1.

1.2 Context of the study

Wood & Wright (2009) define PE as a partnership solely structured to make investments in unlisted companies, with the intention to realize equity value. Kaplan & Strömberg (2009) expanded on the definition of PE by stating that these funds will invest in private companies at various stages of the business cycle and at various stages of a company's life, being either expansionary, start up, the facilitation of management buy-ins (MBI's) and management buy-outs of established companies.

PE investing is typically carried out through a limited partnership structure (Gilligan & Wright 2010). The PE firm or partnership serves as the general partner

(GP) (Kaplan & Schoar, 2005). The investors into the PE firm are referred to as the limited partners (LPs) consisting largely of financial institutions (pension funds, sovereign funds, banks, development funds and other mandated captive funds) which generally provide the bulk of the sort capital by the PE firm (Mathonet & Meyer, 2007). According to SAVCA and Riscura (2016), the South African PE industry has delivered significantly higher returns relative to other asset classes, on a risk adjusted basis. Gray (2012) finds compelling evidence in the USA on a time weighted annual return basis where private equity investments returned 11.35% from 1981-2012 versus a return of 4.71% for the S&P 500 over the same period. Schmidt (2003) found that PE as an asset class for portfolio construction of institutional investors could offer diversification potential, as correlations factors with public markets are low. He further conclusively showed that PE investments can eliminate over 80 percent of non-systematic risk. It is for these unique characteristics that 10x Investments (2017) found that the recently amended Regulation 28 of the Pensions Fund Act of 1956 made explicit allowance for up to 15% to be dedicated towards PE funds.

In addition and important to note, the SAVCA-DBSA (2013) Economic Impact study, found that on average, PE backed firms tended to improve in total sales, operating income, employment, exports, capital expenditure and R&D expenditure. Schmiemann (2009) concludes in his seminal paper that Small and Medium Enterprises (SMEs) remain among the main drivers of economic growth. Of benefit to SME companies backed by PE funds, Folta & Janney (2004) found that SME companies backed by PE firms were able to mobilize additional capital from traditional financial institutions, commercial partners and research far better than non-PE funded companies. This in essence underpins the PE's value proposition.

Meyer (2006) provided for empirical findings that an increase in PE investments of 0.1% of GDP is associated with an increase in real economic growth of between 0.2 pp (buyouts) and 0.8 pp (early-stage investments). Khonowski (2011) further attributed the growth in PE investment inflows to the ability of a country's inhabitants to stimulate local demand through the purchasing power of its

emerging middle class. De Beer & Nhleko (2009) point to SAVCA's (2005) findings on PE's ability to boost economic growth in South Africa when compared to other forms of financing, by enabling a level of higher gearing in the firm and at times the only source of funding available for companies facing insolvency and under business rescue. Furthermore, in a South African context, PE firms facilitate growth in company ownership and involvement from the previously disadvantaged black population under the Black Economic Empowerment (BEE) legislations.

Bernstein *et al.* (2010), Stormberg (2009) and Cernohorska, Linhartova, Sinka & Teply (2012), observe the dynamic factors which drive PE activity. Together they have conclusively shown that PE has a positive influence on firm performance and reduces levels of corporate failure. Cernohorska *et al.* (2012) further observed the vital role PE played both during and post the global financial crisis of 2008 by becoming the last source of capital for distressed companies. These external shocks to macroeconomic variables continue to bring PE to the forefront of capital allocation.

It is conceivable, due to causality, that one might argue that economic growth drives PE. However, Bernstein *et al.* (2010) and Stormberg (2009) in their research, discount this view. It is widely accepted that PE growth depends both on external and internal factors. Among these factors Chikaonda (2012) cited the economic activity of a country, the depth of capital markets, regulations and legislation around PE, tax, the human and social environment and lastly the entrepreneurial culture and deal pipeline. Therefore, if the PE industry is poised to positively impact the country, are policy makers, large institutions and investment professionals astutely aware of the impact their investment decisions can have for the country in the SME sector?

1.3 Problem statement

According to their 2016 survey, SAVCA reported that the PE industry in South Africa, as measured by assets under management, is growing year on year (SAVCA, 2016, Figure 2). This survey reflected that the South African private

equity industry had a total of R165.3 billion in funds under management which was a R15.0 billion increase from the R150.3 billion in FUM at 31 December 2014. Furthermore, this report stated that the industry has achieved a compound annual growth rate of 11.9% in total FUM since 1999, when the survey began.

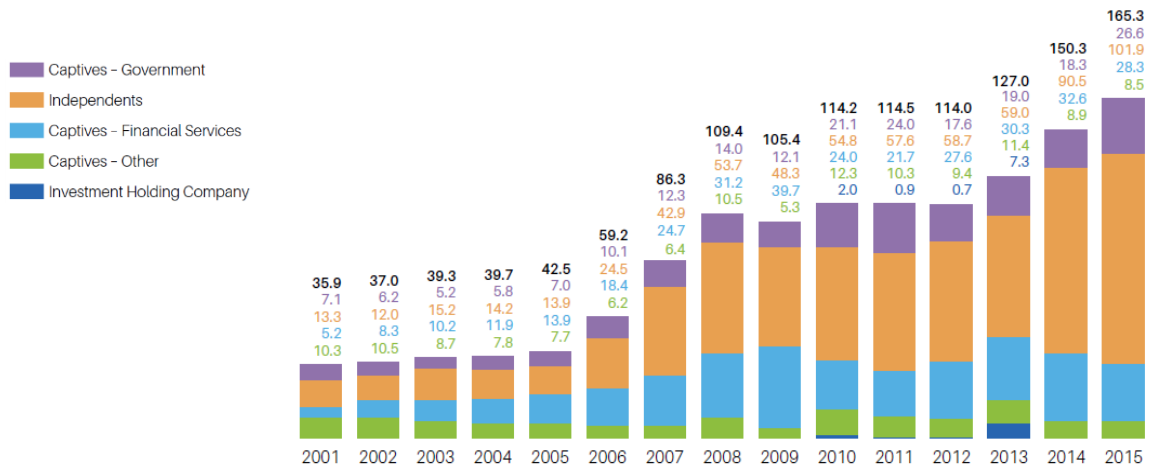


Figure 2 : Total Funds Under Management 2001 to 2015 (R' Bn) (SAVCA & KPMG 2016)

It is therefore evident that PE is emerging and that firms continue to attract capital to invest in various sectors. However, there continues to be a funding gap, in South Africa; even though Metrick & Yasuda (2010) note the role PE can play in providing capital to SMEs. There is persistent growth in PE activity within South Africa (SAVCA, 2016), seemingly; despite the economic conditions, of close to zero growth in GDP, the PE industry continues to direct committed investor funding to the funding of certain SMEs. Are other SMEs aware of the potential funding that exists from the PE sector?

1.4 Aim and objectives of the study

The overall aim of the study is to delineate the role and impact of PE investment on SMEs in South Africa for entrepreneurs and policy makers. The specific objectives of this study are:

- To assess the PE activity in South Africa and the impact of that activity on SMEs;
- To determine and ascertain factors why SMEs do not have linkage with PE investment;
- To investigate whether SMEs and Entrepreneurs are aware of the potential impact of PE investments into their business.

1.5 Gap in the literature

Previous studies on PE in a South African context have concentrated on the cross-sectional analysis, of comparative studies such as work done by Chikaonda (2013), de Beer & Nhleko (2009). (Table 1) They however, do not take into account actual changes in economic variables over a period of time. Furthermore the focus only on qualitative approaches, seeking to understand the continued growth of the industry as understood by the Investment Principals of the PE firms. Bernstein. et. al. (2016) expounded on the difficulty to access information, primarily due to how the industry itself is secretive on reporting on their activities. Whereas SAVCA and associated research agencies continue to develop literature around PE, within a South African concept, there is no further linkage being researched on the impact the growth of the PE industry has had on employment, small medium enterprises and .overall macroeconomic indicators. This is compounded by what Fatoki & Odeyemi (2010), found in that, the 75% failure rate of SMEs in South Africa, is primarily due to a lack of finance, wherein 75% of all SMEs are denied credit facilities by traditional finance institutions.

To understand the apparent information asymmetry, this study seeks to examine and question SME business owners and Entrepreneurs on their understanding of PE as an avenue to raise capital and further grow their business.

1.6 Benefits of the study

This study is expected to create awareness to SME business owners, entrepreneurs, and the public as well as influence government policies. Specifically, it will:

- Inform the private sector by creating awareness for the SMEs and entrepreneurs alike to view PE as an avenue to seek funding for their businesses
- Help the government look at the PE industry more in-depth such that if there are specific activities with a positive role on the economy, such as delivering on innovation and efficiencies as found by Kortum & Lerner (2000).

1.7 Delimitations of the study

Considering the nature of the Private Equity Industry, being secretive in nature and highly competitive, reliance is placed on SAVCA for data pertaining to the Industry. There is an assumed reliability and accuracy in their reporting. There is an inherent difficulty in segmenting the SMEs that are appropriate to answer the survey. And a further limitation, exists in truly being able to determine the impact PE firms can have on SMEs performance and growth. There is an assumed level of honesty and integrity that will be upheld by all respondents, and an inherent disclosure that having the survey sent out to as many respondents, will serve to remedy any such misrepresentations to an insignificant level.

1.8 Outline of the report

The final thesis will be arranged as follows: Chapter 2 presents the literature review. It provides for an in-depth understanding of previously documented literature on PE, its role as an asset class and impact on the economy. Chapter 3 provides detailed discussion and overview on the research design and methodology employed in this study to ascertain the impact of PE on macroeconomic factors of growth in South Africa. The data used and econometric

method is also discussed in this chapter. Chapter 4, outlines the findings and results obtained from the research undertaken and lastly, Chapter 5 provides for a discussion and conclusion as well as further research which could be undertaken in order to further develop the findings of this work.

1.9 Chapter summary

This chapter provided an introduction to the research study by providing the context to the study, the research problems and objectives as well as the benefits of the study. The next chapter examines the literature review.

2 LITERATURE REVIEW

2.1 Introduction

This chapter reviews previous research on PE. This section further considers theoretical links between PE, its role and impact on SMEs. The chapter is structured as follows: Section 2.2 highlights the theoretical framework underpinning this research; Section 2.3 discusses the role and impact of SMEs on the economy. Section 2.4 presents literature on the role and impact of PE on SMEs. Section 2.5 seeks to highlight prevalent literature on the determinants of access to funding by SMEs. Section 2.6 presents the chapter summary which concludes the chapter.

2.2 Theoretical underpinning

Sogorb-Mira (2002) shows that there are two main theories underlying the funding requirements of SMEs are those related to adverse selection and the moral hazard (agency theory)

2.2.1 Adverse selection and moral hazard (Agency theory)

SMEs and entrepreneurial establishments can be extremely diverse in size, growth potential, stage of development; economic or industrial sector as well as owners' ability, motives and sophistication. These factors can have an effect on their potential to access and work with PE investors (OECD, 2017).

The interaction between a PE firm (Investor) and an investee company in terms of financing, ownership and governance is generally rationalised by the agency theory and informational asymmetry. The latter occurs when one party has the undue advantage of having more information about the other party when entering into a contract. If information asymmetry takes place before the contract is entered into, it may lead to what is termed as an adverse selection. If it takes place after

the contract is entered into, it may lead to a principal –agent problem (Mas-Colell *et al.*, 1995).

A moral hazard occurs when there is asymmetric information between two parties and change in behaviour of one party after a deal is struck and should the change in behaviour results in costs, they are then borne in part or wholly by the other party that did not change behaviour. The party with less information is at a disadvantage to the party with more information. The adverse selection situation in a private equity transaction is when for instance a portfolio company is on the verge of collapse but does not declare this information when the PE firm invests. If the portfolio company is in a position where it may not survive without this investment, then the PE firm may end up with an adverse selection situation (Wilkinson, 2012).

The principle-agent problem arises when an agent agrees to work in favour of a principle in return for incentives. During execution of the agreement, the agent may incur additional costs, thereby leading to the problems of moral hazard. Due to these costs incurred, the agent may begin to pursue their own agenda and ignore the best interest of the principle, thereby causing the principal agent problem to occur (Eisenhardt, 1989).

There are two additional types of information asymmetry namely, the hidden actions and hidden information. Hidden information occurs when an agent has more intimate knowledge of a firm's operations than the principal. Hidden action on the other hand is a situation where the principal doesn't observe the actions of the agent. In this case, the agent may pursue their own interest and not those of the principal and it may lead a moral hazard (Jensen and Meckling, 1976). Agency theory seeks to address alignment of interests between principal(s) and agent(s).

2.3 The role of Private Equity

Private Equity (PE) funding serves as an investment intermediary between providers of capital and specific types of private companies (Cumming and Johan

2007)(Figure 3). PE companies operate in an "Ecosystem" that pull together capital from various sources and invests it in suitable business investments.

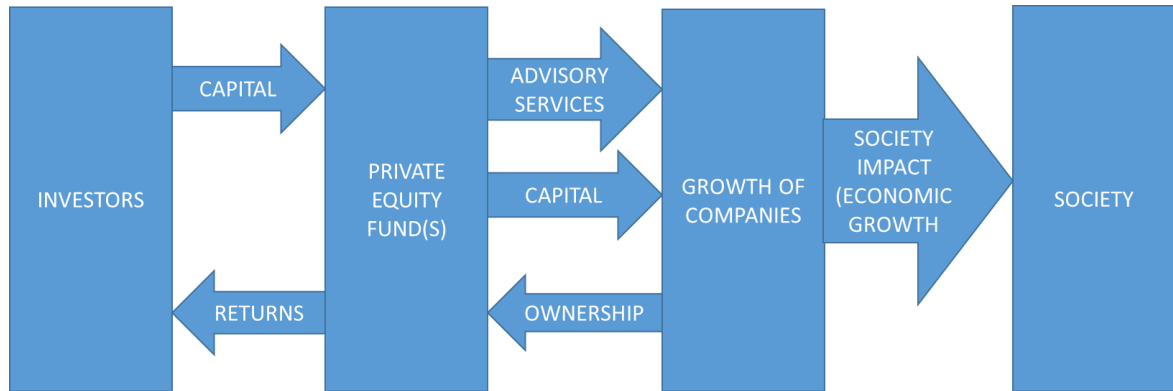


Figure 3 : PE Ecosystem (Adapted from FVCA 2008)

Typically, the suitable businesses are existing companies that are generally inefficient and therefore the PE company would restructure them with the objective of optimizing their financial performance and maximizing returns for limited partners (Rogers, Holland & Haas 2002). In addition to capital, the PE may also provide valuable expertise and actively participate in running and unlocking value in the business. Thus, unlike other institutional investors such as money managers and hedge funds, PE funds become actively involved in their portfolio companies working to ensure success (Kaplan and Schoar, 2005). The latter is usually done through board membership. In a PE funding, the entrepreneur therefore in effect, exchanges part of their ownership in the business for capital and advisory services provided by the fund. This added value is later realized in the exit phase, after which the investors of the fund are compensated according to the returns realized. The typical structure of a PE fund is illustrated by Figure 4.

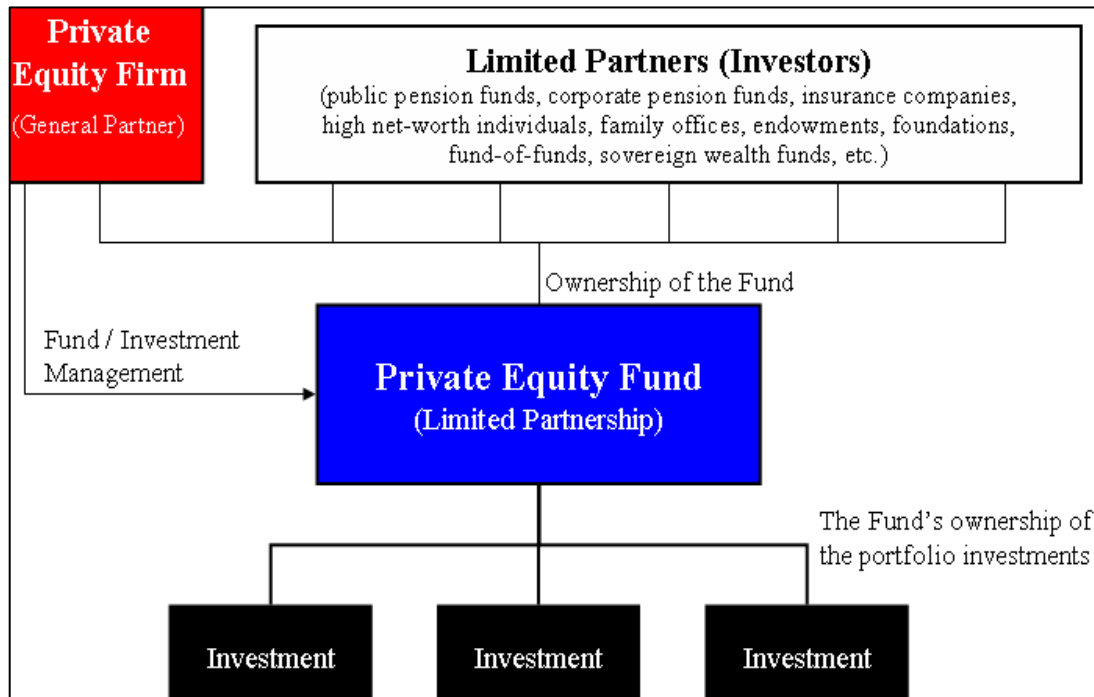


Figure 4 : Typical Structure of a PE Fund (Talmor & Vasvari 2011)

Private Equity capital can be categorised according to investment stage. It may involve direct investments into private entities, or buyouts in public companies that result in delisting (Riscura 2017; Bruton and Ashlrom 2003). PE may also be used to fund start-ups (Venture Capital), grow and/or make acquisitions or balance sheet strengthening. Wood and Wright (2009) stated that PE involves investments made in unlisted companies. Kearney (2007) further expounded that this form of equity financing is unlisted in companies at any stage in its life, which may either be for short-term or for long-term purposes.

Sharma & Prashar (2015), find that the critical part of PE investing process was conducting the due diligence exercise on a prospective investment target. It is in this initial stage, where PE firms will seek to comb through every detail about the business, its historical performance, management reviews, market analysis, economic analysis and amongst other factors, its competitive advantage and risk profile. Once the target is identified and the PE firms believe it can add value into the company, it will offer to acquire a significant stake in the company or fully acquire the business.

Rogers *et al.* (2002), states that the first thing a PE firm does is to clearly define a three to five year investment thesis. The thesis, which guides all actions by the company and usually focuses on growth. The firm will seek to focus on the management of the firm, its employees and closely watch the company's use of available cash reserves. In doing so, Cornelli & Karakaş (2008), find that PE firms in turn put a greater emphasis on governance throughout the duration of their investment, in order adequately guide and monitor the company's activities. The investment thesis is fundamentally grounded on the exit strategy in order to meet their return threshold and deliver on value for the limited partners.

Although PE is increasingly becoming a source of capital for high growth potential companies, the lack of regulation in the industry is a concern to most investors. For example, Cumming & Johan (2007) found that institutional investors sought not to participate in allocating funds to private equity funds. This is due to the lack of regulation which in turn has cost implications of monitoring and screening their activities, primarily because of the low disclosure standards. Barber and Goold (2007) noted that due to the fact that PE companies do not publish their financial statements, they are construed as being secretive and intentionally making PE appear complex.

2.4 The role of SMEs in the SA's economy

Through their prominence in an economy as well as job creation, SMEs play a very critical economic and social role (Oualalou, 2012). The development of SMEs can provide support to alleviate economic developmental challenges such as inequalities, very high unemployment, demographic developments and the need for structural change. In addition, the development of the SMEs sector may assist in increasing competition and productivity and thus stimulate the growth of income both overall and per capita. This development will also stimulate structural change, since a healthy small medium enterprise sector is associated with innovation and technological upgrading (Malefane, 2013).

The SME sector plays an important role in the South African economy by creating employment opportunities. It is estimated that they contribute approximately forty-five (45%) to the GDP (Sibanda, 2013). The South African government recognises the importance of SMEs to economic restructuring and poverty alleviation. Consequently, it has made political and legislative commitment, through policy and strategy, to ensure that SME development is viable (Malefane, 2013; Geyer, 2006). Through the Department of Trade and Industry (DTI) as well as Department of Small Business Development, has established various programmes and grants that are available to SMEs supporting various sectors. These are intended to encourage new SMEs and to create employment in South Africa.

2.4.1 Definition of SME

Section 1 of the National Small Business Act of 1996 (South Africa, 1996) as amended by the National Small Business Amendment Acts of 2003 (South Africa 2003) defines small businesses as:

“... A separate and distinct business entity, including co-operative enterprises and non-governmental organisations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or sub sector of the economy mentioned in Column I of the Schedule14...”

The Act further categorises small businesses in South Africa into distinct groups, namely; survivalist, micro, very small, small and medium, hence the use of the term “SMME” for small, medium and micro-enterprises. However, the terms ‘SMME’ and ‘SME’ are used interchangeably in South Africa. The SME definition uses the number of employees (the most common mode of definition) per enterprise size category combined with the annual turnover categories, the gross assets excluding fixed property.

2.4.2 Broad Definitions of SMEs in the National Small Business (NSB) Act

Survivalist enterprise: The income generated is less than the minimum income standard or the poverty line. This category is considered pre-entrepreneurial, and includes hawkers, vendors and subsistence farmers. In practice, survivalist enterprises are often categorised as part of the micro-enterprise sector.

Micro-enterprise: The turnover is less than the value added tax (VAT) registration limit (that is, R150, 000 per year). These enterprises usually lack formality in terms of registration. They include, for example, *spaza* shops, minibus taxis and household industries. They employ no more than 5 people.

Very small enterprise: These are enterprises employing fewer than 10 paid employees, except for the mining, electricity, manufacturing and construction sectors, in which the figure is 20 employees. These enterprises operate in the formal market and have access to technology.

Small enterprise: The upper limit is 50 employees. Small enterprises are generally more established than very small enterprises and exhibit more complex business practices.

Medium enterprise: The maximum number of employees is 100 or 200 for the mining, electricity, manufacturing and construction sectors. These enterprises are often characterised by the decentralisation of power to an additional management layer.

2.5 The impact of PE on SMEs as an avenue for funding

Metrick & Yasuda (2010) postulated that companies (mostly, SMEs in nature) such as Google, Skype, Baidu, Facebook, Uber, Twitter and most associated technology firms in various industries had their initial funding made by PE companies. The successes of these companies have had a significant impact on the county's economic development and growth. Muriithi (2017) conclusively demonstrated that SMEs play a vital role in introducing new inventions and introducing new technologies which impact on economic development.

Kortum & Lerner (2000) showed that an increase in venture capital activity over a review period of 30 years in the United States of America conclusively led to higher patenting rates. Popov and Roosenboom (2009) further estimated that about 12% of total industrial innovations between 1977 and 2004 in Europe were attributable to PE. Furthermore, Popov and Roosenboom (2009) found that about 116,000 patents registered between the same time period, could be attributable to PE backed companies. Conclusively, Gudiškis & Urbšienė (2015) found a clear positive relationship between PE and innovation, and between innovation and economic growth. They explained that modern economic literature has developed a theoretical framework with broad empirical findings show that innovation can enhance economic growth. This transition from PE to innovation, to Economic growth is illustrated in Figure 5 below.

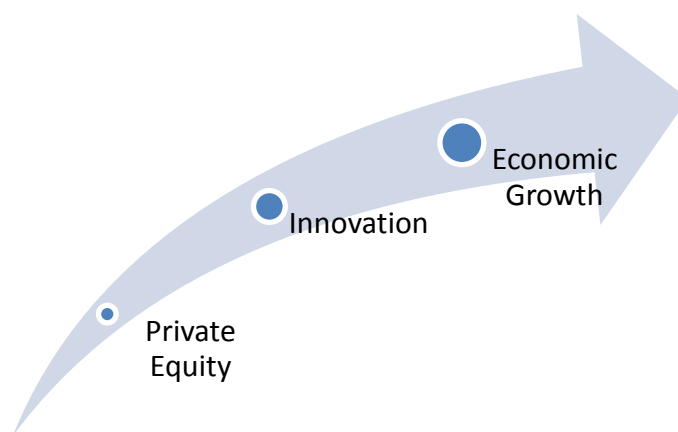


Figure 5 : Transition Channel from PE, Innovation and Economic Growth (Adapted from Gudiškis & Urbšienė (2015))

Meyer (2006) found in his study into the correlations between PE and economic growth that an increase in PE investments within an economy tended to be associated with an increase in economic growth. More noteworthy, Bernstein *et al.* (2010) discovered that industries financed by PE funds in the previous 5 years have grown more quickly in terms of productivity and employment. Boucly *et al.* (2011) stated that PE backed companies are able to increase their capital

expenditure and become more profitable than their competitors, by implication being able to drive employment and growth. Cao & Lerner (2006) proposed that businesses with a PE firm which has invested in the company tends to an increase in operating income, in cash flows and an increase in productivity. The World Economic Forum (2010), further observed that industries that had either been funded or influenced by private equity funding had shown higher growth rates of production and value added, with an average annual growth rate of 0.906%, higher than non-private equity influenced companies.

The PE industry is driven by deal pipelines, PE firm activity, legislation and openness (Chikaonda 2013). Groh *et.al.* (2008), Leeds & Sunderland (2003) and Klonowski (2013) further found that economic activity, entrepreneurial culture and deal opportunities, and regulatory factors, capital markets, human and social environment as well as industry specific factors contributes to PE growth in emerging markets. SAVCA-DBSA Economic Impact study (2013), found that on average, PE backed firms tended to improve in total sales, operating income, employment, exports, capital expenditure and R&D expenditure. Andrade & Kaplan (1998) observed an increased PE activity regardless of the economic cycle (whether in boom or recessionary times).

2.6 Potential challenges in Private Equity finance to SMEs

Literature identifies that the challenges that SMEs face when accessing private equity finance are four-fold namely deal flow, investment structuring and monitoring and exit (Oluwajoba & Oluwagbenga, 2005).

Deal flow refers to the rate at which PE investors receive business proposal.

Limited deal flows from SMEs/Entrepreneurs may arise from:

- i) Limited number of attractive investment opportunities
- ii) Entrepreneur lack of business skills
- iii) Lack of management and technical competence
- iv) Entrepreneurs not willing to give up part of shareholding

Investment structuring during PE and SME due diligence and contracting process. The issues that that have been observed here are

- i) Lack of awareness of private equity investing by SMEs
- ii) Lack of adequate records and slow pace of critical information feedback prolonging due diligence
- iii) Lack of historical financial information, projections, lack of skills and industry data for valuation;

During support and monitoring, a common problem encountered is resistance by entrepreneurs for the PE investor to monitor the business on an ongoing basis and/or allowing people other than themselves to take charge of operations (Mori & Mersland, 2014). Finally, the exit from SME equity investments is often constrained by the lack of a market. (van Zyl, 2014).

2.7 Chapter summary

This literature review sought provide the building blocks of PE and its role and impact to SMEs. It is the intention of this research to present to SME business owners and Entrepreneurs, PE as an avenue to seek funding for their businesses. The next chapter will elaborate on the research methodology to be used.

3 METHODOLOGY

3.1 Introduction

This chapter describes the procedures and methodologies that were undertaken in conducting this study whose aim was to study the role and impact of PE investment on Small Medium Enterprises in South Africa. Specifically, this chapter includes information about the research plan/strategy, population, sample size, data collection technique, questionnaire design and development, face validity of the questionnaire, pre-test the questionnaire, pilot study, final content of the questionnaire, and analytical methods of data.

3.2 Research Design, Plan and Strategy

The research design is the overall strategy that integrates the different components of a study coherently and logically to effectively respond to a research problem or aim(s). It is the protocol for the collection, measurement, and analysis of data (Dul and Hak, 2008). To investigate the research aim, the research employed a mixed-methods design. Although researchers have been employing multiple methods in the past, mixed-methods has only been generally and formally accepted as a “*Method*” over the past few years. Mixed methods research utilises multiple ways of exploring a research question (Creswell and Clark 2011).

For purposes of this study, the mixed-method was four-fold. Firstly, it involved an intensive desk study/literature review of the PE landscape in South Africa. Secondly, it involved a primary qualitative component (In-depth interview) with three (3) key informants (KI's) from the PE industry. Thirdly, KI interviews were conducted with three (3) SME owners. Then fourthly, embed as a further component, a small survey using a structured questionnaire, was conducted to

further investigate the qualitative themes obtained from the KIs. The overall methodological approach followed is summarised below (Table 1).

Table 1 : Summary of methodological approach

Strategy	Sample	Goal	Analysis
Desktop Review	Literature	Establish a theoretical framework for the research, define key terms, identify studies, models, case studies etc. to support the topic.	Literature review
Interviews	Key Informants (PE Managers)	1. Determine their perspective of the relationship between PE industry and Entrepreneurs in general 2. Develop and finalise the quantitative research tool (questionnaire)	Qualitative coding of interview transcripts
Interviews	Key Informants (Entrepreneurs)	1. Determine their perspective of their relationship with the PE industry 2. Develop and finalise the quantitative research tool (questionnaire)	Qualitative coding of interview transcripts
Survey	A random sample of entrepreneurs in Gauteng from Seda	1. Assess Entrepreneurs patterns of funding 2. Assess the specific conditions that hamper entrepreneurship access to PE finance vehicle	Frequency tables and logistic regression

3.3 Justification for mixed-methods

A mixed-method design was selected because it will allowed for detection using open-ended questions, of unanticipated factors/opinions/findings from the qualitative component of the study while retaining the ability, via analysis of questionnaire responses, to determine whether these factors/opinions/findings are

shared by the SME owners. This design is meant to address the potential limitations of a qualitative study.

3.4 Research setting

The research was carried out in Gauteng province which is the economic powerhouse of South Africa. According to Business Tech (2016), with a GDP of R1305.6 billion, the province is the single largest contributor to the country's national GDP (34.4%). This is all despite having only 1.4% of South Africa's land area. The province is home to Africa's largest stock exchange, the Johannesburg Securities Exchange (JSE). According to the South African reserve Bank (SARB), it is also home to over 140 local and international banks as well as several companies that are prominently and consistently listed on the Forbes' 2000 biggest companies listing (South African Reserve Bank, 2017; Forbes, 2017). Furthermore, South Africa has over 110 Private Equity firms with a reported total assets under management upwards of R171.1 billion in 2015(SAVCA, 2017). The majority of which are based in Gauteng province. In 2016, the Global Entrepreneurship Monitor ("GEM") 2016 reported that South Africa has a total early-stage entrepreneurship activity (TEA) index of 6.9. (GEM, 2016/17)

3.5 Data Collection

3.5.1 Target population

The total population of PE firms in South Africa as at 30th November 2017 was over 110 active firms. The names of three firms were identified from the Southern African Venture Capital and Private Equity Association (SAVCA). The target population for the in-depth interview were experienced managers from these firms. Secondly, as described previously in Chapter 2, government, through the Department of Trade and Industry (DTI) as well as Department of Small Business Development, has established various programmes and grants that are available to SMEs supporting various sectors. One such programme is the Small Enterprise

Development Agency (Seda). The latter is an agency of the Department of Small Business and support thousands of SMEs across South Africa. For convenience of access to contact details of SMEs, this component of the study target Gauteng-based SMEs registered with the Seda. Three (3) SMEs owners were thus identified for this study.

3.5.2 Sampling

3.5.2.1 Key Informant In-depth Interviews

For the in-depth interview, the researcher used purposive sampling. Purposive sampling is a non-probability method basing selection on characteristics of a population as well as the objective of the study. This type of sampling can be very useful in situations when you need to reach a targeted sample quickly, and where sampling for proportionality is not the main concern. The researcher therefore deliberately selects the item for the sample (Kothari, 2004).

The purposive sampling was two-fold. Firstly, the researcher purposively identified the top 10 listed, Gauteng-based, PE firms by SAVCA. Therein, 3 experienced PE managers were identified and interviewed. This approach helped gain information concerning their firms and the role they play in a portfolio company as well as their relationship(s) and interaction(s) with SMEs, if any.

Secondly, a small sample of 100 SME owners whose details were obtained from Seda were targeted for a survey. The researcher sought to interview at least one of each of the following i) Black-owned, ii) White-owned and Female-owned SMEs.

3.5.2.2 SME Business structured-interviews

A convenience sample was chosen as the type of the sample for the structured interview. Based on the objectives, this study was interested in obtaining the perspectives and experiences of SME entrepreneurs accessibility of PE

investment. Convenience sampling is another type of non-probability sampling in which respondents are sampled simply because they are convenient sources of data for the researcher (Lavrakas, 2008). In other words, they are selected because of their convenient accessibility and proximity to the researcher (Dillman *et al.*, 2014). Contact details of entrepreneurs registered with Seda were thus obtained and they were contacted randomly via electronic means to respond to a survey instrument Qualtrics®.

3.6 Interview Guide, Questionnaire Design and Development

Identification of items for the study and preparation of the interview guide as well as the questionnaire was a crucial step for the success of the research. As already described above, three draft data-collection tools were developed. The first was a qualitative interview guide for PE firm Managers, the second one was also an interview guide targeting SME business owners and the third was a self-administered close-ended questionnaire. Five fundamental stages were undertaken for constructing the data-collection tools namely:

1. Identification of the first thought questions for data collection
2. Formulation of the qualitative interview guides (PE Managers and Entrepreneurs – Tools 1 and 2)
3. Analysing of the data collected from the qualitative interviews together with literature to inform the questions for the questionnaires
4. Formulation and/or finalisation of the questionnaire (Tool Number 3).
5. Review the wording of questions

3.6.1 Interview Guides and Questionnaire face validity

Face validity is important to see whether an interview guide or a questionnaire appears to be valid or not. A “common-sense” assessment, reported in literature, was conducted by distributing the first draft to two industry experts for assessment

of the validity of the tools (Salkind, 2010). This can result in many useful and important modifications to the tools after their input.

3.6.2 Interview Guides and Questionnaire Pre-testing

Pre-testing an interview guide or questionnaire is done to ensure they ask the right questions as well to ensure good quality data is collected. In other words, pre-testing the tools is an important and necessary step for finding out if the study will have any logic problems, or if the questions are too hard to be understood, if the wording of the questions is ambiguous, or if it has any response bias. The pre-testing was conducted using another PE industry expert.

3.7 Pilot study

After successfully pretesting the tools, a trial run on the tools was done. The interview guides were piloted with a manager in the PE industry who is not part of the target group as well as a conveniently selected entrepreneur respectively. The structured questionnaires were also tested with 2 conveniently identified entrepreneurs. All the tools were then collected, extracted, coded and a data analytic plan developed.

3.8 Conducting of the interviews

The researcher visited the three (3) experienced PE managers as well as at least 3 conveniently selected entrepreneurs to conduct the IDIs using the interview guide. The interviews followed any leads, allowing for the breadth and sequence of topics to flow naturally from respondents' answers to questions opening each topic. Each interview was recorded and transcribed for analysis.

3.9 Conducting the Questionnaire Survey

After face-validation, pre-testing and piloting, the questionnaires were administered to the respondents through an online platform Qualtrics© which is used for data collection and management. As already described above, the aim of embedding a further component involving an entrepreneurs structured questionnaire is to further investigate the qualitative themes from the KIs. This study is a non-probability study that is also limited by time and resources. Furthermore, it is impossible to obtain a denominator due to the difficulty in obtaining the actual “population” of entrepreneurs in Gauteng. Consequently, a conventional sample size calculation was not to be employed. A link was generated through Qualtrics© and sent to at least 50 participants/respondents (SME owners) via email.

3.10 Data Analysis

3.10.1 Qualitative Data Analysis

Data analysis from the in-depth interviews was conducted using the grounded theory, which is premised on content analysis. Content analysis involves coding, dividing text into small units and the grouping of codes into themes (Creswell, 2011). Thematic analysis is a common analytical approach in qualitative research (Guest, 2012). It emphasizes pinpointing, examining, and recording patterns (or "themes") within data (Braun, 2006). Themes are patterns across data sets that are important to the description of a phenomenon and are associated to a specific research question (Daly & Gliksman 1997). In this case, the question is access to PE funds by entrepreneurs in Gauteng. The themes can then become the categories for analysis (Fereday, 2006). Thematic analysis is performed through the process of coding in six phases to create established, meaningful patterns (Braun, 2006). These phases are Familiarization with data; Generating initial codes; Searching for themes among codes; reviewing themes; defining and

naming themes, and conducting the analysis and producing the final report. (Table 2)

Table 2: Thematic Analysis (Adapted from Braun, 2006)

Phase	Process	Result
Phase 1	Read and re-read data for familiarisation and initial patterns identification	Preliminary "start" codes and detailed notes.
Phase 2	Generate the initial codes by documenting where and how patterns occur.	Comprehensive codes of how data answers research question.
Phase 3	Combine codes into overarching themes that accurately depict the data. It is important in developing themes that the researcher describes exactly what the themes mean, even if the theme does not seem to "fit." The researcher should also describe what is missing from the analysis.	List of candidate themes for further analysis.
Phase 4	In this stage, the researcher looks at how the themes support the data and the overarching theoretical perspective. If the analysis seems incomplete, the researcher needs to go back and find what is missing.	Coherent recognition of how themes are patterned to tell an accurate story about the data.
Phase 5	The researcher needs to define what each theme is, which aspects of data are being captured, and what is interesting about the themes.	A comprehensive analysis of what the themes contribute to understanding the data.
Phase 6	When the researchers write the report, they must decide which themes make meaningful contributions to understanding what is going on within the data. Researchers should also conduct " <u>member checking</u> ." This is where the researchers go back to the sample at hand to see if their description is an accurate representation.	A thick description of the results.

3.10.2 Quantitative data analysis

A quantitative method of data analysis can be of great value to the researcher who is attempting to draw meaningful results from a large body that includes qualitative data. Quantitative analytical approach provides the means to separate

out the large number of confounding factors that often obscure the main qualitative (Field, 2009; Abeyasekera, 2013). Statistical methods play a prominent role in most research that dependent on quantitative analysis of data through converting the ordinal data to numeric. This way helps to conclude better results and to link them and comparing with the results of previous research as well as quantitative data to show the contrast and the extent of progress.

Statistical analysis also helps the researcher to identify the degree of accuracy of data and information of the study. It allows reporting of summary results in numerical terms to be given with a specified degree of confidence (Treiman, 2009). Consequently, the data were analysed using Qualtrics. Reliance was placed on the survey to gauge entrepreneurial perceptions about PE and its impact to the sector and their respective businesses. A Likert scale was composed (Annexure 5, Question 10), that will served to measure PE's impact and the perception held by entrepreneurs about the industry. The series of Likert-type questions accordingly to Allen & Seaman (2007), when combined will serve to measure a particular trait, herein; being the entrepreneurs understanding of PE. Appropriate descriptive statistics were used to provide an analysis on the findings.

3.11 Ethical Considerations

There is the potential of obtaining confidential information from the research process herein proposed. Consequently, relevant approval, from the University of Witwatersrand Research Ethics Committee was obtained as well as approval from the management of the various PE firms and organisations.

All interviews were conducted in a confidential manner, and written informed consent obtained from the key informants. The survey respondents were provided with respondent information leaflets detailing everything around the study as well as advised that responding is voluntary. All research undertaken here was within ethical principles and guidelines. The recordings of the interviews were saved on a secure drive to which only the researcher had access, which is also security protected. Transcripts of the interviews were also securely handled.

3.12 Summary

This chapter discussed the methodology used in this research. It included information about the research plan/strategy, population, sampling, data collection technique, questionnaire design and development, face validity of the questionnaire, pre-test the questionnaire, pilot study, final content of the questionnaire, and analytical methods of data.

4 RESULTS and ANALYSIS

4.1 Qualitative Component - Key Informant In-depth Interviews

4.1.1 Interview Respondents Statistics

As described in the methodological section, three (3) experienced PE managers were identified and interviewed. (Table 3) This approach helped gain information concerning their firms and the role they play in a portfolio company as well as their relationship(s) and interaction(s) with SMEs.

Table 3 : Interview Respondents and Statistics

Interview	Position	PE Experience	Gender	Length of Interview
Interview 1	Associate Principal	10+ years	Female	39 minutes
Interview 2	Fund Principal	10+ years	Male	28 minutes
Interview 3	Principal Associate	10+ years	Male	15 minutes

Objective one, which was research question one was to assess the PE activity in South Africa in relation to SMEs. This question reflected on qualitative factors and dynamics between these two key players in the South African economy. The major themes that appeared in the discussions were:

1. Private equity in the context of South Africa
2. From experience, have you, your organisation or colleagues supported SMEs
 - a. If No ask why not?
 - b. If Yes then how many, from which sectors
3. What possible interventions/activities can they propose that will change the status quo?
4. Advice that the Interviewee would provide to an SME business owner

4.1.2 Private Equity in the Context of South Africa

All three interviewees stated that PE has definitely had a positive impact on the South African economy because investors have confidence in it. However, they were not able to link the proportion of the growth directly attributable to PE investment. Interviewee number one said *“I think that private equity, for as long as there is confidence in a particular market and there is huge investment that goes into that particular market, what then happens is that capital spend induces economic growth. However, I can't desegregate the percentage of the economic growth that is attributable to private equity players”*

Interviewee three stated that one of the key drivers to the growth that would be attributable to PE investments especially for assets under management, have been the amendments to regulation 28 of the Pensions Fund Act. He said that according to this amendment, the aim of this regulation is to *“ensure that the savings South Africans contribute towards their retirement is invested in a prudent manner that not only protects the retirement fund member, but is channelled in ways that achieve economic development and growth”*. Thereby, Regulation 28 aims to protect the investor. The amendment to Regulation 28 of the Act prescribes the maximum exposure that retirement fund investments may have to various asset classes” He further said *“The changes prescribed a specific limit on certain asset classes and a lot of funds that were not historically in PE then had allocations.”*

The same interviewee said part of the growth has been on account of an influx of a number of international investors that have come through to South Africa essentially looking at exposure to Sub-Saharan Africa, *“especially in the relatively well-developed South African market. Consequently, they have come through on the funds that are based in South Africa.”*

In further discussion, he said he was however not sure whether allocating a specific percentage of the equity limit specifically to SME would drive growth in this sector. The general feeling overall of all three respondents was that the PE industry in South Africa is on the rise with interviewee one saying *“There are*

annual reports and surveys such as those by SAVCA about PE's growth as an asset class and there now exist a number of funds people are getting comfortable with PE investment."

However, interviewee 2 cautioned that despite all indicators showing growth, its interpretation should be done cautiously because "South Africa has a lot of hot money that distorts evaluations and acquisitions that have happened have not yielded the expected synergies or growth value. So whether it's the performance of the economy or a miscalculation of the acquisition cannot be delineated at this juncture. Overall, it may be hot money that is not new investments in new businesses or new clients on the JSE." She also further stated that to the best of her knowledge, the SAVCA members only focus on growth and late stage establishments/businesses. In those cases, it's just an exchange of shares. So money isn't going in the businesses to grow the economy. There will be some level of capital that goes into the businesses but it is very small compared to the exchange of shares.

4.1.3 Personal Experience or knowledge of Colleagues that have supported SMEs

In South Africa, PE is not investing in SMEs. None of the respondents nor any colleagues they know have worked with SMEs. Interviewee one said "*private equity within the context of South Africa, has not reached SMEs.*" She further said "*The South Africa model of PE has worked for medium sized to larger corporates that's where you would find mergers and acquisitions most prevalent.*" In her experience generally however, PE funds in South Africa target medium to large companies because is the space that fund managers assume to be less risky as they are generally well established companies. Most players in PE are risk averse and the risk matrices they employ do not allow them to invest in SMEs. Furthermore, most SMEs are individually/family owned, do not have a board and they may not want third parties who they perceive will come in to "*take over, control and thereafter kick them out of their own businesses*" and thus prefer their businesses to grow organically.

Respondent one outlined a number of issues in this regard. These are that the PE model in South Africa is not SME friendly. She said in fact *“Even Venture Capital Firms do not seed capital, they grow capital. They want already proven and commercialised and growing concepts.”* She then went on to say that *“SMEs are not usually corporatized. They have no governance structures, financial models and/or profit making histories. PE Model in South Africa is such that all these have to be in place before investing.”* This suggests then that in order to access PE investment therefore, SMEs may need to change their business models, which would be costly and unreasonable exercise on the part of SMEs that are starting up and need to grow. On the other hand, PE firms may need to develop more flexible models that can accommodate SME engagements, support their core profit generating components while helping them to corporatize. She stated PE firms therefore *“Need to have systems that would work much better and appropriately for a smaller business with a view that in the future they will grow to a medium and large business or even a corporate.”*

When asked what she thinks are the reasons why PE funds are not finding their way to SMEs, interviewee number two said the *“one stumbling block around the capital allocation to SMEs is the pension funds and asset al.locators themselves. The allocation is just 10% to listed bonds and listed equities. However, those that allocate to private equities focus on the growth capitalisation and not SMEs.”*

She then proposed that in order to redress this, a starting point could be to make sure that asset owners, the pension funds, actually have in their mandate, have an allocation especially for SMEs because from a legislative perspective that’s the enabler. This would enable capital to flow to the sector and if capital flows to the sector, you will have managers that will be able to specialize in SMEs and therefore target specifically businesses that are SME.

An interesting point discussed by respondent number two was that it information opacity. She said it is a struggle to find data on businesses that are not listed because there is not central data base of businesses showing revenue and other

important numbers. Informational Opacity is perhaps the most important characteristic defining small business finance. Unlike large firms, SMEs do not enter into contracts that are publicly visible or widely reported in the press and contracts with their labour force, their suppliers, and their customers are generally kept private. As a result, SMEs often cannot credibly convey their quality. Moreover, they may have difficulty building reputations to signal high quality or non-exploitive behaviour to overcome informational opacity.

Additionally, SMEs that know about PE may have a bad perception of PE thinking the latter comes in and takes over and chase them out of their own businesses and rid them of all the control they had. To this conversation, respondent number two contributed that from the perspective of an SME business-owner, PE firms take control and disempower the business person. That's why some SMEs tend to regress to their original activities after PE exit. He said some PE investors create value by deploying their own personnel, and controlling the change and then instead of building the capacity of the individual business owner to run the business in a formalized, they exit and sell their share. There is therefore a need for PE to play a pivotal role in helping to develop models that will support the capacity building and corporatization of SMEs as opposed to just focusing on financial control and exit strategies.

However, from the perspective of investors, respondent number 2 said that “*SMEs as an asset class in South Africa do not have a good track record in terms on returns, making investing in them like a roll of a dice*”. A large part of the high rate of failure could also be because the SMEs themselves don't have sufficiently strong support systems so that the entrepreneurs themselves can focus on what they need to do.

4.1.4 Possible Interventions to potentiate PE interest in SME

Respondent three remarked that “*SMEs have the potential in terms of higher labour absorption rates and growth potential that is much better than perhaps*

some of the medium to large enterprises and they may even come with the associated risks that a PE fund manager could probably manage. But there is difficulties in trying to attract capital in that sort of market that is not established and does not necessarily have a track record of performance.” Drawing from this, a number of potential interventions were then discussed with the respondents.

4.1.4.1 Regulations

Respondent three had several suggestions about possible interventions. Firstly, he suggested further changes to regulation 28 saying *“one may be tempted to suggest that an option would perhaps be to further amend regulation 28 to delineate a particular PE investment percentage to SMEs.”* He then further said that *“perhaps as the South Africa PE industry reaches maturity, the medium to large industry space would be saturated and investors and fund managers would look for different avenues such as SMEs.”* Additionally, he went on to say that it is not uncommon that one finds specialist funds such as infrastructure funds. Therefore, as the industry matures, there will be a bigger risk appetite and investment directed more towards SMEs.

4.1.4.2 Deliberate Interventions by Government and Its Influence on Other Stakeholders

Respondent number three stated that key interventions are required from the national key stakeholder who is the government. He said *“the introduction of the small business ministry is a step in the right direction but it only reaches a certain point. What I think is critical is the finding financial resources. If government can deliberately engage partners, especially from among those that would not ordinarily form part of this the likes of Discovery, Bidvests and PIC, and make them commit to joining the SME space. Such an intervention could fast track the emergence of the SME space.”*

Interviewee three discussed that PE funds are performing way below the regulation 28 threshold of 75% and are not putting money into mainstream equities *“So never mind putting money into the lower end of SME.”* He suggests

then that government intervention strategy should focus on encouraging the *“trustees of the retirement funds, high net worth individuals or other capital allocators, including the asset consultants to play a role in ensuring some moneys are allocated to the SME space.”* He further argues that they should campaign for activities that deliberately highlight the potential benefits that may come with investing in SMEs. He further suggests that in South African context, government can even use it as a transformation tool. Ultimately, it could help in terms of labour absorption or job creation.

Another suggestion by interviewee three was that government could also consider getting big businesses to incubate smaller businesses. A strategy would be to incentivise them for partnering with smaller businesses by creating regulation that rewards a particular behaviour *“such as if a larger company were to incubate X number of SMEs or fund them, they would then get Y amount of points for social impact and corporate social responsibility.”*

He acknowledged that there have been some initiatives undertaken previously where some entities that have established “SME funds” but in reality, these SMEs are much larger entities. A case in point was the Ethos PE fund which was supposedly looking into the funding of SMEs. However, they were looking at *“ticket sizes of about R100 million”*.

Government has previously tried various initiatives through various agencies. Respondent number one however argues that unfortunately, these agencies mentioned are an extension of how banks work with loans/financing with same security packages requiring collateral and have a disconnected involvement in a business. She said these initiatives are such as the Small Enterprise Finance Agency (SEFA). The latter is a wholly owned subsidiary of the Industrial Development Corporation Limited (IDC) which is said to exist to provide financial and business support to SMEs either to either establish new enterprises or to grow existing businesses. However, their products which are mainly loans are accessed through commercial banks. This is in stark contrast to PE firms who take a risk by buying a stake in your business where they immerse themselves in

it to help build. In the loan arena, there is trust deficit between business owners and banks of financiers who ties everything a business owner owns to a loan facility (security over-kill and disincentive).

The respondent also touched on the new “*SME fund*” financed by big companies that have made financial commitments to the fund who’s mandate however, focuses on “*growth and employment*” and “*growth-stage and scalable companies*” that are already profitable.

She then stated that there is still a shortage of models which SEFA the SME fund should work on to realign the interests and develop models and systems that can work and reduce trust deficit.

4.1.4.3 Interviewee’s Advice to SMEs if Given an Opportunity

The respondents were then asked, given an opportunity, what advice they would provide to SME business owners looking for funding and whether if someone has a good business, that PE will be able to find them? Interviewee number one said firstly they would advise a mind shift from seeing their business as just a subsistence business to a more longer term one which can potentially grow into a corporate. They would then further advise them that “*100% ownership of 10 million is smaller compared to 50% of 100million. I would then map out the role of the PE firm and the growth and value it can add in areas other than financing such as bigger markets, management and corporatizing. This would help them to understand PE.*”

Interviewee number three said SMEs seem not to know much about PE firms. However, one finds that most of them have taken some level of financing in terms of family money or loans from traditional financial institutions that have enabled their growth. In fact, he says, “*some SMEs have grown to 100 million plus turnover and my view is that those, if put in with correct corporate government structures those are good entry points for private equity firms that are willing to put in the slog for the next 7 years and perhaps grow that top line by 3 or 4 times.*” He

said there was a need therefore, to generally ensure SMEs correctly understand the role of SMEs.

4.2 SME owners Key Informant Interviews

4.2.1 Interview Respondents Statistics

4.2.1.1 Ownership and decision-making Profile

Three SME business owners were identified and interviewed. (Table 4) This approach helped gain information concerning their businesses and their knowledge, awareness and their relationship and interaction if any, with PE. In terms of ownership, Interviewee 1 said he was a sole proprietor whilst interviewee 2 said ownership was spread across 6 people with himself being majority shareholder with 65%. The rest of the ownership was spread equally between five (5) Engineers. Interviewee 3 said the SME was owned by 4 people including himself and all of them were members of the board. He further stated that the board was established in order to have a governance structure however, no physical meetings have been held. He said *“the company is still small but all decisions are made by everyone, but informally. We can make decisions on a WhatsApp® group.”*

Table 4 : Interview Respondents and Statistics

Interview	Ownership	Industry	Turnover	SME Years of existence	Gender	Length of Interview (minutes)
1	Self	Electrical	25 million	10 years	Male	19
2	6 owners. Interviewee owning 65% and 5 Engineers the balance equally	Construction	>3 billion	10+ years	Male	15
3	4 owners with a board	Business advisory	8 million	<10 years	Female	18

Objective two, which was research question two, was to determine and ascertain factors why SMEs do not have linkage with PE investment. This question reflected on qualitative factors, especially those identified from the PE Industry experts key-informant interviews. The major themes that appeared in the discussions were:

1. Ownership and Decision making profile
2. Informational Opacity/Formalisation and Corporatisation
3. Awareness of PE and its product offering
4. Appreciation of PE after explanation
5. Fear of loss of control

4.2.1.2 Informational Opacity/Formalisation and Corporatisation

All three key-informants stated that they maintained audited financial statements. The informants also confirmed that they adhered to all industry regulations and industry good practices. Interviewee 1 said “Yes, you have to. Else you will not get work” whilst Interviewee 2 said “*I am in a highly regulated industry and therefore I have to have all the certifications.*” Interviewee number 3 stated that “*Yes, we are highly sophisticated professionals with CA(South Africa)’s and Registered Auditors.*”

4.2.1.3 Awareness of Private Equity and its Product Offering

Several questions were put to the respondents aimed at answering research question two which aims to determine and ascertain factors why SMEs do not link with PE firms for funding.. Firstly, when asked where they get funding for growing their business, they said it had been from organic growth, shareholder loans, bank loans and/or tender specific funding from agencies. In response to whether they have considered partnerships previously, they all responded in the affirmative. However, the partnerships considered were with friends and/or colleagues. Interviewee 2 said “*Yes I have entered into partnerships with the top engineers in the business who now have shareholding and they assist in making sure we make a profit each year and bring in business*” Interviewee 3 responded saying “*Yes I*

have considered it. In fact, our business is a partnership of four professionals including myself.”

The respondents were then probed about their knowledge and awareness of PE Investors. The first respondent said he *“I doesn’t know much about them but I hear that they just want to take over your business”* Interviewee 2 had a slightly better understanding and he said *“they are investors that look out to invest in great businesses, and grow them to list on the JSE. I have read up a lot on them, as at some point I wanted to sell my business and even nearly approached a few. I forget their names now.”* He then also went on to discuss that apart from PE firms, he knows about investment holding companies and other bigger engineering firms who are into financing, and one of the latter at some point approached him. The third interviewee said he has no idea who they are and what they do stating *“No I do not know them and what they do. Are they SME funding agencies such as the NEF (National Empowerment Fund) and NYDA (National Youth Development agency)?”*

After explaining what PE firms do and how they work, whilst the first respondent was still not clear after the explanation, respondent number two said *“Now I know that you sign an NDA and they do due diligence and such and then propose to you a strategy”* whilst number three said *“It seems they put money where their mouth is and take the same risk as you.”* He then sought clarity on whether they would be *“operationally involved and help you run the business and grow it”* to which he was given a response in the affirmative.

When asked whether someone would be interested in buying into their company, the first two responded in the affirmative. The first one said *“Absolutely, it is profitable and has 3 year contracts that make it profitable and a strong sales team continuously growing the order book”* and the second interviewee said *“I think so. It is a good business and has built a reputation in the industry. Actually we are looking to acquire smaller businesses in different provinces as our entry into those areas.”* The third respondent was not very confident saying that he doesn’t think

anyone would be interested because the business is too small and still gaining traction in the market.

After the researcher explained to them extensively what a PE partner can bring to the table, the discussion then went onto probe for information about whether currently, they would be interested in getting an additional shareholding partner, especially what they would look for, especially if this partner were from PE. Interviewee one said they would need someone with industry expertise and connections, to get more business and that *“You need someone who can grow the topline”* He then went on to say he would need the operational expertise and streamlining of his business and its processes, as well as working capital to enable him recruit and retain good talent that the bigger international companies usually take from businesses like his. Respondent two said he would be interested in *“Someone who can both grow the revenue and help me execute on the projects. That’s the key in this business. But where do you get such a person, who will join you and not want to grow their own business?”* He also said he thinks they can bring business processes expertise as he believes his current processes are substandard He further stated that he would like it if the PE firm brought in funds to acquire other smaller SMEs for expansion. The third one simply said *“bring in more business and we will be the greatest of partners.”* However, he went on to say that perhaps for now, a PE firm would not be interested in investing with him but if at all they were, they should bring some core skills that can help him become the next big consulting firm.

The researcher then asked for the respondents opinion on whether banks and other traditional funding institutions spend the time understanding their business. Interviewee one said *“No, not really, in my experience they just want to know if I will be able to pay back their money.”* Respondent two said *“I have never received any advice from them, expect when they took over my business for 6 months in 2001 when I was close to bankruptcy due to the client not paying me on a job completed.”* The third interviewee was very categorical in saying *“No. The banks do not care whatsoever.”*

All three respondents said they were not sure at what point they can formally approach a PE firm, to pitch for Funding. However, they believe they can grow their businesses with equity partners but they do not know where they can get more information, especially that which is specific to their business, about how they can have linkage with the PE industry.

4.2.1.4 Fear of Loss of Control

A German study recently documented that PE, while a viable option for many privately owned businesses, can be perceived as a solution that is unworkable especially for SMEs which are the typical family owned business because of the fear of loss of control. (Tappeiner F *et al.*, 2012) The researcher tested this notion in the context of South Africa in general but amongst the study participants in particular, three questions were framed asking what the participants terms be to a PE firm wanting to acquire a share in their business. Secondly, what they think would be the greatest loss for your business, if the PE firm were to successfully buy into their business and thirdly, what percentage of their business would they be willing to sell to a PE investor.

Interviewee 1 said they would still want to have control and can make the final decisions in the direction of the company. The greatest loss would be having to let go of the business they drove to this point, and allowing someone to interrogate their strategy. In terms of selling shares, they would not sell more than would result in their losing control of their business. They then went on to say “*Unless maybe if it becomes a billion rand company, can I let go of a lot more.*”

Interviewee number 2 said that “*the dilution of my ownership must be proportional and that I still have a significant stake with protections and such. In terms of loss, I am not sure selling would be a loss unless they come in and get the strategy wrong. But I can sell as much as possible, if it means the business will grow like crazy and be worth a lot more.*”

Interviewee 3 said that he was not sure what percentage of his business that he would sell and it would require a negotiation process but that for a good price, he would sell the whole business. He then said “*according to me, selling a part of his would not be a loss for me. I want to make money and move on to the next businesses and continue to grow them. That is my strategy.*”

4.3 Quantitative Component – Survey

4.3.1 Response Rate and Demographics

The survey was distributed to 100 potential participants and 65 participants responded. (65% response rate) Of these, 63.08% were male whilst 36.92 were female (Table 5)

Table 5 : Gender Distribution of Respondents

#	Answer	%	Count
1	Male	63.08%	41
2	Female	36.92%	24
	Total	100%	65

The highest number of the respondent SME business owners were aged between 31 – 40 years of age (30, 45.45%), followed by those aged 18 – 30 (28, 42.42%).(Table 6) There were only 5 aged between 41 – 50 years old (7.58%) and 3 (4.55% above 50. There seem to be younger business owners and the number reduces as they grow older.

Table 6 : Age Distribution of Business Owners

#	Answer	%	Count
1	18-30	42.42%	28
2	31-40	45.45%	30

3	41-50	7.58%	5
4	50+	4.55%	3
	Total	100%	66

4.3.2 Years of Experience of Respondent, Age of SME Existence and Size of SME (Number of Employees and Turn-Over)

Twenty-three (23) of the respondents (35.38%) had less than five, 26 (40%) between 6 – 10, 16 (24.62%) had more than 11 years' experience. (Table 7) A relatively large percentage therefore had several years' experience working in the SME industry.

Table 7 : Respondent Years' Experience in SME Industry

#	Answer	%	Count
1	1-5	35.38%	23
2	6-10	40.00%	26
3	11+	24.62%	16
	Total	100%	65

Just over a third (23, 35.94%) of the respondents had owned the SME business for between 1 – 5 year. Those that had been business owners for 6 – 10 and 11 and over numbered 21 (32.81%) and 20 (31.25%) respectively. (Table 8)

Table 8 : Years of SME Existence

#	Answer	%	Count
1	1-5	35.94%	23
2	6-10	32.81%	21
3	11+	31.25%	20
	Total	100%	64

The size of the SMEs owned by the respondents by number of employees ranged from 12 (18.18%) having 1 – 5, 22 (33.33%) with 6 – 10 and 32 (48.48%) having

11 or more employees. Based on this spread and according to the National Small Business (NSB) Act, the respondents owned Survivalist, Micro-, Very small and Small enterprises with up to about 20 employees. (Table 9)

Table 9 : The size of the SMEs owned by the respondents

#	Answer	%	Count
1	1-5	18.18%	12
2	6-10	33.33%	22
3	11+	48.48%	32
	Total	100%	66

Profiling the size of the SMEs owned by the respondents by turnover ranged from 5 (9.43%) micro-enterprises (turnover between R0.5million – R2.9million), 25 (47.17%) small enterprises (turnover R3million – R10million), 20 (37.74%) medium enterprises (turnover R10million – R50million). There were 3 (5.66%) business owner respondents not classified as SME (turnover R50millio+) (Table 10)

Table 10 : Profile of Respondents by Turnover

#	Answer	%	Count
2	Micro: Turnover between R0.5m -R2,9m	9.43%	5
3	Small: Turnover between R3m - R10m	47.17%	25
4	Medium: Turnover between R10m -50m	37.74%	20
5	Not classified as an SME: Turnover over R50m+	5.66%	3
	Total	100%	53

4.3.3 Business Sector of the Respondents

The respondents to the survey came from a broad spectrum of business sectors ranging from Agriculture, Mining, manufacturing, construction, social services, transport/logistics, business/financial and tourism and hospitality. (Table 10). However, the majority (31, 51.67%) by far are in the Business and Financial Services sector. However, the spread was sufficient enough to represent the business-owners in South Africa.

Table 11 : Business Sector Distribution of Respondents

Sector	%	Count
Agriculture	8.33%	5
Mining & Quarrying	1.67%	1
Manufacturing	5.00%	3
Construction	5.00%	3
Community, Social & Personal Services	5.00%	3
Transport, Logistics & Communication	10.00%	6
Business and Financial Services	51.67%	31
Tourism & Hospitality	10.00%	6
Other	3.33%	2
Total	100%	60

4.3.4 Participants who had heard of a Private Equity Firm and Those who know What PE Firms Actually do.

Based on the low awareness of the existence of PE firms by the interviewees during the qualitative component of the study, the survey aimed to determine the awareness of the targeted respondents to establish whether they had heard of a private equity firm. Sixty-one (61, 93.85%) of the respondents said they have heard of a PE firm whilst only 4 (6.15% said they had never heard of one. (Table 11)

Table 12 : Respondents Awareness of the existence of PE Firms

#	Answer	%	Count
1	Yes	93.85%	61
2	No	6.15%	4
	Total	100%	65

Asked whether the actually know what the PE firms do which is to acquire a shareholding, usually minor and serve to assist in the growth strategy of the business, with a view to exit at a higher valuation than when they entered, 47 (72.31%) of the above responded in the affirmative. (Table 12) Furthermore, they agreed with the statement that if you find a good PE partner, you can benefit from their resources. Only 6 (9.23%) responded saying no they don't but 12 (18.46%) said somewhat.

Table 13 : Knowledge of What PE Firms Actually Do

#	Answer	%	Count
1	Yes? Acquire a shareholding, usually minor and serve to assist in the growth strategy of the business, with a view to exit at a higher valuation than when they entered. If you find a good PE partner, you can benefit from their resources.	72.31%	47
2	No? I know, they have money, which they can fund businesses. But I have no idea how they work with other people's businesses.	9.23%	6
3	Somewhat? Have heard of the concept, and what they do, but I do not believe they are beneficial to being able to help grow my business	18.46%	12
	Total	100%	65

4.3.5 Survey Responses to Awareness of Private Equity and its Product Offering

As previously described in the methodology, the study included this additional survey component in order to further investigate the qualitative themes that arose from the key-informant interviews. The latter brought to the fore the low level of knowledge and awareness, by SME business owners, of the existence and

activities of PE firms and their role in the economy. Consequently, the survey was designed in such a way as to further test this finding.

The results of this survey are presented herein. Contrary to the findings of the qualitative survey, generally, most respondents were aware of the existence of PE firms as well as their potential value to SME businesses, (Table 13). The respondents strongly agreed to all the 17 questions that related PE being critical to the growth and development of SMEs (Table 14). 59.3% of the respondents said that a PE firm would be interested in looking into the potential of their business and 96.3% agreed that PE can contribute to the SME space in a meaningful way. Further, 75.9% of them said a PE firm can be important for the growth of their business in the short and long run, with 57.4% saying such a partnership can deliver on innovation, employment growth and efficient business processes. 53.7% said the management teams of PE firms can greatly assist SMEs in navigating their growth phase.

All the respondents (100%) agreed that while SMEs can contribute to economic growth in South Africa, they are failing due to lack of government support and the lack of adequate and appropriate funding from traditional banking lines.

Furthermore, 100% of the respondents were of the view that PE, Grant Funding and SEDA like funding alternatives were also not readily available. 92.6% said that with adequate funding and expert operational management support, they can become the next large companies.

71.7% of the respondents denied that SMEs in South Africa continue to be on a decline due to a lack of entrepreneurial flare and 68.5% said that the PE industry in the country had not dedicated enough money to help fund SMEs. 94.3 % of them strongly disagreed when asked whether the government was doing enough to stimulate SMEs in South Africa.

In general, in their responses, they all agreed that PEs can offer a number of secondary benefits providing a diversified mix of capital and corporatization. PE partners can help small business achieve their potential. Furthermore, PE partners can support the installation of systems in SMEs, something that is often

absent in SMEs which are usually family businesses. Furthermore, they can provide access to better human capital and to training. They are also able to attract talent, a function that SMEs find challenging as they simply don't have the resources or skills to find suitable staff.

The respondents however, strongly disagreed to PE firms dedicating enough money to help fund SMEs in the country. They also disagreed when asked whether government is doing enough to stimulate SMEs in South Africa and instead all of them strongly agreeing to SMEs are failing due to lack of government support (Table 14).

Table 14 : Consolidated Likert Scale Responses to Survey (The 6 Point Likert Scale, Annexure 6)

# Reference Question	Question 10: Role of Private Equity in the South African SME space. Please indicate how much you agree or disagree with each of the following statements	Sum Responses of Agree	Sum Responses of Disagreement	Neither Agreed or Agreed
1	PE can contribute to the SME space in a meaningful way.	96.23%	0.00%	3.77%
6	PE firms deliver on innovation, employment growth and efficient business processes.	56.61%	5.66%	37.74%
3	SME's have continued to seek innovative ways of raising financing in the market place.	96.22%	1.89%	1.89%
4	SME's contribute towards economic growth in SA.	100.00%	0.00%	0.00%
17	A PE firm would be interested to look into my business as a potential investment.	58.49%	9.44%	32.08%
7	SME's deliver on innovation, employment and growth.	100.00%	0.00%	0.00%
8	SME's with adequate funding and expert operational management team, they can become the next large companies.	92.45%	0.00%	7.55%
9	The management teams of PE firms greatly assist SME's in navigating their growth phase.	54.72%	5.66%	39.62%
12	PE firms can be important to the growth of my SME in the short and long run.	75.47%	9.44%	15.09%
13	SME's can benefit immensely from PE funding.	96.22%	0.00%	3.77%
14	SME's suffer from the lack of PE funding.	94.35%	1.89%	3.77%
15	The PE industry is important to the growth and recognition of the SME space.	60.38%	7.54%	32.08%
22	SME success rates are directly affected by the business cycle and the current economic climate.	86.79%	3.78%	9.43%
18	SME's are failing due to government support.	100.00%	0.00%	0.00%
20	SME's in SA are failing due to PE, Grant Funding and SEDA like funding alternatives, that is not readily available.	100.00%	0.00%	0.00%
21	SME's in SA are failing due to a lack of adequate and appropriate funding from traditional banking lines.	100.00%	0.00%	0.00%
5	PE has been able to assist contributing towards economic growth.	49.05%	18.87%	32.08%
19	SME's in SA continue to be on a decline due to a lack of entrepreneurial flare.	26.92%	71.16%	1.92%
2	PE allocates enough money towards SME's.	11.32%	77.35%	11.32%
16	PE has dedicated enough money to help fund SME's in the country.	20.75%	69.82%	9.43%
10	The government is doing enough to stimulate SME's in South Africa.	5.77%	94.23%	0.00%
11	The government is doing enough to make sure PE firms, focus on looking to fund SME's.	3.77%	88.68%	7.55%

5 DISCUSSION

5.1 Qualitative Component of the Study

The findings of this study reaffirm the well documented fact that PE, through its fund format, channels finance and intellectual capital to entrepreneurs, helping to make a material and positive contribution to the South African economy. This is in line with the findings of the 2009/2013 SAVCA reports on the economic impact of venture capital and PE in SA. (SAVCA 2015) The latter study covered a number of PE portfolio firms and found that PE-backed companies out-employed, out-performed, and out-invested comparable universes of private and listed peers. PE as an investment class also materially assisted in raising the level of empowerment ratings and compliance in portfolio companies. One of the key drivers of this growth is perhaps the recent amendments to Regulation 28 of the Pension Funds Act. This amendment prescribes the maximum exposure that retirement fund investments may have to various asset classes with 25% in property, 25% in offshore assets and importantly for this study, 75% in equities, (Regulation 28, 2011). Another driver identified is the influx of a number of international investors that have come through to the country and are using South Africa-based PE firms. (SAVCA, 2015)

5.2 From the perspective of the PE Industry

Unfortunately however, according to the findings of this study these investments and the activity therefrom have not reached the SMEs and this is despite the vast number of SMEs operating in the country. The SMEs that participated in this study encompass a variety of businesses and sectors, ranging from relatively stable businesses looking to expand, to companies that leverage innovation. However, an “equity financing gap” is very apparent.

A review of the literature reveals that this is not unique to South Africa but is a general trend across most developing countries and emerging economies. The market for SME PE in many developing countries generally represents a small fraction of the overall

quantity of fund investment. Between 2009 and 2011, SME investing in Latin America exceeded \$600 million but represented less than 5% of overall capital invested by PE firms in the region. (World Bank, 2014) Similarly, Latin American Private Equity and Venture Capital Association (LATVA) reported that of all the PE investment across the region, there was an only 10% investment in SMEs (LAVCA 2012). In East Africa, a 2012 survey conducted by Deloitte of activities by all 16 active funds in the region, there was a total investment of \$188 million averaging at \$10 million per deal, meaning that SMEs who usually seek much less funding than this to support their growth or expansion remained largely excluded.

Although increased flows of PE investment can result in growth in the SME industry and ultimately the economy in South Africa, PE firms target larger and more established enterprises. Several reasons can be advanced for this. Firstly, PE investment is a relatively new financing source in many South Africa, and potential investors find a lot of less risky opportunities in already established medium to large companies. Most role players in PE are still getting to understand PE, they will naturally be more comfortable with established counterparties than SMEs.

Secondly, investing in SMEs on the other hand is riskier and may be equated to “rolling dice” due to information opacity. Data on these businesses, which are mostly family owned and are generally not listed that shows revenue and other important numbers is unavailable. Informational opacity is perhaps the most important characteristic defining small business finance and as a result, SMEs often cannot credibly convey their quality. Consequently, they find it difficult to access PE investment due to the high level of information asymmetries between themselves and the external investor. (Cole, Goldberg and White, 2004) Information asymmetries result in the perception of higher default risk.

Thirdly, the model of PE investment in South Africa fund structures was most likely developed in more developed and/or advanced economies and then transplanted to South Africa which is an emerging economy without making adjustments reflective of the unique situation of the country. These structures have developed country best industry practices which may not be conducive to the specific needs of funds that should be operating in South Africa.

5.3 From the perspective of the SME

From the findings of this study, the size and scale of SMEs is relatively small and therefore limits their capacity to access PE investment. Additionally, most of SMEs are structured in the traditional family-own management set up and are lacking in terms of the necessary financial management and information openness. SMEs that are interested in attracting PE investment should formalize practice such as governance, reporting, record keeping, formal contracts, systems and compliance to government regulations.

A German study recently documented that PE, while a viable option for many privately owned businesses, can be perceived as a solution that is unworkable especially for SMEs which are the typical family owned business because of the fear of loss of control. (Tappeiner F *et al.*, 2012). Families tend to refrain from sharing equity with non-family resources to ensure continuity of family control and therefore less likely to use PE investment (Anderson and Reeb, 2003) and it is not uncommon for them to increase business risk to maintain control and socioemotional wealth. (Gomez-Mejia *et al.*, 2007) The perception about maintaining control remains a common theme amongst SMEs. (Adler and Gunderson 2008) The lack of trust may also be a reason why SMEs may not want to allow PE investment and this may lead to the lack of commitment to understanding the potential of PE investment by SMEs. This is precipitated by SMEs having limited insight into the PE asset class and would therefore be apprehensive about taking an equity investment from a fund manager. Equity investors as well as government could take a number of measures to improve this perception. They should establish a forum of equity investment stakeholders (potential and existing investors, investees, and equity promotion organisations) for learning, information sharing and networking. This will address the fear of loss of control by the SME business owners.

5.4 Quantitative Component of the Study

The PE industry experts key informant interviews component of the study brought out four general themes namely, private equity in the context of South Africa, From experience, have you, your organisation or colleagues supported SMEs, Advice that the

Interviewee would provide to an SME business owner. The SME business owners qualitative component aimed at determining some qualitative factors leading to the SME' and PE investment disconnect in South Africa. The results brought out additional themes namely, Ownership and Decision making, Informational Opacity/Formalisation and Corporatisation, Awareness of PE and its product offering and fear of loss of control. Per the methodology, a quantitative component was then conducted in order to test these themes through a survey.

5.5 Ownership Profile

There seem to be younger business owners and the number reduces as they grow older. This finding is consistent with that of a survey conducted by the 2016 BNP Paribas Global Entrepreneur Report (2016). The survey report referred to them as the "millennipreneurs," who at a range of between 20 to 35 years old, are starting more companies, managing more staffs, and targeting higher profits than their baby boomer predecessors. Most of the report compares millennials to boomers, the latter who are identified as anyone over age 50. The results from this study are suggestive of a consistent pattern in South Africa where 88% of the respondent business owners were below the age of 40 (43% between 18 to 30 and 45% 31 to 40 years old). One could attribute this trend to new technologies as well as today's increasing acceptance of young Chief Executive Officer and/or business owners (Fortune magazine, 2016)

This study profiled the size of the SMEs owned by the respondents by employment number and turnover. The majority were very small with a turnover of much less than R50million. This was consistent with reports suggesting that while global trends are on a growth trajectory, South Africa's SMEs are showing a decline in employment, turnover and a majority are struggling to survive. This is according to the Small Business Project's (SBP) 2015 SME Growth Index, which reported 1 in five SMEs reporting a decline in turnover compared to the preceding year and an additional 1 in five reporting no growth in turnover during the same period. (SBP 2015) Industry experts have suggested a quantum change in government interventions as an urgent countermeasure.

5.6 Business Sector

The majority of the respondent SMEs (51.67%) were from the Business and Financial Services sector. Information about the spread of business sectors of SMEs in South African continues to be fragmented. There is a need to capture this data as it would perhaps be a starting point for linkage to PE investment. Such an activity would be a plus for the reduction of informational opacity in the SME sector.

5.7 SME knowledge of the PE Sector

Contrary to the findings of the qualitative survey, generally, most respondents were aware of the existence of PE firms as well as their potential value to SME businesses. The respondents strongly agreed to all the 17 questions that related PE being critical to the growth and development of SMEs. Furthermore they agreed that PEs can offer a number of secondary benefits providing a diversified mix of capital and corporatization. PE partners can help small business achieve their potential. Furthermore, PE partners can support the installation of systems in SMEs, something that is often absent in SMEs which are usually family businesses. Furthermore, they can provide access to better human capital and to training. They are also able to attract talent, a function that SMEs find challenging as they simply don't have the resources or skills to find suitable staff. As discussed previously, the results from the qualitative component were opposite perhaps due to the lack of trust of PE industry by SMEs which has led to the lack of commitment to understanding its potential.

6 CONCLUSIONS and RECOMMENDATIONS

This study examined the role and impact of PE investment on Small Medium Enterprises in South Africa for entrepreneurs and policy makers. In particular, it shed light on the PE activity in SA and the impact of that activity on SMEs. In doing so it examined factors why SMEs do not have linkage with PE investment. It also investigated whether South African SMEs and Entrepreneurs are aware of the potential impact of PE investments into their business.

The analysis outlined results in eight thematic areas. Firstly, it found an indication of the positive impact of private equity in the South African economy. Secondly, it presented evidence that PE industry professionals in South Africa have no experience with SMEs. It then outlined, given an opportunity, the advice that PE professional would give to South Africa SME business owners. The study also delineated some qualitative factors leading to the observed SME and PE investment disconnect in the South African context. It then went onto profiling SME business ownership and decision making and then tried to characterise informational opacity/formalisation and the lack of corporatisation of SMEs. Further, it brought out the level of awareness of PE and its product offering among SME business owners and finally identified the factors relating to their fear of the loss of control if they allowed PE investment.

This study aimed firstly to contribute to the conversation on private equity financing in SMEs in the South African context where the medium to large enterprise space is not yet saturated. Secondly it aimed to contribute to identification of countermeasures that would change the status quo. However, the results have some limitations due to the small sample interviewed and/or surveyed. Therefore, the results are not necessarily representative of PE investments in SMEs in South Africa in general. Moreover, since the PE industry experts were purposively chosen from a limited number of firms, as well as SMEs only from the SEDA database for data collection and analysis, the study has to acknowledge that the findings in a differently selected group or population may be different.

This study could serve as a starting point for future analysis. Additional research could shed light on the experience in different economic sectors where SME business owners exist. It therefore encourages future quantitative and qualitative studies in these directions to gain a better understanding of South African specific reasons why the delink between South Africa PE investments and SME exists.

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Annexures

Annexure 1: Definitions

For ease of reference, Table 1 presents the general definitions of key terms that will be used throughout this report.

Terms	Definition
Gross Domestic Product (GDP)	The total value of all final goods and services produced within the boundaries of a country in a particular period (usually a year) Mohr & Fourie (2004)
FTSE/JSE All Share Index (ALSI)	<p>The FTSE/JSE Africa Index is designed to represent the performance of South African companies, providing investors with a comprehensive and complementary set of indexes, which measure the performance of the major capital and Industry segments of the South African market.</p> <p>The FTSE/JSE All-Share Index represents 99% of the full market capital value i.e. before the application of any investability weightings, of all ordinary securities listed on the main board of the JSE, subject to minimum free float and liquidity criteria.</p>
Gross Capital Formation (GCF)	The purchase of fixed capital goods, such as buildings, machinery and equipment, thereby referring to an increase in physical assets within the measurement period (usually on a yearly basis). Mohr & Fourie (2004)
Private Equity	Investments in unquoted companies, both inclusive of debt and equity financing of businesses various stages of their business life cycle. Wood & Wright (2009)
Limited Partner (LP)	Understood to be the Investors in the Private Equity Fund, their participation is limited to the amount contributed. Heed (2010)
General Partner (GP)	The GP manages the operations and reporting of the partnership activities, liable for all debts and commitments of the Partnership. Heed (2010)
Regulation 28	Regulation 28 to the Pension Funds Act imposed limits on the investments of retirement funds. This states that Private Equity fund investments are to be limited to 15%.

Pension Fund Act No. 24 of 1956	To provide for the registration, incorporation, regulation and dissolution of pension funds and for matters incidental thereto.
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Annexure 2: PE Managers Interview Guide

Interview: To Industry Experts?

Questions	Key Things you will need to look out for, and ask if not tackled, to enhance the conversation
1. Please introduce yourself and your background?	<ul style="list-style-type: none"> - PE equity Principal - Years experience - Role Currently involves, looking into SME investments
2. Explain Private equity and what it is in the context of South Africa?	<ul style="list-style-type: none"> - Investment Vehicle, that is willing to take risk and grow companies - Takes institutional money and seeks to explore riskier propositions
3. What do you believe is the driving principle of what you do as PE?	<ul style="list-style-type: none"> - Find and grow businesses? - For profit and is it together with the Entrepreneur or founders
4. How do you find these investments?	<ul style="list-style-type: none"> - Hours and hours of hard work, networks, banking clients - Knowing the industry and the players
5. Is the information readily available, on businesses, their financial information and performance?	<ul style="list-style-type: none"> - No, governance, not recorded, no disclosure and such is tricky. Being close to audit firms, and SARS and such and understanding that the information is opaque
6. Do you find it easier to approach the companies once you have identified them, and the role you believe you can play in assisting them with their business?	<ul style="list-style-type: none"> - Lack of corporate governance, or policies, and such - This usually leads to PE firms not wanting to waste their energy as well working on these systems
7. From experience, have you, your organisation or colleagues supported SMEs?	<ul style="list-style-type: none"> - Much rather focus larger transactions

If No ask why not? If Yes then how many, from which sectors	-
8. Is there a natural shift away from such SME prospects due to the amount of work needed to work the company	<ul style="list-style-type: none"> - Inherently there is such, most firms would rather work on certain sized companies - You find at least audited financials and a few basic policies are adhered to, - Usually sectors that are highly regulated tend to have businesses structured well
9. Is PE good for the Economy, and if yes. How so?	- Provide growth, employment and innovation
10. Then why, is PE not participating actively in assisting with the low levels of economic growth?	<ul style="list-style-type: none"> - Deal flow is tough? - Good businesses do not exist, and those that do, tend to be over priced; safer places now is for the bonds and stocks
11. Do you think there is a lack of information to entrepreneurs about how PE works?	<ul style="list-style-type: none"> - Yes, - Due to misconception, that we make it tough for the business owner to operate and burden them with too many contracts
12. What would you tell an SME or business owner	- Seek out a PE, for the most part even if they do not fund you, they will most likely give you great free advice on many areas of your business

Annexure 3: Entrepreneurs and Business Owners Interview Guide

Interview: To Entrepreneurs and Business Owners?

Questions	Key Things you will need to look out for, and ask if not tackled, to enhance the conversation
13. Please introduce yourself and your background?	- Business, sector, when founded and what the business truly has done and high level milestones
14. How did you fund your business, throughout its growth phase?	- Bank loans, friends, mortgages, etc.
15. Why did you fund the business the way you did at the time?	- Accessible, and cheaper to fund? Only way I could do so?
16. Do you know about Private Equity? Where have you heard of PE, and give me examples of success PE funded businesses that you have heard	<ul style="list-style-type: none"> - Yes, and not sure - They acquire businesses that they can sell later - Vultures whom take your business and kill your idea

	and vision for it
17. Do you know what PE investors do once they have invested alongside you in your business	<ul style="list-style-type: none"> - Assist, and give you money to execute on your vision - Take your business and transform it for the better - Make you rich, by buying at a higher price - Cashing in equity
18. Do you believe PE could be of benefit to your company right now?	<ul style="list-style-type: none"> - No, maybe, Yes - Perhaps and assist me in either understanding the growth path
19. Why did you not approaching a PE fund when you started?	<ul style="list-style-type: none"> - Didn't know they look at my business - My business is generic, and only works when large scale for them
20. Would you approach a PE fund now?	<ul style="list-style-type: none"> - Too small, do not know of any that could understand what I want to do with my business, - I do not want to be bossed around
21. On what terms would you want to share the equity of your business?	<ul style="list-style-type: none"> - Keep majority, they provider shareholder funding and let me execute on the business and grow it for them - That it be a loan and not equity, as I have worked hard and want to leave it for my children
22. But PE can greatly assist the growth of your business? And a 20% of a R2 billion company is better than 100% of your current NAV	<ul style="list-style-type: none"> - Well, where will I be; I want to run my business; and not be fired like all these other guys
23. Have you ever approached a PE firm? And sat down with them?	<ul style="list-style-type: none"> - No, I do not see the reason why, - My business can get financing from the bank
24. As a PE firm, ever approached you, to acquire a stake in your business or start conversations along those lines?	<ul style="list-style-type: none"> - No, Yes - I do not think they would know of me, and how much I make to want to buy my business, it's my private information - Yes, but we couldn't agree
25. Do you think enough information exists about PE in South Africa, and within your sector?	<ul style="list-style-type: none"> - No, there is no media coverage and I do not know of many people who trust them - Yes, but they focus on more fancier transactions and what I do would not be for the fancy MBA suits and such

Annexure 4: Entrepreneur and Business Owner Survey questionnaire

Qualtrics Survey: Target 50-100 entrepreneurs

Q1 - Age?

#	Answer
1	18-30
2	31-40
3	41-50
4	50+

Q2 - Gender?

#	Answer
1	Male
2	Female

Q3 - Type of SME? Classification by Turnover

#	Answer
1	Micro: Turnover between R0.5m -R2,9m
2	Small: Turnover between R3m - R10m
3	Medium: Turnover between R10m -50m

Q4 - Your years' of experience in SME industry? (Years)

#	Answer
1	`1-5
2	`6-10
3	11+

Q5 - Number of employees at SME?

#	Answer
1	`1-5
2	`6-10
3	11+

Q6 - How long has your SME been in existence? (Years)

#	Answer
1	`1-5
2	`6-10
3	11+

Q7 - What sector is your business in?

- # Answer
- 1 Agriculture
 - 2 Mining & Quarrying
 - 3 Electricity, Water & Gas
 - 4 Manufacturing
 - 5 Construction
 - 6 Community, Social & Personal Services
 - 7 Transport, Logistics & Communication
 - 8 Business and Financial Services
 - 9 Tourism & Hospitality
 - 10 Other

Q8 - A private equity firm (sometimes known as a private equity fund) is a pool of money looking to invest in or to buy companies.

For all intents and purposes, the firm has no operation other than buying and selling companies, which go into its portfolio. Have you heard of a private equity firm?

Answer

- 1 Yes
- 2 No

Q9 - Do you know what PE funds actually do?

Answer

- 1 Yes? Acquire a shareholding, usually minor and serve to assist in the growth strategy of the business, with a view to exit at a higher valuation than when they entered. If you find a good PE partner, you can benefit from their resources.
- 2 No? I know, they have money, which they can fund businesses. But I have no idea how they work with other people's businesses.
- 3 Somewhat? Have heard of the concept, and what they do, but I do not believe they are beneficial to being able to help grow my business

Q10 - Role of Private Equity in the South African SME space. Please indicate how much you agree or disagree with each of the following statements

#	Question	Strongly Agree	Agree	Somewhat agree	Neither agree nor disagree	Somewhat disagree	Disagree	Strongly disagree
1	PE can contribute to the SME space in a meaningful way.							
2	PE allocates enough money towards SME's.							
3	SME's have continued to seek innovative ways of raising financing in the market place.							
4	SME's contribute towards economic growth in SA.							
5	PE has been able to assist contributing towards economic growth.							
6	PE firms deliver on innovation, employment growth and efficient business processes.							
7	SME's deliver on innovation, employment and growth.							
8	SME's with adequate funding and expert operational management team, they can become the next large companies.							
9	The management teams of PE firms greatly assist SME's in navigating their growth phase.							
10	The government is doing enough to stimulate SME's in South Africa.							
11	The government is doing enough to make sure PE firms, focus on looking to fund SME's.							
12	PE firms can be important to the growth of my SME in the short and long run.							
13	SME's can benefit immensely from PE funding.							
14	SME's suffer from the lack of PE funding.							
15	The PE industry is important to the growth and recognition of the SME space.							
16	PE has dedicated enough money to help fund SME's in the country.							
17	A PE firm would be interested to look into my business as a potential investment.							
18	SME's are failing due to government support.							
19	SME's in SA continue to be on a decline due to a lack of entrepreneurial flare.							
20	SME's in SA are failing due to PE, Grant Funding and SEDA like funding alternatives, that is not readily available.							
21	SME's in SA are failing due to a lack of adequate and appropriate funding from traditional banking lines.							
22	SME success rates are directly affected by the business cycle and the current economic climate.							

ANNEXURE 6: Likert Scale Responses

(Discussed in 4.3.5)

Q10 - Role of Private Equity in the South African SME space. Please indicate how much you agree or disagree with each of the following statements																
#	Question	Strongly Agree		Agree		Somewhat agree		Neither agree nor disagree		Somewhat disagree		Disagree		Strongly disagree		Total
		%	Count	%	Count	%	Count	%	Count	%	Count	%	Count	%	Count	
1	PE can contribute to the SME space in a meaningful way.	79.25%	42	7.55%	4	9.43%	5	3.77%	2	0.00%	0	0.00%	0	0.00%	0	100%
2	PE allocates enough money towards SME's.	3.77%	2	5.66%	3	1.89%	1	11.32%	6	5.66%	3	56.60%	30	15.09%	8	100%
3	SME's have continued to seek innovative ways of raising financing in the market place.	75.47%	40	15.09%	8	5.66%	3	1.89%	1	0.00%	0	1.89%	1	0.00%	0	100%
4	SME's contribute towards economic growth in SA.	83.02%	44	15.09%	8	1.89%	1	0.00%	0	0.00%	0	0.00%	0	0.00%	0	100%
5	PE has been able to assist contributing towards economic growth.	11.32%	6	3.77%	2	33.96%	18	32.08%	17	5.66%	3	13.21%	7	0.00%	0	100%
6	PE firms deliver on innovation, employment growth and efficient business processes.	22.64%	12	7.55%	4	26.42%	14	37.74%	20	5.66%	3	0.00%	0	0.00%	0	100%
7	SME's deliver on innovation, employment and growth.	77.36%	41	18.87%	10	3.77%	2	0.00%	0	0.00%	0	0.00%	0	0.00%	0	100%
8	SME's with adequate funding and expert operational management team, they can become the next large companies.	67.92%	36	16.98%	9	7.55%	4	7.55%	4	0.00%	0	0.00%	0	0.00%	0	100%
9	The management teams of PE firms greatly assist SME's in navigating their growth phase.	9.43%	5	13.21%	7	32.08%	17	39.62%	21	5.66%	3	0.00%	0	0.00%	0	100%
10	The government is doing enough to stimulate SME's in South Africa.	3.85%	2	0.00%	0	1.92%	1	0.00%	0	21.15%	11	48.08%	25	25.00%	13	100%
11	The government is doing enough to make sure PE firms, focus on looking to fund SME's.	3.77%	2	0.00%	0	0.00%	0	7.55%	4	13.21%	7	35.85%	19	39.62%	21	100%
12	PE firms can be important to the growth of my SME in the short and long run.	28.30%	15	13.21%	7	33.96%	18	15.09%	8	5.66%	3	1.89%	1	1.89%	1	100%
13	SME's can benefit immensely from PE funding.	88.68%	47	3.77%	2	3.77%	2	3.77%	2	0.00%	0	0.00%	0	0.00%	0	100%
14	SME's suffer from the lack of PE funding.	90.57%	48	1.89%	1	1.89%	1	3.77%	2	1.89%	1	0.00%	0	0.00%	0	100%
15	The PE industry is important to the growth and recognition of the SME space.	24.53%	13	5.66%	3	30.19%	16	32.08%	17	3.77%	2	3.77%	2	0.00%	0	100%
16	PE has dedicated enough money to help fund SME's in the country.	15.09%	8	3.77%	2	1.89%	1	9.43%	5	7.55%	4	43.40%	23	18.87%	10	100%
17	A PE firm would be interested to look into my business as a potential investment.	13.21%	7	9.43%	5	35.85%	19	32.08%	17	1.89%	1	1.89%	1	5.66%	3	100%
18	SME's are failing due to government support.	88.68%	47	7.55%	4	3.77%	2	0.00%	0	0.00%	0	0.00%	0	0.00%	0	100%
19	SME's in SA continue to be on a decline due to a lack of entrepreneurial flare.	26.92%	14	0.00%	0	0.00%	0	1.92%	1	9.62%	5	44.23%	23	17.31%	9	100%
20	SME's in SA are failing due to PE, Grant Funding and SEDA like funding alternatives, that is not readily available.	92.45%	49	7.55%	4	0.00%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	0	100%
21	SME's in SA are failing due to a lack of adequate and appropriate funding from traditional banking lines.	90.57%	48	5.66%	3	3.77%	2	0.00%	0	0.00%	0	0.00%	0	0.00%	0	100%
22	SME success rates are directly affected by the business cycle and the current economic climate.	11.32%	6	47.17%	25	28.30%	15	9.43%	5	1.89%	1	1.89%	1	0.00%	0	100%

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