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**A Study of Criteria and Success Factors in the Private Equity
and Venture Capital Investment Process and a Comparison to
the South African PE/VC market**

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A STUDY OF CRITERIA AND SUCCESS FACTORS IN THE PRIVATE EQUITY
AND VENTURE CAPITAL INVESTMENT PROCESS AND A COMPARISON TO
THE SOUTH AFRICAN PE/VC MARKET

ABSTRACT

This study endeavors to shed more light on venture capital investment decision making process and the criteria and factors that are used to evaluate new ventures. The study will look at the investment process carried out by a typical venture capital firm, and the primary focus will be on the initial deal screening and the due diligence processes and the factors and criteria the venture capital and private equity practitioners employ in an effort to evaluate new ventures, such that potentially successful ventures are selected and are ultimately funded. This paper will also compare the South African private equity and venture capital environment to other VC/PE markets such as the USA and Europe.

Keywords: venture capital, investment process, due diligence, screening, criteria

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1. Introduction

Venture capital is largely understood to be a vital component in funding of early stage ventures, and thereby facilitating entrepreneurship, innovation, employment and general economic growth. A mechanism to promote such business activity has historically been to establish a public sector venture capital companies to open the market for private investors.¹

Entrepreneurs are considered to be highly valuable assets due to the fact that they are considered to be job creators. The problem however, is that it is not enough to merely create jobs. These newly created businesses must grow, and due to the way in which they are financed, preferably very rapidly. Before these new business can produce sustainable cash flow, they require financing. The quality of this financing relies on the technology pursued, the length of time required to develop the product, and the characteristics of the market that the new business is looking to operate in. In some cases the total resources necessary, can be quiet large.

Achieving financing for these start-ups is not easy. The problem lies in that, these businesses are not mature enough and have little or no immediate cash flow. This problem is further exacerbated by the fact that start ups in general have severe informational asymmetry regarding their quality, lack of assets or reputation to back up the financing and reduce the risk of the debt securities they issue.

It is with these challenges in-mind that these newly established businesses, or potential businesses approach firms that are able to provide them with the necessary financing and further, the accompanying advice to expand, monitor their progress. These firms that provide such services are usually business angels and venture capitalists (VC).

¹Maunula, M, "The perceived value-added of venture capital investors. Evidence from the Finnish biotechnology industry." ETLA, The Research Institute of Finnish Economy, 2006, p86

Venture capital firms typically receive a large volume of proposals from potential new ventures or established businesses, seeking to grow. In trying to sort out which are lucrative and which are not, VC firms naturally use processes or mechanisms to rapidly screen out the deals that are not of interest. Due to the fact that each new potential venture has its own characteristics, it is understood that there is no one best approach to screening. Not only is the new venture unique but, each firm has to determine what is critical to its fund and what types of deals will fall in-line with the funds requirements. These requirements are typically defined as “fit”. Nelson et al described fit as the particular stage of the new venture, the geographic region that the new venture operates in, the size of the deal, and the industry sector.²

While a large volume of the past research has evaluated the VCs’ decision-making process in large and developed private equity markets, only a minority of these studies have been carried out in geographies where the private equity industry remains diminutive. These are typically the emerging markets where private equity is not yet an alternative source of financing. It is also very evident that a majority of the research activity has primarily concentrated on the post-investment functions of VC’s. These studies focused on the financial agreements struck between VC’s and investors. The pre-investment selection process has not been given as much attention in the VC context. A study carried out by Kaplan and Strömberg (2004) empirically examines the contents of VC’s investment analysis, and their relation to the type of contracts and ex-post involvement of these VC’s. Garmaise, (2006) et al., examines a model where VC’s have superior know-how in project evaluation compared to other agents.

Although screening is an essential facet of the complete investment process, screening of new ventures has received little attention in theoretical work, where Ueda (2002), and Gehrig and Stenbacka (2003) are noticeable exceptions.

² Nelson, H; Wainwright, F; Blaydon, C; “*Note on due diligence in venture capital*”, Tuck School of Business, Dartmouth College, 2004

Since the 70s academic researchers have tried to analyze and understand the VC decision making process. The primary objective by these studies has been to determine how venture capitalists can evaluate potential investments (Tybjee and Bruno 1981, Kahn 1987). The previous studies have typically asked venture capitalists to list and rank decision criteria that affect their investment decisions (Tyebjee and Bruno 1981, Kahn 1987). These criteria generally relate to the quality of the entrepreneur/team, uniqueness of the product/service, attractiveness of the market as well as financial considerations (Tyebjee and Bruno 1984, MacMillan et al. 1985, 1987). During making investment decisions, venture capitalists use several information sources such as business plans, outside consultants, and due diligence

There is a long and established line of research which has gone to asses the results of decisions based on criterias by VC's during investment evaluation (Franke et al., 2006; Hall & Hofer, 1993; MacMillan et al., 1985; MacMillan et al., 1987; Matusik et al., 2006; Muzyka, Birley & Leleux, 1996; Shepherd, 1999; Tyebjee & Bruno, 1984; Zacharakis & Meyer, 1998; Zacharakis & Shepherd, 2005; Zopounidis, 1994). A clear conclusion from this body of research is that the human capital of the founder of the new ventures is vital (Matusik et al., 2006; Shepherd & Zacharakis, 1999; Zopounidis, 1994).

However, what is not clear is how and on what basic multiple factors the venture capitalists make their investment decisions (Hill & Power, 2001). According to Roberts (1991) each venture capital firm follows its own guidelines and rules. Wu (1988) states that venture capitalists invest in people and their ability. Zacharakis & Meyer (1998) do not agree with Wu (1988).

They defined market characteristics as market competition and market familiarity. Tybjee & Bruno (1984) and Shepard (2000) agreed with the findings of Zacharakis & Meyer (1998). But they also found that the size of the investment, cash-out potential, and product differentiation are the other important factors in venture capitalists investment decisions.

The study of how VC's make their criteria decisions to invest, such that those decisions yield significant returns, still remains a relatively unexplored field. The author now understand that part of the difficulty in studying venture capital decision criteria lies in the fact that the majority of the deals are private, are generally never publicized and the decisions involve the experience and some times the unquantifiable skill and personal "flair" of a venture capital practitioner. Hence it must also be noted that due to the fact that the information collected will not be quantitatively tested, disputing whether a particular factor is statistically significant or not, will be difficult; however the paper will discuss and compare the relevance of a factor in a South African context. For example, where as in the United States of America or Europe, the geographic location of a new venture might be a factor in the screening and due diligence process, due to the large physical distances, making access to management, operations or other services that the venture capital firm might provide to assist the new venture, difficult and thereby potentially jeopardizing the success of the investment.

1.1 Aim of the study

There are two prime foci of interest in this study. The first relates to the potential added value gained from conducting thorough screening and due diligence processes. The hypothesis is that by improving these processes, this will improve the portfolio returns for venture capital firms and this is as a consequence of reducing the number of inappropriate investments. Secondly, a thorough screening and due diligence exercise should limit the opportunity costs related to time and capacity usage.

RESEARCH OBJECTIVES

The primary objective of this research is to conduct an analysis of the influence of success factors in new ventures and a comparison to the South Africa venture market. The research question thus is as follows: **What factors influence the success of a new venture?**

In order to achieve the primary objective, the secondary objectives are formulated. The secondary objectives are to:

- identify the factors that influence the success of a new venture
- make recommendations to the existing body of knowledge on the success factors identified in South Africa, which could be considered by policy makers and education and training institutions

So far, many studies reveal insight into the decision making process of VC investors out of different geographical areas, for example the United States of America and Europe. Still, little or nothing is known about how the investment decision process is structured in a South African environment and what the necessary criteria requirements are. The assessment is further enriched by comparing criteria with other SA venture capital investment firms. After the description of the decision making process the paper then compares it with findings from published academic writing in the field and continues to explore the difference in the domestic market. In this paper, venture capital is understood to represent a subset of private equity and it refers to equity investments made to early

stage (seed and start-up), or to expand a business, whereas private equity in general, supplies capital to enterprises not quoted on a stock market. This research paper will focus exclusively on the private sector venture capital investment process. Due to the lack of insight into the investment processes of public, corporate, and generally, informal venture capital i.e investment angels etc., these sectors will not be addressed in this paper.

1.2 A Definition of Venture Capital

Venture capital (also known as VC or Venture) is a type of private equity capital typically provided to early-stage, high-potential, growth companies in the interest of generating a return through an eventual realization event such as an IPO or trade sale of the company. Venture capital investments are generally made as cash in exchange for shares in the invested company. It is typical for venture capital investors to identify and back companies in high technology industries such as biotechnology and ICT.

A venture capital fund refers to a pooled investment vehicle (often an Limited Partner - LP or Limited Liability Company- LLC) that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans.

As defined by the European Private Equity and Venture Capital Association, a venture capitalist is described as a manager of a private equity fund, who's primary responsibility is the management of the fund's investment in a particular portfolio company. Although this is a near accurate description, not all managers of VC funds are actual capitalists, but are rather, employed as professional managers of VC funds. Therefore it becomes essential to separate ownership from control, as VC companies are now owned by widely diverse organizations. Essentially, venture capitalists are "legal persons, owned either by natural persons or legal persons whose decision making authority is vested in natural persons acting as board members"

Therefore, what actually makes a fund manager a venture capitalist lies in their share of ownership of the VC company. It is understood that if a manager or a team of managers own a majority share of the venture capital company, they are in essence venture capitalists; otherwise they are just venture capital managers. VC companies, in turn, are vehicles used by venture capitalists. Usually VC's utilize limited life partnerships, typically 10 years. In these structures, funders from outside, participate as limited partners of the fund.

VC companies can also consist of and utilize a limited liability company. With this structure, outside funders participate together with the venture capitalists, as shareholders for an undefined period of time.³

1.3 A brief history of venture capital

Prior to World War 2, VC investments, or development capital as it was known, was mostly for wealthy individuals and families. It was only after World War II that what is today defined as true private equity investments began to emerge. The advent of the modern version of private equity was initiated by the establishment of the first two venture capital firms in 1946. These were American Research and Development Corporation (ARDC) and J.H Whitney and Company.

The establishment of the Small Business Investment Act of 1958 furthered the progress towards a professionally-managed venture capital industry. The Act essentially gave the U.S. Small business administration (SBA) the ability to license private "Small Business Investment Companies" (SBICs), this facilitated the financing and management of small entrepreneurial businesses in the United States⁴.

³ Maunula, M, "The perceived value-added of venture capital investors. Evidence from the Finnish biotechnology industry." ETLA, The Research Institute of Finnish Economy, 2006, p86.

⁴ Small Business Administration Investment Division (SBIC)

During the 60s and 70s, VC's focused their activity mainly on creating and growing new ventures. The majority of these new ventures were taking advantage of breakthroughs in electronic, medical or data-processing technology. As a result, venture capital became synonymous with technology finance. It was also in the 60s that the common form of private equity fund, still in use today, emerged.

Private equity firms have been organized such the investors, who are passive limited partners, put up the capital and the investment professionals served as general partner. These structures are usually limited partnerships which hold investments. The compensation structure, still in use today, also emerged with limited partners paying an annual management fee of 1-2% and a carried interest typically representing up to 20% of the profits of the partnership.⁵

The early successes of the VC industry in the 70s and early 80s, such as Digital Equipment Corporation, Apple Inc, Genentech, paved the way for a major explosion of VC investment firms. From just a few firms, the industry grew to over 650 firms by the end of the 1980s, and each one of these firms was searching for the next big "new thing". Despite the fact that the number of firms continued to grow, the capital managed by these firms increased by only 11% from \$28 billion to \$31 billion over the course of the decade.

The growth industry was severely hampered by heavily declining returns and some venture firms began posting losses for the first time. Due to the number of firms competing in the same space, this increased competition among firms and the further impact of other factors, impacted returns negatively. The IPO (initial public offerings) market slowed during the mid-1980s prior to collapsing after the stock market crash in 1987 and foreign corporations, especially from Japan and Korea, bombarded early stage ventures with financing.

⁵ articles entitled "Silicon Valley USA" were published in the Electronic News

Growth within the industry remained muted throughout the 80s and the first half of the 90s. The value of the VC market increased from \$3 billion in 1983 to a little over \$4 billion in 11 years. After a decline in the number of VC managers, the more successful firms retrenched, preferring to target improvements in their portfolio companies operations at their rather than continuously making new investments in an attempt to grow returns. Returns began to turn very attractive, and would ultimately generate the venture capital boom of the 90s. Former Wharton Professor Andrew Metrick refers to these first 15 years of the modern venture capital industry beginning in 1980 as the "pre-boom period" in anticipation of the boom that would begin in 1995 and last through the bursting of the internet bubble in 2000.⁶

The late 90s were a boom time for the venture capital. This was driven by the general interest in the internet and other technologies. IPO's of equity for "tech" and other growth companies were plenty and VC's were making large returns.

1.4 Types of Venture Capital.

Over time the VC industry has developed and the definition and understanding of what venture capital encapsulates has also developed. Venture capital was previously understood to be direct equity participation in new technology based companies, which were entrepreneur-driven start-up ventures by individual capitalists.

At the moment the term venture capital covers a far wider level of activity. VC investment can vary in periods from a few months to decades, and investments can range from vanilla type common stock to convertible bonds or warrants and other complicated option structures. Furthermore, an investment portfolio does not only contain the regular technology-based start-ups but can also hold established large corporations in mature businesses led by employed managers and everything in between. Those people within the venture capital market form an eclectic mix of professionals, who are skilled at applying complex contractual agreements and corporate structures. To fully evaluate the workings of venture capitalists, it is critical to understand that venture capitalists are a

⁶ Metrick, Andrew. *Venture Capital and the Finance of Innovation*. John Wiley & Sons, 2007. p.12

heterogeneous grouping of individuals and entities, each having their own missions and objectives. As well as providing direct capital to firms (or funds), governments may give financial incentives to VC investments and revise investor regulations. These are known as public sector venture capital. They make venture-like financings with public funds.⁷

Corporate venture capital (CVC) is a form of venture capital where the investor is a financial intermediary of a non-financial corporation. The investee companies are either young firms' outside the corporation or business ideas emanating from within the corporation. These investments are usually organized as corporate subsidiaries, not as limited partnerships.

The aims of companies active within the corporate venture capital market are very diverse. Some corporate venture capitalists are after financial gains. This is done by targeting investments in projects that yield the highest return on investment. However it is common that corporate venture capitalists investments are made for tactical purposes and the investments are made to spur the investor's own commercial interests. The VC industry has become strongly institutionalized. The "traditional" individual venture capitalists are now referred to as "informal" venture capitalists or business angels.

According to Lumme et al. (1998, p.11), the "informal" or traditional venture capital market comprises wealthy, self made, private individuals who have an entrepreneurial or commercial background and provide small amounts of equity capital to businesses in which they have no family connection.⁸

For clarity, only the private sector venture capital will be addressed in this paper. This has been purposefully done due to the lack of insight into investment processes and other complexities i.e political agendas; that are associated with mostly public venture funds, none of the above venture types will be dealt with in this research paper.

⁷ ⁸ Maunula, M, "*The perceived value-added of venture capital investors. Evidence from the Finnish biotechnology industry.*" ETLA, The Research Institute of Finnish Economy, 2006, p86.

2. Methodology

Traditional financial research methodologies are not well-suited to an examination of the venture capital investment process. The transactions involved are private. What little information that is available from secondary sources describes the ultimate investment but not the process used to make it.

In an attempt to overcome the difficulties involved in assessing venture capital investment processes, this research paper will employ a two-stage methodology. The paper will first describe the entire selection process. In order to do this the author constructs a generic model. The generic model is a conglomeration of the authors' investment experience and evidence from published research. Criteria employed by venture capitalists in Europe and the USA were identified from published research in international journals and were used to construct the model. In the second stage the author elaborates on the criteria that are employed by venture capitalists in the selection of new ventures.

To date, the studies have been restricted to straightforward, "one-dimensional" studies only. The aim of these studies has been to identify VCs' general characteristics and argued that these impact their evaluation decisions. Despite the fact that some key deficiencies of the VC decision making processes were able to be detected in this manner, the fundamental rationale is still rather mechanistic as VCs are assumed to react in a stable manner. Despite the positive finding, if this was true, biases could be identified and corrected in a relatively easy way, thereby driving continuous improvement in the quality of financing decisions, and preserving implications for research on the success factors of new ventures. Clearly this is not the case given the wide dispersion between successful VC funds and failures⁹

⁹ Franke; et al *What you are is what you like – similarity biases in venture capitalists' evaluations of start-up teams*", Journal of Business Venturing, [2006], 21(6): 8-2-826

3. General Literature Review

The current research on how VC's make their investment decisions can be categorized into two broad streams: one is *processual* research. Processual research concentrates on the course of events and actions that lead to an investment decision (e.g. Wells 1974, Tyebjee and Bruno 1984, Silver 1985, Hall 1989). The other stream is known as *criteria research*. Criteria research concentrates on finding what criteria's are used by VCs when evaluating proposals (e.g. Poindexter 1976, MacMillan et al. 1985, Khan 1987). The majority of studies can be located within either one or the other research stream and some even embody a combination of the two, having produced models outlining the phases of the decision-making process and the criteria used in each phase (e.g. Wells 1974, Boocock and Woods 1997).¹⁰

With regards to the distribution of these studies, a majority of these studies have focused on criteria research only, with a few covering both criteria and processual research. It has been found that even fewer researches such as Tyebjee and Bruno (1981) have concentrated on primarily processual research. The earliest example of a combined criteria and processual research was done by Wells (1974) even though this was on a small sample size of 8 venture capital funds. In 1976 Poindexter carried out a criteria research study which covered 97 VC funds.

Within the criteria research stream, there has been a vast range of studies. The initial wave of studies focused on identifying the criteria that were commonly used in evaluating proposals. As a result of this first wave of studies, a weighted list such as the one compiled by Wells (1974) or a ranked list similar to the one compiled by Poindexter (1976) was achieved. In Wells' (1974), study he found that VCs generally consider management commitment as the criterion having the highest weight in appraisal of proposals. This criterion was closely followed by product, market and marketing skills.

¹⁰ Silva, J; "Venture capitalists' decision-making in small equity markets: a case study using participant observation" Venture Capital, April-September 2004, VOL. 6, NO. 2/3, 125 – 145

Poindexter's findings were very similar in that he found that the quality of management was the criterion with the highest rank in the view of VCs, which was followed by the expected rate of return and expected risk. In Tyebjee and Bruno's study of 1981, they found that management skills as the most significant factor. The study by MacMillan et al. (1985) reveals that five of the 10 most essential criteria were related to the entrepreneur's experience or personality. It is clear that within these studies, management and those aspects surrounding management, was the most important criteria towards a successful venture¹¹

MacMillan et al. (1987) represents one of the earliest attempts to investigate whether the criteria identified in preceding studies (mainly in MacMillan et al. 1985) were really helpful to differentiate between successful and unsuccessful ventures. A chief finding of their study, which was identified through regression analysis, was that the two key criteria predictors of venture success were:-

1. The degree to which the venture is initially protected from competition
2. The degree to which there is verified market approval of the product.

Khan (1987) also carried out research in this area, but adopted a different approach. He applied two different types of non-compensatory actuarial models, a conjunctive and disjunctive model, to arrive at model that both described the VCs' judgement and the environment. The results of this study highlighted that VCs generally emphasised the entrepreneurs' desire to succeed and the uniqueness of the product, as essential variables in arriving at their investment decision. A further outcome of this work suggests that VCs' assessments of a new venture are weak predictors of the actual outcome and that derived models, generally outperform VCs' judgments.¹²

^{11, 12} Silva, J; "Venture capitalists' decision-making in small equity markets: a case study using participant observation" *Venture Capital*, April-September 2004, VOL. 6, NO. 2/3, 125 – 145

Another group of studies, in an attempt to solve the likely introspection biases linked with the methods used in earlier work, have applied real-time data gathering methods. One of the techniques initiated was verbal protocols, a technique that consists of asking the research participants to ‘think aloud’. This required the research participants to verbalize their thoughts as they are simultaneously carrying out a specific task. In a study conducted by Sandberg et al. (1988) they tested the applicability of this technique.¹³

Hall and Hofer (1993) carried out a more widespread verbal protocol study with 4 venture capital funds and 16 protocols. The output of this work suggested that in the initial proposal screening, the most important criteria was the fit of the new venture with what the firm’s lending policies were and the long term growth projections and profitability of the industry in which the new venture intends on operating in. Following this, what was found to be an important factor in the proposal assessment process was the source of the proposal.¹⁴

Hisrich and Jankowicz (1990) conducted a study which investigated the nature and components of what was considered to be “intuition” in venture capital decisions. This was in an attempt to enhance their understanding of what particular subjective factors are at play. Even though VC firms establish investment objectives and philosophy to try and minimize the subjective evaluations, there are still some observed inconsistencies between the official and de facto policies for the evaluation of a new venture proposal (Shepherd et al., 2000). This disconnect between what actually exists and the policies that are constructed, is credited to the fact that decision makers, especially experienced ones, tend to ignore well-known objectives and instead rely on what is known as “gut feel” and various heuristics when undertaking the selection process. Heuristics are understood to be “rules of thumb” while these are not necessarily “bad”, they are however vulnerable to various sources of cognitive biases.

^{13, 14} Silva, J; “*Venture capitalists’ decision-making in small equity markets: a case study using participant observation*” *Venture Capital*, April-September 2004, VOL. 6, NO. 2/3, 125 – 145

Some of the sources of this cognitive biases that eventually may affect the way venture capitalists arrive at their investment decisions, includes overconfidence, which when the decision maker believes that they know more than they actually do, and another is called anchoring, which is the act of following past practice and shunning innovative alternatives to the detriment of the fund.¹⁵

Due to the less than optimal performance of some of these cognitive biases, some entrepreneurship scholars have attempted to recreate the investment decision process with the aim of ultimately improving it. Such attempts comprise the work of MacMillian et al. (1985) which analyzed how VCs select new ventures to invest in. Further studies by Fried et al. (1993) simulated similar outcomes. Both studies used questionnaires that provided the venture capitalist with 24 criteria for evaluating an investment, and asked the respondents in the study to weigh these criteria directly on a four-point scale.¹⁶

Tyebjee and Bruno (1983) carried out a study where they requested venture capitalists to evaluate previously examined plans on 23 criteria using a four-point scale, again in an attempt to replicate the decision process. Despite the fact that these studies further enlighten us on how VC's go about selecting ventures, Zacharakis and Meyer (1998) suggest that methods that use these types of surveys where venture capitalists are requested to reassess previous decisions and use the same decisions to base their decisions are eventually biased. Approaches that respond to this exact concern include Conjoint Analysis, Actuarial Models and "Utility Additive (UTA) Models.

The conjoint analysis approach, which is a descriptive process, which proposes to capture decision policies as the decisions are made, further informs us about the criteria which are considered relevant for the decision making process.

¹⁵ Shepherd DA, Zacharakis A, Baron RA. 2003. VC's decision processes: Evidence suggesting more experience may not always be better. *Journal of Business Venturing* **18**: 381-4014

¹⁶ Silva, J; "Venture capitalists' decision-making in small equity markets: a case study using participant observation" *Venture Capital*, April-September 2004, VOL. 6, NO. 2/3, 125 – 145

The actuarial models as proposed by Zacharakis and Meyer (2000) are another attempt at accomplishing some improvement in the venture capitalist decision process.¹⁷

There is a large amount of work, which concentrates on the use of multi criteria methodologies in financial decision making such as investment portfolio selection and extension of credit and foreign direct investment. Multi Attribute Value Theory (MAVT) is one of the most widely employed Multi Criteria Decision Assessment (MCDA) methods in practical applications.¹⁸

Research work employing factor analysis has arrived at the conclusion that the 3 most critical success factors for the outperformance of VC-funded venture are:-

1. The “strategic fit” between the venture capitalist and management.
2. Management’s long-term commitment
3. A focused strategy.

In work done by Shepherd (1999), he shows that venture capitalists generally use criteria that are consistent with research found in the strategy literature. These criteria which are known as “in-use” criteria, are not necessarily the criteria venture capitalists would report as their “espoused” criteria.¹⁹

Research has looked at investment rates, success rates, return rates, and various aspects of the decision-making models used by the venture capitalists. Earlier research focuses more on industry statistics and the structure and governance of the industry. Attempts to try and study the decision criteria, which are applied in new venture evaluations, have been evolving over time.

^{17,18,19} Silva, J; “*Venture capitalists’ decision-making in small equity markets: a case study using participant observation*” *Venture Capital*, April-September 2004, VOL. 6, NO. 2/3, 125 – 145

There have been many attempts to try and develop models for venture capitalists' investment activity. These models are mostly correlation and statistically driven. However the observable deficiencies of these models and the need for better understanding of how VC's actually make their decisions, has led to more research in this area.²⁰

As intimated previously, the majority of research on venture capitalists' decision making has produced empirically derived lists of criteria that venture capitalists report they use when evaluating new venture proposals, examples of this type of study is demonstrated by work done by Tyebjee & Bruno (1981,1985); Gorman & Sahlman, (1986). In work done by Fenn, Liang and Prowse (1995), they estimated that when using such lists of criteria that only 1% of the projects received by venture capitalists obtained financing.

Researchers such as Zacharakis, Meyer and Shepherd have revisited the venture capitalists' decision-making problem. These researchers suggest that the statistical models developed in the literature may not be reliable or valid because of inherent decision- making biases, e.g., overconfidence, and they question the usability of actuarial decision models by the VCs.

Competing theories

A large amount of work relating to how VCs make their investment decisions belongs to what is described as the "espoused criteria" school of thought. This school of thought is based on what VC's say they use to screen investment opportunities. The work based on the espoused criteria has relied on the results of surveys and questionnaires that supply "decision cues" for the researchers to generate and test the efficiency of their models.

A decision cue is understood to be a decisive factor that elicits a reply in the judgment process. Prior research paid particular attention on how VC decision making has determined criteria espoused by VC's using different emphasis. Work done by Benoit

²⁰ Mishra, S; Kemmerer, B; Shenoy, P.P; " Managing venture capital investment decisions: A knowledge-based approach" University of Kansas.

(1975), Tyebjee and Bruno (1964) assumed some form of counting was applied, while Wells (1974) and Dixon (1991) employed a rating scale, Poindexter (1976) and Macmillan et al (1985), focused on the ranking scale methodology, Muzyka (1996) engaged the trade-offs methodology.²¹

A key objective of studies done at the firm level has been to precisely identify characteristics that differentiate between viable, successful ventures from ventures that are likely to fail. Strategy research suggests that superior performance comes from an alignment between the competencies of a venture and the key success factors of an industry (Shepherd [1999]). When this philosophy is applied to the analysis of VC investment decision making, this thinking falls into the “known attributes” school of thinking. Within this school of thought, success factors or viable venture attributes represent the necessities for success within a particular industry.²²

In practical terms what this means is that, a new venture team must commit to a number of viable venture attributes that, they believe, will lead to success within the competitive environment. The reason why this methodology has been partially successful is that viable venture attributes within industries remain stable, and hence when these known attributes are applied to select new ventures, the likelihood of success of the new venture, is improved. In an extensive survey of prior work it has been determined that there are six independent attributes of viable ventures 1) innovation, 2) value 3) persistence 4) scarcity 5) non-appropriability and 6) flexibility.²³

While the hallmark of new venture selection has been based on identifying a set of attributes, in numerous studies across a variety of fields, decision aids such as actuarial models, have proven to be quit robust. It was found that only six of 117 studies found that clinical or intuitive decision, i.e where the selection of a new venture is made without a technical aid, equaled or outperformed actuarial models.

^{21, 22, 23} Mainprize B, et al “*Toward the standardization of venture capital investment evaluation: Decision criteria for rating investee business plans*”, 2002

An actuarial model enables the individual doing the selection to consider and rate individual cues independently and allows the user to optimally combine the values assigned to each cue using a weighted algorithm to derive the answer. Given the number of potential contributing factors, and the fact that not all factors are equal in their impact, intuitively, derived models should outperform when stacked against plain intuition. It is difficult to believe that even a skilled practitioner is capable of identifying the number of potential correlated outcomes, whether negative or positive, given the number of different factors that are needed to truly evaluate the real outcome of a new venture.

In a study performed by Zacharakis and Meyer, they found that when using a “bootstrap” actuarial model which was based on “espoused” criteria, that the bootstrap model better predicts actual outcomes than the VC’s own intuitive decision process. Within the VC industry, the percentage of correct investment decisions is known as the “hit rate.” The effectiveness of VC decisions can be determined using the hit rate. The average hit rate for VC decision making is calculated at approximately 20%, at best.

In another study by Mainprize; Hindle et al (2003), rather than using a “bootstrapping” actuarial model, they tested a “venture attribute actuarial model”. They replaced the espoused “cues” with known, viable venture attributes. It was found that the attribution, bootstrapping and environmental models that were tested achieved different hit rates. The attribute-based actuarial model achieved a hit rate of 64.3%, compared to a 51.9% hit rate for the trained evaluation teams’ own intuition. The attribute based actuarial model using only potential profitability as a predictor, achieved a hit rate of 57.4%.²⁴

²⁴. Mainprize B, et al “*Toward the standardization of venture capital investment evaluation: Decision criteria for rating investee business plans*”, 2002

More recent studies suggest that previous results might be misleading due to biases in the decision process of VCs. This outcome directly challenges the implicit assumption of earlier studies that evaluations by VCs can be treated as objective assessments of new venture quality disturbed only by a random error. To date, research has been limited to biases due to the information processing or characteristics of the VCs.²⁵

4. A generic investment decision-making model

The following chapter outlines and explains the stages that a typical venture capital firm would engage in when evaluating a new venture.

A key differentiator of the VC industry from other forms of finance, besides direct active and temporary involvement, is its cyclic nature. The venture capital cycle can be broken into five step cycle that starts with 1) raising of funds from committed investors 2) the investing of those funds into potentially high yielding ventures 3) the monitoring of these new ventures such that failure is limited through early intervention by the VC if need be 4) adding value to firms such that the return profile of the new venture is improved and lastly 5) existing out of successful deals and returning capital to their investors.²⁶

²⁵ Shepherd DA, Zacharakis A, Baron RA. 2003. VC's decision processes: Evidence suggesting more experience may not always be better. *Journal of Business Venturing* **18**: 381-4014

²⁶ Maunula, M, "The perceived value-added of venture capital investors. Evidence from the Finnish biotechnology industry." ETLA, The Research Institute of Finnish Economy, 2006, p86.

The figure below illustrates alternative venture capital investment processes derived by Tyebjee and Bruno (1984), Fried and Hisrich (1994) and Klonowski (2007)

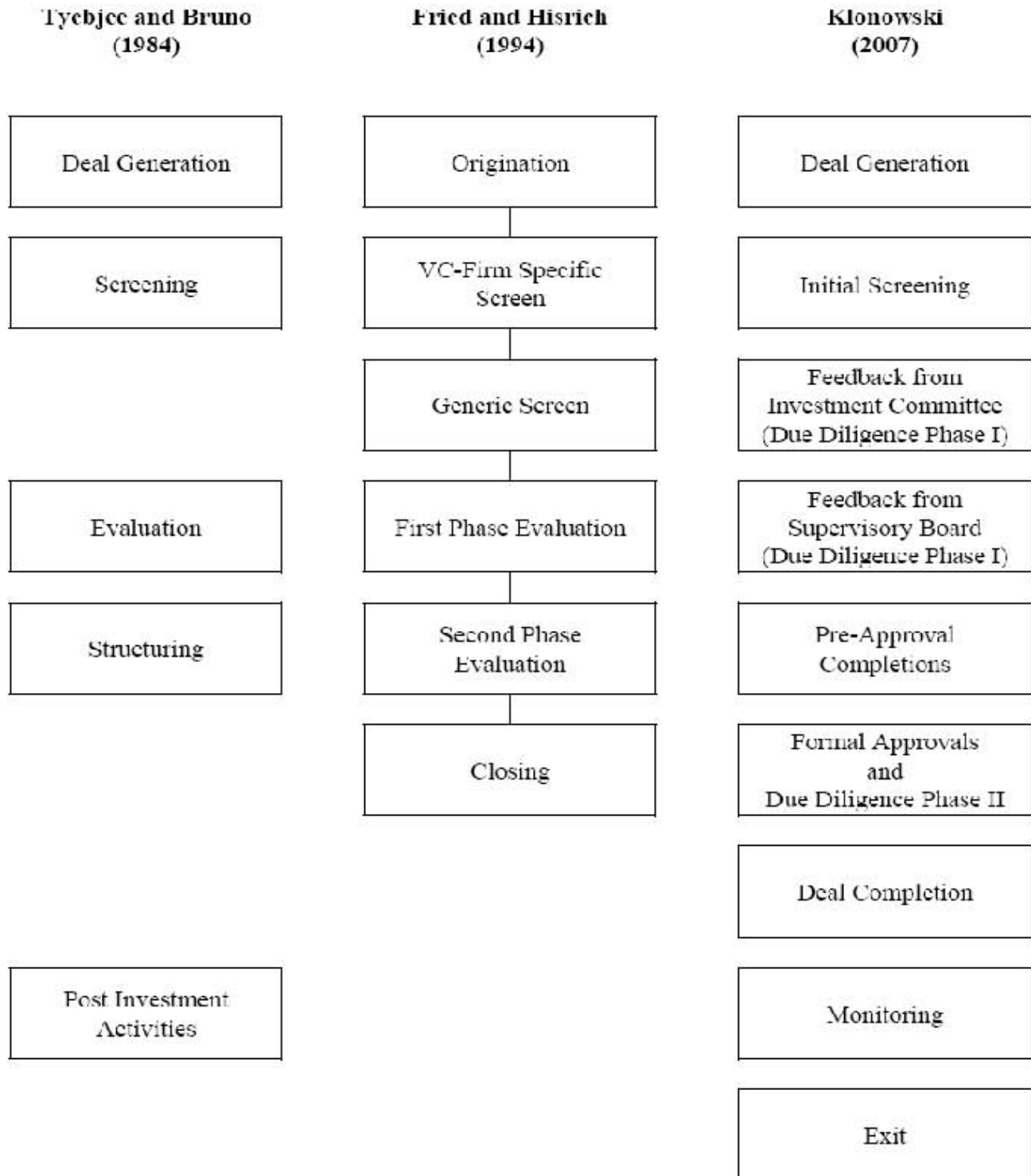


Figure 1: Comparison of various models of the venture capital investment process

While not all VC firms follow the same steps, the main stages of the venture capital process are as follows: deal origination; initial screening; due diligence; pre-approval completions; formal approvals; deal completion; monitoring; and exit.²⁷

The following section further articulates the different stages in the investment decision process.

Deal origination. The ability of a VC firm to access information regarding the high-quality investment opportunities, or the deal flow, is essential. In order to maintain this access to information, firms rely on their relationships with investment bankers, brokers, consultants and lawyers to generate qualified leads on deals, and also count on referrals from firms they have successfully dealt with in the past. Venture capital firms also contend directly with other agents such as investment advisory firms or brokerage houses to find appropriate potential new ventures. Some of the most used deal producing techniques include self-generation, and direct marketing, this is where the venture capital firm concentrates on generating deals in their predetermined size range, industry, stage of development, etc.²⁸

New ventures generally approach the VC firm with what is known as an investment proposal or a business plan. Business plans of proposals can be received in three ways; through the venture capitalists directly, through indirect sources such as the investee firm contacts; or through the office without any direct intervention or also known as an unsolicited proposal.

^{27, 35, 36} Klonowski D; “*The venture capital investment process in emerging markets Evidence from Central and Eastern Europe*”, International Journal of Emerging Markets Vol. 2 No. 4, 2007 pp. 361-382

When a proposal or business plan is received, the managing director or chief operating officer assigns the investment proposal to a venture capital practitioner in the firm. The practitioner at this point usually makes an initial assessment about the attractiveness of the deal and its suitability to the venture capital firm. Some firms have restriction with regards to the type of investments that they are allowed to accept, some of these restriction might include only investing in specific sectors or not allowed to invest in ventures that produce or are associated with or produce military equipment, alcohol, tobacco, etc.²⁹

At this stage any meeting that is held between the firm and an entrepreneur that is considered to eventually turn into a prospective project, is recorded in an initial report. The report is then usually distributed to the rest of the investment team prior to an internal meeting, often called a deal meeting. Once the deal meeting has been convened, the practitioner will then present the proposal to the rest of the team. At this point a decision is made whether to continue with further steps or to reject the project. If the proposal is given a “proceed” decision, and if the investment is to be syndicated, an agreement is reached among the participating venture capitalists on what steps are to be implemented by the individual leading the deal.”³⁰

Screening. A key aspect to the initial screening is aimed at locating potential “deal breakers” as quickly as possible in the investment process. The process is meant to investigate the attractiveness of the underlying investee firm or its commercial proposition. In order to sift out the majority of proposals; venture capitalists use a process recognized as screening. At this point the VC will dispose of those proposals that are deemed incapable of achieving the required investment criteria or that have been previously unsuccessful in certain sectors.

³⁰, ³⁸, ³⁹ Klonowski D; “*The venture capital investment process in emerging markets Evidence from Central and Eastern Europe*”, International Journal of Emerging Markets Vol. 2 No. 4, 2007 pp. 361-382

At this point, the aim of the process is to eliminate those proposals that seem generally without prospect. A considerable amount of proposals are discarded during this stage of the process for a variety of reasons, however the initial deal size is an important consideration at the screening phase. As little as 10 to 15 % of business proposals surpass the screening phase. The opportunities that pass the initial screen will be appraised further with the comprehensive due diligence.³¹

An initial assessment is done on all the commercial areas of the business such as the management, the product being presented, the market that the venture is operating in, the competition, the new ventures finances and the ventures potential IRR. This is done as swiftly and with minimal cost to the firm as possible. The reason why this part of the process can be done at minimal cost and fairly quickly is because the initial assessment is carried out on the basis of obtainable information, which is the business plan from the investee firm and the internal “knowledge base” of the venture capital firm. Another reason why this step in the process can be done with minimal cost and fairly quickly is that usually those practitioners chosen to the team are likely to have pertinent industry experience and are capable of making an informed assessment without devoting a considerable amount of time to the process.³²

An important factor at this stage is the likelihood of closing the deal. In order for the firm to assess the probability of closing the deal, preliminary discussion is held with the new venture founders concerning the basic terms order to complete the deal. This dialogue is typically held early in the investment process in order to assess the odds of closing the deal and also helps in highlighting any potential “deal breakers” early in the process. The critical areas of discussion are usually related to exit provisions, issues relating to corporate governance, and conditions or events that could potentially lead to modification of control such as “voting flipover events”.

^{32, 41} Klonowski D; “*The venture capital investment process in emerging markets Evidence from Central and Eastern Europe*”, International Journal of Emerging Markets Vol. 2 No. 4, 2007 pp. 361-382

It must be understood that the screening stage of the process can be differentiated from subsequent evaluations. Firstly, there are no costs incurred at this stage, whereas a due diligence can be a costly affair and, secondly the firm has limited contact at this stage with the investee firm.³³

Although the majority of venture capitalists will conduct a screening, there is no single best approach to screening since each firm has to decide what is critical to its fund and what types of deals will fit. Fit is often described by the stage of the business, geographic region, size of the deal, and the industry sector. In screening for a high quality deal there are a few extra areas of focus. Therefore most firms screen based on investment fit and investment potential.³⁴

Investment Fit – Refers to whether the initial proposal is aligned with the investment philosophy of the firm. VC's can be categorized as either generalist or specialist depending on their investment strategy. Generalists, generally invest in various industry sectors, geographic locations, or different stages of a company's life, whilst specialists, concentrate on investing in one or two industry sectors, or may seek to invest in only a localized geographic area.

- **Stage** – Not all VC firms invest in “start-ups.” A lot of firms will invest at different stages of the business life cycle from seed, to early, or even late stage. A firm may choose to invest in a business when there is only an idea; before a product or company is formed. This is recognized as seed investing. Early stage investors may supply capital to a company in the initial or second stages of the business life cycle. Some VC firms prefer to invest during the late stages of the business development cycle to assist the growth of a company towards exit. Finally, buyout investing might assist management or an outside party to obtain control of a firm.³⁵

³⁴, ⁵¹ Nelson H, et al; “*Note on due diligence in venture capital*” (2004)

• **Geography** – Frequently firms choose to invest in opportunities that are in a local geographic area. The reason behind a geographic inclination tends to simply be a desire to simply manage the investment. The investors will require to spend time with the management of the company regarding strategic business decisions, in addition to the other investments in the firm’s portfolio. If the investment is situated within the firm’s “region,” it saves time in attending meetings, monitoring the investment, and visiting the management team. Furthermore location may afford access to resources such as a high quality labor pool, top legal firms, or other needs of a developing business.³⁶

• **Size** – Venture firms will often establish a minimum and / or maximum amount that they like to invest. There are numerous reasons for establishing the range of investment. The lower bound is frequently associated to the requirement for the investment to be big enough to justify the participation of the firm. The firm does not want to dilute their time over a lot of small opportunities. Also the minimum amount could be a result of the size of the fund and the need to put a sufficient amount of capital to work. The maximum amount is frequently correlated to the size of the fund as well because the venture firm wants to ensure that the fund remains sufficiently diversified.³⁷

• **Industry Sector** – There are venture firms that will be largely diversified and will invest in industry sectors as varied as information technology, life sciences, and consumer goods, and others that may concentrate in only one technology. While technology investment constitute the majority of the investments, venture firms also invest in companies such as retail, manufacturing, business services, etc. It is nearly impracticable to maintain the knowledge and skills necessary to understand all industry sectors, thus every investment opportunity. Therefore, discipline is necessary to make sure that firms focus on sectors that they understand, or solicit consultation, to maximize their potential for success.³⁸

³⁶, ⁵³, ⁵⁴ Nelson H, et al; “*Note on due diligence in venture capital*” (2004)

Investment Potential – As soon as the proposal has been judged to “fit” with the philosophy of the firm, a screening is conducted to test the feasibility. Despite screening as a mechanism being distinct to a particular firm’s needs, there are some common threads that a firm evaluates.

- **Management** – Generally speaking, one of the most main criteria in the screening process is the quality of management. In real estate it is often said that the three most important words are “location, location, location.” In evaluating a business, numerous venture firms will assert that the three most imperative words to be “people, people, people.”³⁹

Typically VCs’ seek high-energy, driven founders who are aware of the benefit of building a world class organization. One of the reasons that venture capitalist place so much importance on the quality of management is because they know that the environment will change. Management will need to react to competitive pressure, changing customer needs and demands, new rules, and other dynamics. Making the right tactical and strategic decisions will be critical for a company’s success.

Venture firms want to be sure that the management team is up for the challenge. Venture firms realize that management teams may often be incomplete. This is not a show stopper. The focus then turns towards understanding the access to key resources and / or the ability to attract the necessary talent.⁴⁰

Some of the factors that are examined are:-

- Who are the founders and what are their backgrounds?
- Do they have relevant experience?
- How well do the individuals function as a team?
- Do they have a track record of success?
- What critical resources do they have access to?

³⁹, ⁵⁶ Nelson H, et al; “*Note on due diligence in venture capital*” (2004)

- How well do they evaluate risk?
- Are they detail oriented?
- Do they exhibit a capacity for a sustained effort?

• **Market** – It is no secret that venture firms are looking for large, high growth markets. In fact, it would be surprising to see a business plan that does not suggest a significant market. The ability to clearly articulate why a particular business proposal will experience rapid market growth is essential. Most vital is being capable to elucidate the competitive landscape. The entrepreneurs must be able to clearly identify their target customers and define strategically how they will reach them. In addition it is essential that the competitive landscape is mapped out and action plans developed to minimize competitive threats.⁴¹

Some of the questions asked with regards to the market are:-

- Who are the users of the product and how many of them are there?
- What are the drivers that are fueling the growth?
- How is the company positioned against competitive threats?
- Describe the competition.
- Is, the customer, the supplier, and / or the competition fragmented?
- Are there attractive substitutes?
- What regulations govern this market space?
- What are the barriers to entry?
- What is the distribution channel and who controls it?
- What are the market boundaries?⁴²

⁴¹, ⁵⁸ Nelson H, et al; “*Note on due diligence in venture capital*” (2004)

• **Product / Service** – The key to evaluating a product or service is to ask, “What customer problem is being solved?” Once an understanding of the solution is clear, the next question is, “Can the problem be solved profitably. The companies must describe how their product / service will deliver value to the customer and cannot be easily replicated by the competition. A platform that can be easily modified to meet changing market needs and stay ahead of the competition is important. In addition scalability becomes important to the financial success of the venture.⁴³

With regard to the product or service the venture capitalist will inquire about some of the following criteria:-

- What customer problem is being solved?
- What unique technology and / or knowledge does the company have?
- How does this technology and / or knowledge create value for the customer?
- Why is this product or service superior to the competition?
- Are there any strategic relationships?
- Does this product exhibit scalability?
- What are the barriers to enter? IP protection?⁴⁴

• **Business Model** - Simply put, how is the company going to make money, and how will it operate over time? As noted earlier, there is much discussion in the industry about “pattern recognition.” Does the business model appear similar to other proven models? Identifying analogous business models is not a requirement, there are obviously new models developed every day, but the venture firm will be more comfortable if they can identify with proven success.⁴⁵

⁴³, ⁶⁰, ⁶¹ Nelson H, et al; “*Note on due diligence in venture capital*” (2004)

In examining the business model of the venture, the following criteria will be assessed:-

- How will the company sell its product or services?
- How will the customer perceive value?
- Are there comparable companies to benchmark?
- Who are the key market influencers that the company needs to target?
- What are the financial requirements, ie capital investment, cash, etc.?
- Is the business model scalable?
- What is the potential for recurring revenue?
- What are the anticipated margins?
- What is the exit strategy? Is it feasible?⁴⁶

Evaluation. Once the proposal has cleared all the initial screening hurdles, proposals move onto another stage where they are more heavily scrutinized. Information included in the provided documents is confirmed and financial forecasts are investigated. Further sources of information are contacted such as the company's key employees, the venture existing customers, suppliers, and creditors. Though the general objective of this due diligence process is to gain a thorough understanding of all business aspects, the focus of investigation may vary from deal to deal. The venture capitalist's professional experience is crucial to the general effectiveness of the evaluation process.⁴⁷

At this stage the investment committee and or the supervisory board will get involved. They will present their view on the business concept and the sector or industry at this time. The members also list their concerns related to the deal. Once the investment committee and the supervisory board are satisfied, a more intense interaction is had with management and founders/entrepreneurs.

⁴⁶ Nelson H, et al; "Note on due diligence in venture capital" (2004)

⁶³ Klonowski D; "The venture capital investment process in emerging markets Evidence from Central and Eastern Europe", International Journal of Emerging Markets Vol. 2 No. 4, 2007 pp. 361-382

Due diligence. The due diligence refers to a rigorous examination and evaluation of an investment opportunity before committing funds. The due diligence process is intended to reduce the investors' risk by comprehending the issues and challenges entrenched in a business proposal. Fundamentally this process is similar to the screening process in that it involves asking and answering a series of questions, the difference however is that it is done at greater depth. This data is used to decide if the deal warrants further contemplation in moving to the next phase of the process, valuation and deal structuring.⁴⁸

The due diligence process involves the assessment of management, the industry the new venture operates in, historical and projected financial data, the firm's products and services, competitive positioning and strategy, and other issues, in a more concentrated manner. During this stage, a list of key commercial and deal issues is redrafted. This list is revisited throughout the due diligence process. The list forms the basis for the development of a more comprehensive due diligence plan implemented later in the process and the formulation of key terms in the deal or if need be, the nature and type of protections required given what could potentially go wrong with the business.⁴⁹

At this point the VC also plans a budget for an external due diligence, generally including accounting, legal, and environmental investigations. The accounting investigation focuses on auditing the historical financial data over the last 12 or 18 months, identifying off-balance sheet liabilities, and commenting on the adequacy of the internal processes in the accounting department. The legal investigation is an audit of all legal matters and is related to the legal title to the assets, the agreements with external parties such as consumers, suppliers, and financial institutions, the proper constitution and proceedings of the investee firm, and related-party transactions.

The environmental investigation relates more to manufacturing firms and generally focuses on waste management. Industry experts may be included to participate if the VC team lacks depth or experience in some specific areas. Typical VC firms expend 1.7 percent of the invested value on external due diligence.⁵⁰

A generic “term sheet” or “heads of terms” is developed internally by the VC and this is often used as a starting point in the formulation of deal-specific terms and criteria. The VC reiterates the main points of the due diligence results in a full report. This report is often called the investment memorandum, deal qualification memorandum, or deal memorandum.

Once negotiations of the major deal terms have been completed and the term sheet has been signed, this document is then forwarded to the investment committee for its first formal approval. The term sheet illustrates to the investment committee that in principle the deal is acceptable and that major areas of commercial investigation have been checked.⁵¹

After conducting the external due diligence, a report which contains the findings from the external due diligence is sent to the investment committee. In this document, VC practitioners make recommendations on whether the findings form the basis for any re-negotiation of terms and whether the due diligence accurately reflects the preliminary assessment made by the investment team. This is to ensure that there have been no new material findings. The investment committee discusses the document and a decision is made on whether to proceed, reject, or re-negotiate.⁵²

^{50, 48} Klonowski D; “*The venture capital investment process in emerging markets Evidence from Central and Eastern Europe*”, International Journal of Emerging Markets Vol. 2 No. 4, 2007 pp. 361-382

^{44, 45, 46} Klonowski D; “*The venture capital investment process in emerging markets Evidence from Central and Eastern Europe*”, International Journal of Emerging Markets Vol. 2 No. 4, 2007 pp. 361-382

If further discussions or re-negotiations are needed with the founders or entrepreneurs, the lead VC will proceed with such negotiations. VC's in may in some instances submit a budget which relates to the finalization of the transaction to the investment committee. This expense generally relates to incurring legal costs for converting the initial term sheet into binding legal documents. It is estimated that VC's generally have to produce at least 20 different pieces of documentation for review by internal team members or by the investment committee and the supervisory board. This undoubtedly highlights the extraordinary scrutiny that VC firms are subjected to by their capital providers, which are the chiefly the limited partners, this also reflects the perceived high level of risk that capital providers anticipate in the VC market.⁵³

Deal structuring. If no major issues are uncovered in the due diligence process, the venture capitalists will proceed to negotiating the deal. Several studies have focused on the degree of control exercised by venture capitalists and these studies confirm that venture capitalists enjoy a disproportionately large degree of control. The academic literature relating to venture capital contracting is significant. Kaplan and Stromberg (2003) have done work which provides a comprehensive explanation and description of the basic rights that are generally found in venture capital contracts. Chan et al. (1990) describe the salient features of venture capital contracting, Their work also includes analysis work done on the inability of entrepreneurs to walk away from the business.⁵⁴

Post-investment activities. The reason for active involvement of VC's in their portfolio companies revolves around the fact that there is significant information asymmetry and an extended period of illiquidity. Any information asymmetry venture capitalists face can cause significant agency risks.

⁵³, ⁶⁵, ⁶⁶ Klonowski D; "The venture capital investment process in emerging markets Evidence from Central and Eastern Europe", International Journal of Emerging Markets Vol. 2 No. 4, 2007 pp. 361-382

An extended period of illiquidity, in turn, can result in a questionable exit scenario and relatively poor returns. In order to reflect current market conditions and changes in business opportunity, business plans, operational goals, and shareholder agreements need to be regularly evaluated and revised, from time to time, after the initial deal is closed.⁵⁵

Achieving an exit, or divestment, is the most critical of the post-investment activities. An exit from a portfolio company or investment is driven by a venture capitalist's need to generate a profit for their capital providers and partners. An exit can be achieved through two common paths, the first is an initial public offering (IPO), and the second is a trade sale to strategic investors. Regardless of which option is selected to exit the investment each exit option has a different outcome for both venture capitalists and entrepreneurs. Generally, investee firms favor the IPO route because this has the added benefit of preserving the independence of both the firm and the entrepreneurs, and further it still gives the investee firm continued access to much needed capital.⁵⁶

Admittedly the generic model is not without its shortcomings. Firstly, the model in its' current form, is unlikely to be fully compatible in situations where the venture capital firm participates in privatization deals or tender processes. In these types of circumstances, while the initial stages may ultimately be the same, the venture capital firm may be faced with a situation where they have limited windows of time to conduct full internal or/and external due diligence. In such circumstances, the venture capital firm's internal approvals would almost certainly need to be agreed upon prior to the initial screening process. A second potential short coming of the model could be the fact that the research that has generated this model is based on venture capital firms that have been in operation for at least five years or longer.

^{56, 68} Klonowski D; "The venture capital investment process in emerging markets Evidence from Central and Eastern Europe", International Journal of Emerging Markets Vol. 2 No. 4, 2007 pp. 361-382

It is possible that newcomers would likely go through different phases as their processes are less mature and refined. In fact their processes might perhaps have even more rigorous phases of due diligence and consultation with their internal approval units. This would most definitely alter the generic model and likely extend it and create more stages in the investment process.⁵⁷

5. South African Literature Review

Frese, M and de Kruif, M, focus on psychological factors of entrepreneurial success in Africa, they mention that micro and small scale entrepreneurial owners are important contributors to the economies of developing countries. While it has been shown in western countries that small scale entrepreneurs are an important force for economic development, innovation and flexibility, they are even more important in developing countries. They go on to mention that the general theory of entrepreneurship has to be placed in the context of African cultures (Kiggundu, 1998). Cultures have an influence on all processes that are related to entrepreneurship, relations with employees, and what is regarded as success. One of the first successful attempts to understand culture was presented by Hofstede (1980, 1991), he distinguished five dimensions of culture: power distance, individualism, masculinity, uncertainty avoidance, and Confucian dynamism. His study was based on IBM employees. Hofstede distinguished east, west and South Africa in his study.

Pretorius, M and Shaw, G (2004), in their paper “ Business Plans in Bank Decision-Making when Financing new Ventures in South Africa “ suggest that in many cases, lack of finance is cited as a reason for business failure and non start-up. In South Africa, lack of financial support is the second most reported contributor to start-up failure, after education and training (Orford, Wood, Fisher, Herrington & Segal, 2003: 17).

Nieuwenhuizen (1999: ii) reports in a comprehensive study the criteria to be used for financing of small industrialists. These include seven success factors associated with the

personal characteristics of the individual (perseverance, commitment to and involvement in the enterprise, willingness to take risk, sound human relations, creativity and innovation, and a positive attitude and approach) and ten factors that relate to functional management skills (planning of the enterprise, knowledge and skills relating to the enterprise, the use of experts, client service, knowledge of competitors, market orientation, concern for high quality work, bookkeeping for own benefit, financial insight and financial management). Of these 17 success factors financiers use only eight for evaluation in general.

Watson, G (2004) in his paper “A situational analysis of entrepreneurship mentors in South Africa” suggests that mentorship could be a possible solution for the large number of unsuccessful new ventures in South Africa. He goes on to mention that The GEM 2001 survey highlighted several factors that influence entrepreneurial performance and sustainability.

These are,

1) Education;- The higher the level of education, the higher the entrepreneur’s chances of creating a successful and durable new venture. The survey suggests that, in South Africa, the education system is generally poor. The lack of education and basic business skills hampers the entrepreneur’s development

2) Entrepreneurial culture. Confidence, innovation, creativity, networking, role modeling and trust are important elements that determine the likelihood of an entrepreneur’s success. These elements are currently lacking in South African entrepreneurs

3) Team. The importance of the entrepreneurial team has been well documented (Timmons 1999:39). In South Africa, however, 61,8% of start-up businesses are started by individuals who operate alone.

Luiz J,(2002) in his article for “the Journal of Applied Business Research” reports that The SMME sector was seen to be facing major obstacles and challenges to their success. These can be classified under seven factors:

Finance - It was generally felt that this is an area which has been significantly addressed and that it has become less of a problem. However, it remains an obstacle and commercial banks were singled out as being far too conservative and risk averse in their lending which, in turn, negated Khula’s efforts.

Labour - Labour legislation was criticised repeatedly for raising the costs associated with employment. Complying with tougher labour laws was a costly exercise. Small and micro-enterprises rely heavily on informal labour contracts so as to keep costs down and this was being challenged by new laws. The SMME sector finds it difficult to attract skilled labour and the cost of unskilled labour was seen as too high.

Trade - Although South Africa has seen significant deregulation in the past decade, some felt that overregulation was still an issue and that licensing, health and safety laws and the like needed to be relaxed.

Tax - The complexity of the tax system raised the cost of doing business because SMMEs do not have the capacity to administer this area and found it difficult to afford accountants.

Procurement - The public sector tendering system was regarded as inaccessible to SMMEs. It was too complicated and tenders were too large for SMMEs.

Infrastructure - This is a particular problem in the townships where inadequate roads as well as electricity and telephone networks hampered SMME development.

Demand - This came up repeatedly as the primary challenge facing SMMEs. The growth of this sector was being stunted by the lack of a steady demand for their products.

He suggests that it is in this area that links with big business (the business linkages as a success factor) have a critical role to play but these are as yet underdeveloped. The reasons given by business revolved around problems of asymmetric information in that there were enormous risks in awarding contracts to SMMEs with limited track records.

Africa,M.(2007) in his research report submitted to the Gordon Institute of Business Science, suggests new business creation is fundamental to the growth of the South African economy and to the future socio-political stability, and hence access to equity funding, education and experience are key elements in successful venture creation.

Timmons (2007) insists that, at the heart of the entrepreneurial process, is the founder, the opportunity seeker, the creator and initiator, the leaser, problem solver and motivator, the strategizer and the guardian of the mission, values and culture of the new venture. He argues that without this human energy, drive and vitality, the greatest ideas, even when they are backed by an overabundance of resources and staff, will fail or grossly underperform, or simply never get off the ground.

Nieman, G, Hough and Nieuwenhuizen C, (2003) go on to suggest that in the South African economy, entrepreneurs are seen as the primary creators and drivers of new businesses and therefore are clearly distinguished as economic actors. Entrepreneurship plays a vital role in the survival and growth of any emerging economy. Due to low economic growth, high unemployment and an unsatisfactory level of poverty in South Africa, entrepreneurship becomes a critical solution.

Olufunso, O.F (2010), reports in his journal article that one of the obstacles to the success of an enterprise is lack of willingness to take risk. Fear of failure and embarrassment prevent people with ideas not to explore them and venture into a competitive stage. However, in order to be successful, new entrepreneurs must gain knowledge on their tolerance of risk (Robinson, 2008). Many young entrepreneurs become risk averse because of their social environment (Kazela, 2009). However, starting a business needs drive and perseverance (Botha, 2006). Crime is also regarded as one of the barriers to

graduate entrepreneurship in South Africa and it is regarded as a major challenge hindering graduate entrepreneurship. Crime causes stress and additional costs for security and this retards the development of emerging markets such as South Africa.

South Africa's crime situation is worrying as it is ranked among the top five highest murder rates in the world together with Colombia, Jamaica, Guatemala, and Venezuela (United Nations Office on Drugs and Crime (2007). High crime rates are a serious challenge to business formation (Arzeni, 2004).

Groenewald, Mitchell, Nayager, Van Zyl, Visser, Train & Emanuel, 2006:25-26), suggest that when the factors that draw people into small business are present in a country, the conditions will be positive for entrepreneurship to do well there. A variety of economic and non-economic, social and personal conditions needs to be present for entrepreneurship to grow – economic conditions include, for example, availability of capital, support from government, financial infrastructure and using new technologies; non-economic conditions include, for example, desire for personal achievement, desire for social contribution, opportunity to improve personal wealth and social status, research and development, good educational system and good infrastructure.

Van Eeden, Viviers and Venter (2003:13) indicate that the estimated failure rate of SMMEs is between 70% and 80% and millions of Rands are being lost on business ventures because of avoidable mistakes and problems. Streek (2001) in Van Eeden et al. (2003:13) indicated that 117 246 small businesses failed during the period 1997 to 2000 and this resulted in a lost of R68 million.

Verhoeven and Smit (2001) did empirical research on the factors influencing profitable growth in small and medium-sized businesses. This research attempted to resolve the research question why some small and medium-sized business grow profitably and others not. They identified that three factors are mainly responsible for a profitable growth in small and medium-sized businesses: the opportunity, the entrepreneur and the resources.

The small and medium-sized businesses experience resource problems and cash flow as the main problems that inhibit profitable growth in small and medium-sized business.

Environmental contributors relevant for entrepreneurship	Speculative perception of the typical South African scenario	Specualtive perception of the typical US scenario
General view towards failure	Bad - shows poor judgement	Good- show perseverance
Achievement motivation	Someone will do it for you	I want to do it myself
Innovation	This is how it works - don't tamper with it	I can do it better. I'll find an alternative way
Locus of control	I can't change the way things works	I am in charge
Risk propensity	Don't make a mistake. Find right answer only. Try win the lotto	There will be more chances if this doesn't work
Energy	Passivity and wait for someone to do it	Fired up to do something yourself
Typical role models	Lack of entrepreneurial role models	Achievers in business and sport through hard work
Aspirations	Don't hurt the other	Make a difference

6. Research Comparison

In the next chapter the author compares the outputs of the generic model, with 1) international research 2) domestic findings and local venture capital firms

It is generally accepted that venture capitalists evaluate potential companies under three broad criteria: the quality of management, a unique product or market opportunity, and potential for capital appreciation. It is also a fact that this evaluation process amalgamates elements of objective information gathering and analysis with the venture capitalist's intuition, gut feeling and creative thinking

Possibly the most significant result from the study is direct corroboration of the repeatedly iterated view that above all it is the quality of the entrepreneur that ultimately determines the funding decision.

The generic model already discussed expands on the three basic constructs identified by Hisrich and Jankowicz (1990). The generic model also has similarities with the model proposed by MacMillan et al. (1985). However the criteria described in the generic model are more clearly defined and are not limited to new technology based investments. While the generic model has many similarities with the model proposed by Tyebjee and Bruno's, there are also some major differences. In Tyebjee and Bruno's work they do not divide the evaluation phase into two parts, rather they show only one phase, with pricing negotiated after that. Their model suggests that pricing is negotiated much earlier in the process than what is commonly expected. The impact of negotiating a price upfront is that the level of VC evaluation activities increases significantly after a price has been settled on.

Although the generic model is not a completely exhaustive model, it does however highlight at least eight different investment criteria that would be considered critical to the success of a new venture.

These being:

- 1) Life stage of the business
- 2) Geography in which the business operates
- 3) The size of the deal
- 4) The industry sector in which the new venture intends to operate in
- 5) The quality of the management team
- 6) The market in which the new venture intends to operate in
- 7) The product or service being offered
- 8) The business model of the new venture

Davidson and Klofsten (2003) have done some work which describes a business platform which has eight firm-level cornerstones. These cornerstones are the business idea, the product, the market, the organization, core group expertise, core group drive/motivation, customer relations, and other relations. In their work they explain that the cornerstones can be divided into the development process cluster, which comprises the idea, the product, the market, and the organization, The second cluster is known as key persons, which comprises the founder or entrepreneur, the CEO (Chief Executive Officer), the board of directors, who have specific expertise and are there for motivation. The third cluster is understood to be the flow of external resources, which comprises the customer and other firm relations.

The process emphasis in Davidson and Klofsten's work appears to capture the inter-dynamic nature of the new venture creation a lot better than just a static list of criteria. It must be noted that the study was tested on young high-tech ventures. With regards to the quality of the management team Oakey (2003) points out that the technical entrepreneur is the acknowledged key catalyst. Kakati (2003) enforces this view by explaining that entrepreneurial quality plays a critical role in the gathering and application of resources. Whilst technical ability may be necessary, sufficiency to ensure success "lies in an ability to develop additional management skills to exploit such expertise". Thus it can be

concluded that the crucial role of the entrepreneur is an amalgam of technical knowledge, managerial capability and something that can only be described as passion.⁵⁸

Davidson and Klofsten also refer to the type of strategy employed. There are two different views which advocate dissimilar start-up strategies in order to gain competitive advantage. The first is the formal strategy led by frameworks such as Porter's (1980) 'Five Forces' model, which analyzes the forces driving the competition within the industry, while the adaptive 'visionary' approach, which was proposed by Mintzberg (1994), concentrates on running the organisation according to a mission, and decisions are reached through learning and experience and are premised on the creativity and intuition of the key personnel in the business. Although Davidson and Klofsten refer to strategy, with regards to the generic model this compares favorably, where the generic model describes the business model as a critical factor. When detailing the business model, strategy would be integral to this description. One of management's most critical strategic choices is whether to compete broadly across many geographic segments or, alternately, to focus on a more limited set of geographic markets. Some research work has suggested that a broad strategy is more appropriate for high growth markets and a focused strategy whilst penetrating a mature market, whilst others advocate focusing on the early stage of products.⁵⁹

Previous research work has identified strong market orientation, which is described as a market driven and a product which is customer focused, as a key success factor for new products. Market-oriented businesses usually aim to understand the customers' expressed and latent needs and develop their businesses by delivering superior solutions to meet these needs. A potential negative for those market oriented businesses is the over-emphasis of current customer needs, and this may potentially lead to overlooking future products and growth opportunities.⁶⁰

⁵⁸ Chorev S, et al "Success in Israeli high-tech start-ups; Critical factors and process" The Robert Gordon University, August (2005)

There is however a disparity amongst academics regarding the significance of market attractiveness. Research proposes that the market must be preferably large and growing quickly, hence the venture must consider market size, intensity of competition, revenue (and margins) potential over five years and potential customers. Researchers have found that markets growth and size are often highly positively correlated with new product success. But conversely, Stuart and Abetti (1987) found a strong negative correlation between success in young technological companies and market attractiveness. Their study shows that companies entering smaller and slowly growing markets were doing better than those in the larger faster growing markets. This may be due to lower level of competitiveness and the avoidance of head on competition with large and strong organisations. Nonetheless, there is broad agreement that expertise in marketing activity and marketing effectiveness of the new product diffusion are critical for new products success.⁶¹

The literature suggests that the product must meet a market need. Development of new technology, or being first to market, does not necessarily determine success. The issue of what the market wants and needs thus requires a combination of marketing and technical skills. Moreover, the importance of buyer/seller relationships, particularly in improving the new product development process, is a growing area of study. The pace of environmental change requires start-ups to be managed, not only by skilled managers, but also by a team capable of managing changing markets. It has been demonstrated that founders of successful high-tech ventures tend to form larger, more complete teams. Thus a diversified management team, in which technological expertise coexists with business skills in other key areas such as marketing and finance, is recognized as a deciding factor for success in high-tech start-ups.⁶²

Again the model is agreeable with regards to the size of the deal, or the size of the funding required. Most start-ups raise seed funding then raise additional rounds of capital

^{61, 74} Chorev S, et al "Success in Israeli high-tech start-ups; Critical factors and process" The Robert Gordon University, August (2005)

until exit or acquisition; most successful high-tech start-ups eventually become public or are procured by a bigger company. Funding is thus the oxygen of start-ups. (Lerner 2005)

In a study carried out by Jason Camp [2002] although the criteria methodology was applied, the criteria used to assess the viability of a new venture are very different from previous studies. Another departure from previous studies is that the criteria used do not directly describe the quality of the new venture, but indirectly inform the venture capitalist of the actual quality of the new venture. For example Camp, examines the quality of other equity investors, quality of the legal counsel whether the deal has been shopped to other venture capital firms as indicators of the quality of the new venture.

A simple and yet effective screening criteria, which is used by many venture capitalists is to scrutinize the routes from which deals are generated. It is common practice for VC's to overwhelmingly favour those deals that have been referred to them by "trusted" sources. The reason why VCs' prefer to adopt this approach is that they usually know more about the quality of the source itself. It thus makes sense for them to use the quality of the source of the deal as a rough proxy for the quality of the actual deal.⁶³

Although the process of assessing the supplier of the transaction as a proxy for the quality of the deal is not copious in the literature, in reality this is a tool that is engaged in by many VC's. Camp (2002) goes further to suggest that the quality of the overall appearance of the transaction, attention to the level of detail, the clarity of the business model, coherence of the business idea, and how focused the business idea is presented, often conveys a lot about the quality of the investment opportunity itself.

Camp (2002) also goes on to suggest that the quality of the other equity investors who are participating in the deal is a key criterion. Although the generic model does go on to address this issue, syndication, which is where VCs' join together on a deal, is a growing area of research. Syndication has the impact of lowering the overall risk on the deal. Collaboration on a deal gives the investors comfort on the overall risk because alliance on

⁶³, ⁷⁶ Camp, Justin J. (2002) "Venture Capital Due Diligence: A Guide to Making Smart Investment Choices and Increasing Your Portfolio Returns", Published by John Wiley and Sons, New York

the deal acts a signal, where all participants are aware that the other investors would have also done their own assessments of the deal and have decided to participant.⁶⁴

It is also common practice for venture capitalists to focus on the quality of existing equity investors and potential current round co-investors as a screening mechanism. This is done for two reasons. The first reason is that an impressive investor list is often indicative of a good investment. Secondly, high quality investors often contribute significantly to their company's success. Simply put, great companies attract high quality investors. Equally, a company's inability to find any high quality investors suggests that an investment may not be a very promising one.

Depending on the particular investors, they may provide any or all of the following to their portfolio companies: general business knowledge, finance knowledge, technical expertise, entrepreneurial experience etc. Equity investors may also bring to their portfolio companies extended networks of contact firms, public relations, customers etc.⁶⁵

Similar to assessing the quality of existing investors VCs also tend to examine whether and to what extent, existing equity investors are willing to participate in the current round of financing. A failure to participate in the current round of financing to support the company may dramatically reduce interest on the part of the other venture capitalist. This is because generally existing investors in many cases have unique information about the companies in which they hold equity. A more important factor is that the existing investors almost surely have more high quality information than that available to potential investors, even after a thorough due diligence process has been embarked upon. Consequently if the existing investors decide not to partake fully in subsequent rounds of financing, this may possibly signal that there are problems that are not visible to potential investors.⁶⁶

⁶⁵, ⁷⁸ Camp, Justin J. (2002) *Venture Capital Due Diligence: A Guide to Making Smart Investment Choices and Increasing Your Portfolio Returns*, Published by John Wiley and Sons, New York

Another area that the model does not cover is the role of support systems and processes which are needed to support the venture such that it becomes successful. Camp (2002) suggests that successful early stage companies usually need good legal advice. Camp explains that the road from start up of a new venture through high growth to eventual successful maturity is fraught with such hazards that to forge ahead without a high quality and appropriately experienced law firm on board, is ultimately detrimental. Those companies that receive sound quality legal counsel increase their likelihood of success. Serious legal mistakes in the start-up and growth phases of a new venture can acutely jeopardize a company's ultimate value. Furthermore, law firms have the added benefit of being able to provide other services, such as recommendations with regards to the business plan, advice relating to financing strategies etc, receiving this type of assistance from knowledgeable and well connected lawyers can also have the affect of boosting a company's likelihood of success.⁶⁷

A further signal and a screening mechanism for most VCs', and one which is not addressed in the generic model is whether the deal has been "shopped" around or not. Venture capitals generally keep away from shopped deals. Shopped deals by their definition have been reviewed and rejected several times by many other VC firms. However it must be noted that in order to come to this conclusion, the VC must have formed a positive opinion or trust the work of the other VC participants that have already declined the deal. If a particular venture capitalist trusts the business and investment judgment of another investor who rejected the deal, it would make no sense to then negate the work done by the other participants and not rely on the latter's negative due diligence. However, rejecting a deal solely because it was shopped, without finding out "who" rejected the deal and why it was rejected, could result in the venture capitalist missing a great opportunity.⁶⁸

⁶⁷, ⁸⁰, ⁸¹ Camp, Justin J. (2002) *Venture Capital Due Diligence: A Guide to Making Smart Investment Choices and Increasing Your Portfolio Returns*, Published by John Wiley and Sons, New York

A factor that is aligned with the generic model is geographic compatibility. The location of a new venture can have significant ramifications for the company's long term success. One reason is the actual distance away from the portfolio company means that the venture capital has less frequent contact with the management of the company and thereby curbing the significant value from the monitoring process. Another reason is if a company is situated in a place that doesn't have the necessary infrastructure; it is unlikely that the venture capitalist will invest.⁶⁹

In an attempt to rank the importance of different criteria, in an international study a questionnaire was used and the respondents were asked to grade each of the 15 topics and its associated parameters on what is known as a Likert scale of 1-7, where 7 was qualified as the most important, and 1 the least important. Respondents were also asked questions about details of the topics and to discover any additional issues.⁷⁰

Table 1 presents the findings of the ranking. When assessing the results of the international study, the most informative aspect of the data was the relatively high ranking that was placed on the team criteria. Team Commitment was ranked the highest, with the constituents of that segment i.e core team motivation and core team associations with goals, making up the highest contributors. The team expertise was ranked 4th, marketing ranked the second most important criteria followed by customer relations in 3rd. These results support the current literature which suggests that the entrepreneur and his team are the most important criteria when considering a new venture.⁷¹

⁷⁰ Chorev S, et al "Success in Isreali high-tech start-ups; Critical factors and process" The Robert Gordon University, August (2005)

⁷¹ Chorev S, et al "Success in Isreali high-tech start-ups; Critical factors and process" The Robert Gordon University, August (2005)

	Mean	SD		Mean	SD
Idea	5.89	1.240	Strategy	6.00	1.140
Idea formulation	5.87	1.390	Mission statement	5.30	1.555
Idea meets customer needs	6.27	1.136	Industry analysis	5.99	1.138
Core team expertise	6.13	1.018	Strategy clarity	5.09	1.487
Team diversified experience	5.95	1.142	Strategy update	5.82	1.295
Team former experience	5.04	1.490	Core team commitment	6.47	.936
Team leadership capacity	6.32	1.183	Core team association with goals	6.46	.921
Consultants	5.24	1.478	Core team motivation	6.58	.919
Investors' contribution	4.64	1.450	Marketing strategy	6.17	1.088
Organization	4.95	1.327	Market expertise	6.03	1.240
Employee definition of responsibility domains	5.08	1.238	Marketing plan	6.01	1.051
Few organizational levels	5.19	1.368	Marketing research	5.08	1.457
Customer Relationship	6.15	1.110	Market growth	5.22	1.324
Customer needs	6.15	1.167	New market standards	4.78	1.533
Customer buying behavior	6.16	1.126	International market penetration	5.69	1.252
Feedback implementing	6.15	1.167	Market dynamics	5.75	1.286
Market receptivity	6.11	1.173	Patents registration	5.36	1.751
Continual sales	5.53	1.588	Perceived utility	6.34	1.120
Management in general	6.05	1.250	Distribution channels	4.63	1.538
Management style	5.27	1.588	Product positioning	5.56	1.383
Team solidarity	5.99	1.204	Marketing R&D relationship	5.96	1.265
Employee development	5.63	1.300	Main market penetration	5.92	1.285
Networking in general	5.46	1.241	R&D capability	5.95	1.038
Complete solution	5.36	1.485	Technological manpower availability	5.78	1.141
A gadget	4.64	1.455	Defense technology and infrastructure	4.23	1.806
Complete product	5.39	1.561	Development team	5.95	1.161
Cooperation in R&D	5.31	1.528	Innovation level	5.70	1.358
Cooperation in marketing	5.71	1.426	Technological breakthrough	5.34	1.353
Funding Type	5.31	1.303	Easiness of adaptation	5.55	1.341
Political situation	4.34	1.553	Product quality and durability	6.12	1.256
Political environment	4.39	1.658	Product price	5.71	1.346
Security situation	4.26	1.708	Time to market	5.41	1.480
General Environment	4.96	1.219	Economic Situation	5.43	1.271
Military service	4.45	1.730	Global economy	5.63	1.340
Entrepreneurship education	4.85	1.387	Domestic economy	4.79	1.586
Availability of skilled workforce	5.64	1.259	Availability of financial resources	5.82	1.246
Government support	4.89	1.420			
Cultural and social norms	5.18	1.325			

Table 1: Ranking of criteria

Other criteria that were judged to be significantly important were Strategy 6.0, R&D 5.95 and Idea 5.89 complete the list of the top eight topics which formed the group of high effect factors on start-ups success. The following seven topics, starting with Networking at 5.46, were ranked much lower and are perceived to belong to the second group, deemed to have a relatively lower impact. Thus the team's characteristics appear in this part to be the most important set of factors for start-up success.⁷²

⁸⁴, ⁸⁵ Chorev S, et al "Success in Israeli high-tech start-ups; Critical factors and process" The Robert Gordon University, August (2005)

This literature highlights the often reiterated position that a good team is more likely to be successful and that the actual product itself is of less importance. Furthermore the data suggests that a good team is likely to succeed even in poor economic, environmental and political circumstances. To obtain better discrimination between topics, respondents were asked to focus on ranking the topics. They were asked to classify the topics into one of three groups, very important, important and less important and afterwards to rank the topics within each group. The final part of the study involved asking half of the respondents to comment on the results of the general survey (Delphi method).⁷³

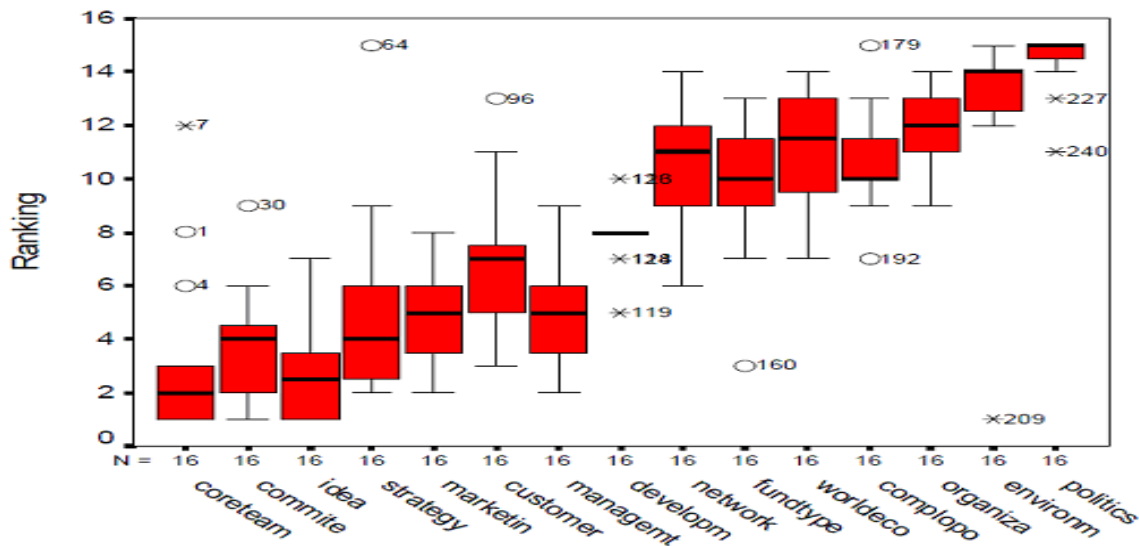


Figure 2: Delphi ranking of the validity of responses

The results of the Delphi process are depicted in figure 2. The box shows the answers in the 2nd and 3rd quartiles and the bold line is the median of the results. The Delphi results again emphasise two distinct groups; the first containing the seven topics with high importance and the second with seven topics perceived as having lower effect with development (R&D) providing a buffer between the two groups with strong indications it belongs to the first group. Whilst it is acknowledged that the Delphi method does have the effect of averaging responses, it also lends support, as expert confirmation, of the critical importance of the top rated factors.⁷⁴

⁷⁴ Chorev S, et al “Success in Isreali high-tech start-ups; Critical factors and process” The Robert Gordon University, August (2005)

Figure 3 is a summary of the rankings.

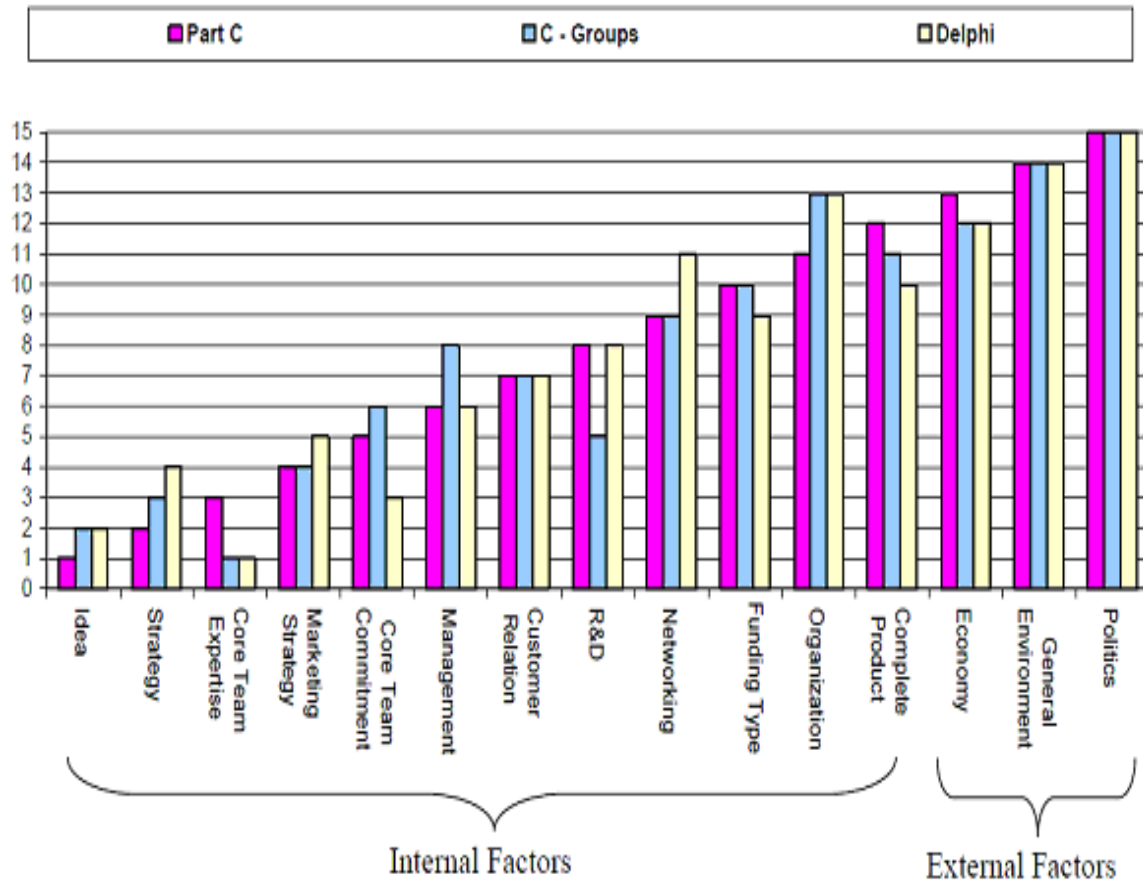


Figure 3: The respondents ranking of the topics⁷⁵

Whilst the above analysis illustrates that there are some minor discrepancy with regards to the relative ranking of some of the critical components, it do however demonstrate a general broad trend of agreement about the relative importance of the different topic areas. The primary group consists of 8 topics deemed of highest importance and 7 topics of the secondary group with a lower impact are clearly delineated. In the Delphi ranking, there are five topics which are deemed to be very important and are ranked at the top. This implies that all features associated with the core team (commitment and expertise), the idea, strategy and marketing are considered critical for the new high-tech venture. Customer relationship, management and R&D also belong to the high impact group. Less important topics are networking, funding type, the economy, the complete product and

⁷⁵, ⁸⁸ Chorev S, et al “ Success in Israeli high-tech start ups; Critical factors and process” The Robert Gordon University, August (2005)

the organization, while the external factors of general environment and political situation are ranked at the bottom and apparently have the lowest influence on the fate of the start-up.⁷⁶

A clear result from the work done with regards to the decision-making criteria applied by VCs, is that the VCs' attention is indeed very much focused on the entrepreneur, what type of personal and professional characteristics they are equipped with and their commitment to the business idea. Additionally, VCs tend to carefully assess the business idea, whether it has growing potential as well as the sustainability of its competitive advantages. An important finding from these studies is that contrary to findings in previous literature, the observations in the field studies suggest that the financial projections do not play such an important decision factor for early-stage proposals. Intuitively this makes sense based on two factors, the first being that due to the significant asymmetry of information, financially projecting or forecasting correctly the successful outcome of a new venture is very difficult. Secondly, considering the growth challenges faced by new ventures, forecasting the outcome becomes very complicated. Forecasting in itself is a very difficult assignment.

A primary conclusion from the research is that the human capital of the founder is a critical factor in the success of the new venture, and hence, VCs pay a significant amount of attention to assessing the entrepreneur. Human capital of the founder is often described as his or her relevant experience in both the new venture's industry and with previous start-ups. In general, VCs appear to mitigate investment uncertainty by backing individuals with superior human capital, exhibited by strong references and valuable experience.⁷⁷

⁷⁷ Franke et al "What you are is what you like – similarity biases in venture capitalists' evaluations of start-up teams", *Journal of Business Venturing*, [2006], 21(6): 8-2-826 "

A further conclusion from the research is that not only is the management important but the team dynamics of the core team is also critical in determining the success of the new venture. It is also clear that the majority of venture capitalists spend a considerable amount of time evaluating management. The literature suggests that, whilst technical ability may be necessary; the capability to ensure success “lies in an ability to develop additional management skills to exploit such expertise”. It is clear from the research that the human factor is recognized as a deciding factor in the screening process.⁷⁸

In several ways we find confirmation, that a good team and capable management will be successful and that the actual product is of less importance. More importantly the data strongly suggests that a good team will succeed despite a poor economy, or even difficult environmental and political circumstances.

Investment Criteria Comparison with Domestic Research

The venture capital industry in South Africa is still in its infancy and not as strongly developed as, for example, in the United States. The private equity sphere has in recent years been dominated rather by the merger and acquisition activities of the larger corporates, with the formation of Black Economic Empowerment (BEE) companies being an important driver in this market. (van Deventer et al [2009])

A survey was conducted among the members of the South African Venture Capital Association (SAVCA). Although SAVCA has more than 80 members, many of these are not true venture capitalists as they merely supply legal and other consultancy services to the venture capital industry. Others are more involved in hedge fund and private equity transactions, or act as investment holding companies. After an elimination process, only 16 SAVCA members were found to qualify as true venture capital investors.

⁷⁸ Chorev S, et al “ Success in Israeli high-tech start ups; Critical factors and process” The Robert Gordon University, August (2005)

Van Deventer et al found that six out of the 12 top-rated items place the spotlight on the entrepreneur. The entrepreneur will be the starting point of evaluation, and it is the person's honesty and integrity that appear at the top. Still, on a par with the person's character is the need to be convinced of the product's market acceptance and a high financial return. Lower on the priority list what the findings imply is that, should the entrepreneur motivate a proposal mainly around its BEE component, or no need for top-up investment, or a market where there is little competition, or low marketing and production costs, the proposal is likely to end up in the 'rejected' basket.

The research done by van Deventer 2009 et al complies with the model suggested and further more is aligned to international findings. Overall the work done by van Deventer et al suggests that venture capitalists will be most concerned about the honesty and integrity of the entrepreneur. To feel secure about their future returns, they will need to trust the person in charge. On top of this they will make sure that this person has a desire for success, is hard-working, has excellent management skills and experience, and shows leadership ability. Venture capitalists domestically want pretty solid evidence that there is market acceptance for the product and that it enjoys a competitive edge. They will also want to know that there is a sufficiently strong need in the market, and that the market is in a growth phase.

Local venture capitalists are looking for exceptional returns on investment to make their bet worthwhile. For this reason, the future valuation projections and the potential for high earnings growth will be carefully scrutinized.

Below is a table summarizing the investment criteria required by a sample of domestic venture capitalists'.

InvFin	Business Partners	Horizon Equity	Brait	Imbewu
Global potential	Product	Company size	Attractive purchase price	Business model
Passionate people	Market acceptability	Use of capital	Management	Strong cash flow
Core offering	Market size	Geography	Support systems	Sustainable growth
Need	Gearing of the business	Industry sector	Ability to add value	Deal size
Revenue	Ability to exit	Stage	Identifiable exit	Value add
Proof of concept	Stage			
Market	Profit potential			
Team	Geography			
Funding Requirement	Entrepreneur			

Table 2: Comparison of criteria by domestic venture capital firms

Please see the appendices for a description of the venture capital firms included in the domestic sample.

From the chart above we can see that InvenFin have global potential and proof of concept as some of their criteria. These criteria are very different from those detailed in the generic model. Furthermore, no other domestic venture capital requires the new venture of idea to immediately demonstrate global potential. Other criterion required by InvenFin that differs with the other VC players and the generic model is the requirement of proof of concept.

Business Partners will consider the gearing of the business. Although not an entirely new idea, as it would be expected that the other VC players would also examine the gearing of the company, however by stipulating this requirement upfront, suggests that Business Partners expects the new venture to have received some sort of prior funding and hence ability to leverage the balance sheet of the new venture.

Although Business Partners and Brait are the only local VC players to stipulate a clear exit, international research however suggests that this would also be a key criteria for the international players as well.

Horizon Equity has stipulated “use of capital” as a criterion. In other words, how does the entrepreneur intend on employing the capital. Horizon Equity has limited its use of capital to acquisition finance, buyouts, growth capital – including companies that have yet to reach profitability, BEE (Black Economic Empowerment) – were Horizon Equity can facilitate the introduction of BEE shareholders to a company through a leveraged recapitalisation, Recapitalisations, Public-to-private transactions, PIPES (Private Investment in Public Enterprise).

We can further see that Brait requires support systems and the ability to add further value to the new venture as key criteria. The requirement for entrepreneurs to have support systems in a domestic context is in-itself an interesting criteria. As earlier explained, the South African market is still very much in its infancy, it would therefore also be expected that new ventures are unlikely to have support systems in place prior to approaching a venture capitalist.

Imbewu requires strong cash flows and sustainable growth. This would suggest that the criteria points to companies that are already producing cash. This is not surprising considering that the venture firm in this case is still fairly new and not of a significant size, hence the requirement for investments to be already producing cash. This obviously brings forward the payout stream and hence immediate access to capital for the venture capital firm.

Recurring criteria for the domestic players are the stage of growth of the company, the market, the product or service, the deal size, the business model and the quality of management. In this regard the generic model compares favorably to the criteria employed by the domestic venture capital players.

Study of Domestic Venture Capital Market Trends

Fledgling private equity companies took a thumping from 2008's liquidity squeeze. To cope, they had to rely on experienced management teams and a big dose of creativity. The price expectation gap between buyers and sellers is the biggest problem, says KPMG head of private equity Warren Watkins. He says sellers still believe in yesterday's prices, and there is not enough clarity on future profits - and this is causing deals to fail.

Medu Capital is one example of a fund that has stuck to its mandate, in spite of tough times. Medu's first fund was incubated by Brait, the JSE-listed financial services company that holds 49% of Medu, in 2003.

Largely thanks to the Brait relationship, Medu was able to raise R250m in capital - and provide big returns for its funders. This cash was invested in such companies as Pepkor Holdings and Durban-based human resources company Capital Outsourcing. Medu founder Nhlenganiso Mkwazi says the second fund, which closed at R900m last May, is three times bigger than the first, and was raised independently. However, he says the finance chaos over the past year has forced Medu to adapt its decision-making. Medu has also had to lower its growth expectations for some of the companies within its portfolio. But, says Mkwazi, these companies aren't under liquidity pressure - thanks to Medu's policy of selecting companies without significant debt, and with strong balance sheets.

A newer entrant to the private equity scene is Capitalworks Equity Partners, which says it is raising funds easily despite the global downturn. Capitalworks managed to raise funds and nail down two investments last year. Director Darshan Daya says this was largely a function of sticking to Capitalworks' strategy of investing in the middle market.

Another small player, the black-owned Vantage Risk Capital, began doing business in 2001 on the steam of experienced private equity experts like Luc Albinski, its managing partner. But while Capitalworks ventured into the top end of the midmarket, Vantage played in a different space. Vantage identified a shortcoming in SA's private equity

space: little mezzanine capital is available. This finance sits between equity and debt. Interest payments are sometimes not paid for several years, but when they are paid, it is at a higher return. By offering mezzanine capital, Vantage became the first independent player in this asset class. By November 2007, it raised a R1bn mezzanine fund from investors including the Netherlands Development Finance Company and the Transnet Pension Fund. Of this R1bn, it has already invested R980m in five investments, including the acquisition of 21% of Safripol by Thebe Investment Corp.

Horizon Equity Partners, one of SA's longest established private equity firms, has evolved from a technology venture capital specialist to a general mid-market investor. Horizon has raised more than R900m from investors. Good returns and a strong team have kept these investors happy – relationships, its team would do well to foster in a tight credit environment.

RMB Corvest, founded in 1989, used to dominate the midmarket space. It was incubated by FirstRand's merchant banking arm RMB, and is a captive fund, which means it uses its own funds and not third party funds. Being a captive fund also means it does not have the same pressure to exit investments that other companies do. The company has completed about 130 deals, 30 of which are empowerment deals, valued at R5,7bn overall.

Another example is Treacle Private Equity, which built its reputation by providing solid returns to investors despite the dot-com bust. Treacle looks for investments in medium-sized businesses, particularly export and manufacturing businesses in need of capital to grow their operations. It also looks at businesses supplying goods and services to core industries in SA. Though most small private equity players target medium-sized businesses on a general basis, others have taken a "sector-specific approach" - a strategy that could become more common.

New Africa Mining Fund, managed by Decorum Capital Partners, is another sector-specific fund. Established in 2003 with R564m in committed capital, it has overcome a bumpy start. It took investors a long time to understand what the fund was trying to do.

This mining fund was established to invest in junior mining activities in SA and other African countries. It provides funds for exploration, including pre-feasibility studies. It has had a number of notable successes, including the JSE-listing of Petmin (in which the fund held 25%), Jubilee Platinum, and SA Coal Mining Holdings. Most of these investments have been "realised"

Another new niche fund is Agri-Vie, which was formed by Sanlam Private Equity last year. It focuses on agricultural businesses, and has already secured R330m in investments. The fund is the first of its kind in SA and it's focused on entrepreneurs in the agribusiness value-add sector rather than directly in the farming business. Development finance institutions have invested heavily in the fund.

General Trends in the Domestic Market

In 2007 the mega private equity deals made headlines. Five of the six biggest private equity deals ever in SA were completed this during period. Topping the list is the successful takeover and delisting of retailer Edcon by private equity house Bain Capital of the US for just more than R27bn. The transaction stands out not only as SA's biggest ever, but also only the second time that a large foreign private equity player got involved in the local market. Seemingly without a foreign participant, the "mega deals" in SA are simply not feasible. Given what has occurred in the global economy, for the time being the list of top deals looks likely to remain fairly static over the next few years.

Besides the five large transactions in 2006, the deal flow in 2007 was limited to relatively "smaller" transactions: Absa Capital's leveraged buyout of furniture group Steinfurn for R1,6bn from Steinhoff; Brait's R1,5bn management buyout of Premier Foods; and Ethos and Sphere's joint R1,4bn buyout of JSE-listed retailer Brandcorp. Absa Capital also led the R1,4bn leveraged buyout of Tsebo Outsourcing.

In 2008 when a record number of funds flowed into the SA private equity industry, it was again the independents (companies such as Ethos, Brait and Actis that don't rely on their parent company's balance sheet for funding) who raised most of it - more than R11bn, the bulk from offshore sources.

According to KPMG's annual survey of the private equity (PE) industry, the total value of deals concluded in 2008 came in at R21,3bn - an 18% decline from the heady heights of 2007. In fact, overall funds under management increased in 2008 quite substantially from R86,3bn to R103,1bn, KPMG has calculated. Though this is a surprising result, especially considering the sharp rise in funds under management in 2007 compared with 2006, it is partially explained by the sharply reduced number and value of disposals. In 2007, disposals came in at R10,5bn, compared with only R7,2bn in 2008, as private equity houses struggled to offload assets during the market decline.

The difference between the domestic market and the international scene was strikingly vast. A paper produced by the Boston Consulting Group, written by Heino Meerkatt and Heinrich Liechtenstein, characterised the international industry as being in the middle of a "perfect storm". From 2003 through 2007, nearly all private equity firms were able to grow exponentially, due to an unusually favorable financial and economic climate and in particular, four major drivers of growth: huge amounts of cheap debt, rising profitability across all industries, escalating asset prices and the allocation of significant assets from institutional investors to private equity. But the paper concluded that the financial crisis "sent all these drivers racing rapidly in the opposite direction". The study also predicted that 20%-40% of private equity firms would disappear within the following two years.

Warren Watkins, KPMG head of Private Equity Markets for Africa, says the difference between SA and many European markets was that in many developed markets the banks just closed. However in the domestic market banks were looking for better coverage ratios." Typically local banks could lend to private equity houses at three or four times EBITDA (earnings before interest, taxes, depreciation and amortisation), whereas during the boom times, they would do so at five or six times.

This was in contrast to the developed markets where they offered from eight times EBITDA right down to zero. Difference however was that the banks domestically were not providing as much debt. The domestic banks had healthy loan-to-deposit ratios relative to their global peers. The balance sheets of SA companies were also stronger on many metrics such as a high ratio of cash-to-assets. Prudent monetary policy management also allowed for a normal interest rate cycle. Second, the local private equity industry - if seen as a proportion of GDP and of mergers and acquisitions activity - remained below international levels, partly for legislative reasons. Third, SA had clear, emerging market growth drivers. Fourth, SA is also changing from consumer-led to investment-led economic growth. Fifth, SA has a leadership position in Africa. As the continent begins to show some real change with enormous improvements in governance, the platform that SA offers as a continental springboard is becoming more attractive.

According to Ethos partner Cláudia Koch, one immediate effect of the financial crisis was that deals got smaller. In order to create a R4bn deal, practitioners had to raise R2bn and then have to find about R2bn in equity to back that up. An example of this type of deal was the R5,16bn acquisition of electrical engineering group Alstom SA by Actis and Old Mutual.

On the contrary, a side effect of a smaller average deal size was a more competitive middle sector. Yet increased competition meant that there was an increased number of "club" deals where funders teamed up. Another trend that emerged was a new focus on particular sectors that might be more resilient to downturns. Typically, private equity players would try to ride the investment through its growth period. But making investments in 2007 and 2008 meant investing in an expensive market. This meant that it was imperative to pick good companies with growth potential over the period of the investment, in spite of the market.

With economic growth declining private equity firms are now eyeing investments in sectors where growth is more likely. The infrastructure sector is the most obvious candidate, since many government infrastructure projects are still coming on-stream. It was also important that PE firms concentrated on existing portfolios. It became critical to preserve and create value in those portfolio companies.

Follow-on investments will be in abundance as managers aim to strengthen, recapitalise and restructure portfolio companies and possibly finance strategic bolt-on acquisitions. Investors are likely to revisit their asset allocation strategies in search of greater yield and liquidity and - pending any material recoveries in the equity markets - this will give rise to a reduction in the capital allocated to alternative assets and in turn PE and VC. Target fund sizes will come under pressure and the all-important final close will be elusive, which may result in a profound restructuring of the SA PE and VC industry and a change in the competitive landscape.

During 2009 the value of private equity funds under management dropped 2.7% from R109.4bn, while only R5.5bn was raised, compared to R10.6bn in FY2008. The drop in real activity was highlighted by the number of deals concluded. Deals worth only R6.9bn were concluded, down sharply from the R18.9bn in FY2008, and the R26.1bn in FY2007. The latter notably capturing the deal completed by Bain's purchase of Edcon.

Warren Watkins, KPMG's head of private equity markets, suggested that what we saw in FY2009 was a "holding pattern". There were fewer investments, poor fundraising activity, and "people simply watching the market for any signs of a return to normality". SAVCA (South African Venture Capital and Private Equity Association) executive head, JP Fourie said the trend was that it took longer to do deals, longer to raise funds, more time to raise debt, and the number of very large deals were "off the table".

Although the domestic market had a difficult time, it did not suffer alone. Global fundraising in FY2009 fell off a cliff: only \$246bn was raised internationally, this was less than half the \$636bn raised in the previous year. The fourth quarter of FY2009

represented a low point, with only \$35bn raised by 75 funds the lowest recorded quarterly total since the third quarter six years prior. This period was characterized by a significant amount of uncertainty on every score, namely the amount of credit available, the risk attached to investments, and a lack of visibility and trust in the numbers coming out of the markets.

Previously credit was abundant and banks were willing to provide finance for deals based on up to 7 times the earnings of the target company. Currently, banks are considering funding deals based on 2x or 3x earnings. Brait Private Equity CEO, John Gnodde says SA firms had the ability to mitigate the impact of the recession, by suggesting that because the impact of the recession only hit South Africa some nine months after it had arrived in Europe and the US, this enabled the local markets to prepare for the domestic impact. The problem encountered however, was that neither the private equity players nor the local banks had an idea where the earnings levels of companies would be on a 2 year outlook. As a result, private equity firms went back to basics by applying the principles of sound investment practices. The outcome of this view was a lot more follow on investments, a slowing down of growth in portfolio companies, fewer disposals as a result of PE firms holding onto their portfolio companies, rather than sell assets at relatively low prices.

The positive feedback from this activity meant that only R1.9bn was returned to private equity investors in FY2009. This was much lower than the R4.2bn in FY2008, or the R9.1bn in FY2007. Rand Uranium, (target of the R1.9bn purchase by Pamodzi Resources) executive Gerard Kemp suggested that normality would only return to the market in about 18 months and that the whole model of private equity is being reviewed, as are relationships between partners, and investors are reconsidering their options. It should be noted however, that there should be a significant amount of capital available for quality deals with reliable cash flows and predictable earnings.

Already signs of a recovery are emerging, with Braits R1.7bn bid for 81% that it didn't already own in the JSE listed Freeworld Coatings, highlighting such a recovery. Warren Watkins also suggests that the equity market in Sub-Saharan Africa over the past two years has been characterized by unwilling sellers and an inability of fund managers to invest their funds and as a result, the appetite for deals has been reined back significantly.

The KPMG figures showed that black empowerment deals – a key driver of private equity deals – was also lower last year. An interesting observation is that the black empowerment market is maturing: as there is more capital available. In all, 79% of the R106.5bn being managed in the domestic PE market was handled by managers who had at least some degree of empowerment, or from government funds. This is up sharply from two years hence.

A notable output of the recession and its impacts has been the rise in what is referred to as “active value management”, a fundamental part of private equity that faded into the background due to abundant credit and a race to grab assets. The financial crisis has now forced managers to find ways to drive superior returns from their portfolio companies. This meant that managers had to “actively” manage their investments as the majority of their assets were bought during the good times and for relatively “full” prices, and subsequently experienced earnings pressure from the economic downturn. Where investments were significantly leveraged, private equity firms needed to make sure that debt covenants were not breached.

What has arisen as a positive is the relative conservatism of the SA private equity market compared to its overseas peers. This has resulted in no large failures. This is puzzling given the current structure of the market, where debt and leverage significantly add to risk and as a result reduces the margin of error. This therefore suggests that the domestic PE market deals that have been completed have been robust, despite the economic environment.

A KPMG survey suggested that 15% of portfolio companies were likely to breach their covenants during the recession. In unpredictably the banks did not take the opportunity to foreclose on these deals, as was witnessed in other markets, but took the opportunity to re-price them. Old Mutual, wrote down its private equity portfolio by only about 10% between September 2008 and the trough experienced in FY2009.

BEE (Black Economic Empowerment)

Savca (South African Venture Capital Association) CEO J P Fourie says the vast majority of investments concluded by the private equity industry have a significant BEE component and the majority of private equity fund managers come with a sizeable BEE shareholding. These include the two largest venture firms in the SA market - Ethos and Brait.

Brait is owned 26% by a BEE consortium led by prominent businessman Bheki Sibiyi. The consortium bought the holding in 2005 for R124m. Brait has been involved in a number of large deals, including the R6,6bn acquisition of glass manufacturer Consol in 2007, and was also involved in the Mineworkers Investment Company-led buyout of Primedia and Peermont Global - each valued at R7,3bn. Its proposed R15bn takeover of retailing giant Shoprite failed, however.

Ethos, owned 24% by BEE private equity firm Sphere, was involved in the buyout of financial services group Alexander Forbes. The deal was led by Actis, the third-largest private equity firm operating in SA, which is majority British owned. Actis came under fire after the group last year ousted Peter Moyo, the black CEO of financial services group Alexander Forbes. The incident remains one of the few BEE blemishes in the track record of the private equity industry. The past few years have also seen the emergence of independent black-controlled firms such as Shanduka Fund Managers, Kagiso Ventures, Sphere, Vunani Private Equity Partners and Vantage Capital. In November 2008, Vantage Capital launched a R1bn mezzanine fund, SA's biggest-ever, backed by Old Mutual. Vunani has R500m under management and also owns 35% of Glenhove Fund Managers.

Industry charters have spurred empowerment investment. So it's no surprise that most of the BEE investments took place in the infrastructure, manufacturing and mining sectors. According to KPMG, there was a 38% increase in BEE investment in 2008 to R16,3bn from R11,8bn. The average deal value rose from R30m to R49m, helping offset a fall in the number of BEE deals made - from 390 to 331 during 2008. The survey shows that while the total investments made in the private equity industry dropped 18,4% from R26,1bn in 2007 to R21,3bn in 2008, BEE investments rose significantly. Of the total R103bn private equity funds under management, R54,9bn of that has some type of BEE component - a 17,6% increase on 2007's R46,7bn.

When investing in BEE projects, the private equity industry uses the criteria laid down in the financial sector charter. These are:

- More than 50% of voting rights must rest with BEE investors;
- More than 50% of profits must accrue to BEE investors;
- The private equity fund manager must be a BEE-owned company; and
- Over a 10-year period more than 50% of funds must be invested in companies that themselves are at least 25% BEE-owned.

Zola Fubu, a director at SizweNtsaluba VSP, a firm of accountants, auditors and business advisers, believes the private equity industry will score big after 2010 when the majority of large BEE deals will be finalised in terms of the charters. This is where private equity entities will gain, as some banks won't be keen to finance these deals. "It is in this new era [after 2010] that private equity entities could be sourced to co-finance these deals. Some of the smaller private equity entities today would have advanced to a level where they have significant balance sheets, and are therefore able to syndicate the restructured and refinanced BEE deals."

The KPMG study suggests that the principle of active value management is a hallmark of private equity and a key industry differentiator, coupled with long term investment horizons and superior incentive structures. The global financial crisis has left its mark on

the domestic market, and therefore forcing the local managers to refocus their capabilities on actively managing their portfolio companies. Traditionally, PE managers allocate themselves four to seven years to build returns in their portfolio companies. This approach allows them to engage and implement long term strategies to create sustainable shareholder value.

Incentive structures within the industry require fund managers to personally invest alongside portfolio executives and institutional investors. Fund managers typically only receive returns on the fund after institutional investors have received their capital, costs, management fees and a required rate of return. This incentive structure ensures that there is alignment of interests between the key parties and a focus on long term value creation for the fund's investments.

Prior to the recession, the abundance of freely available debt has skewed the PE model. With relatively cheap debt providing a larger portion of the investment return over a shorter investment horizon. Although this phenomenon also occurred in the domestic market, the bubble however not as pronounced. This resulted in managers de-emphasising the importance of value management.

Post the recession however, the demand to actively manage assets is reemerging. The environment is such that deals are likely to be concluded applying less debt but where competitive pressure will ensure pricing pressure and hence thereby force managers to actively manage underlying portfolio company's in order to drive portfolio returns.

Having pondered the process change within PE firms, the question then becomes what is it that PE firms have to do in order to respond to this structural change. Firstly, due to the skills required to embark on actively managing assets, means that strategic and operational excellence with regards to deal structuring and deal making competence will need to be enhanced. There are many different approaches to achieving the desired outcome. Models range from building in-house expertise to outsourcing targeted activities on a project basis, with a host of variants in between.

The primary object of active value management is to drive earnings growth in portfolio companies. This activity begins and ends with strategy. PE firms have to identify growth, optimization and efficiency opportunities, and derive strategies for executing these strategies before making an investment. Furthermore, once an investment has been made, the PE firm should assist management and act as an additional resource. A major element of this post-investment phase is the constant monitoring and evaluation of strategy. This challenge is easier when the PE firms have the ability to engage with CEO's and their executive teams at a peer level.

In our assessment of the South African venture capital market, the analysis captured 68 funds in total, with all of them investing in Africa, and some having a physical presence in South Africa. Of the 68 funds, some funds excluded particular industries which they do not invest in. Some of the exclusions included primary agriculture, property, armaments, tobacco, mining (with some specifying the exclusion of early stage mining and exploration), businesses engaged in gambling, alcohol, oil and gas exploration, biotechnology and life sciences.

The average size of fund is calculated at R2.49 billion, with the average invested to date at cost calculated at R1.29 billion, i.e 52%, however the average percentage of funds invested (which quantifies how much of the capital raised was actually invested) was calculated at 69%. It must be noted that the percentage of fund invested is skewed by a few large funds, namely Old Mutual Investment group, national Youth Development Agency, Brait private Equity and Ethos private Equity.

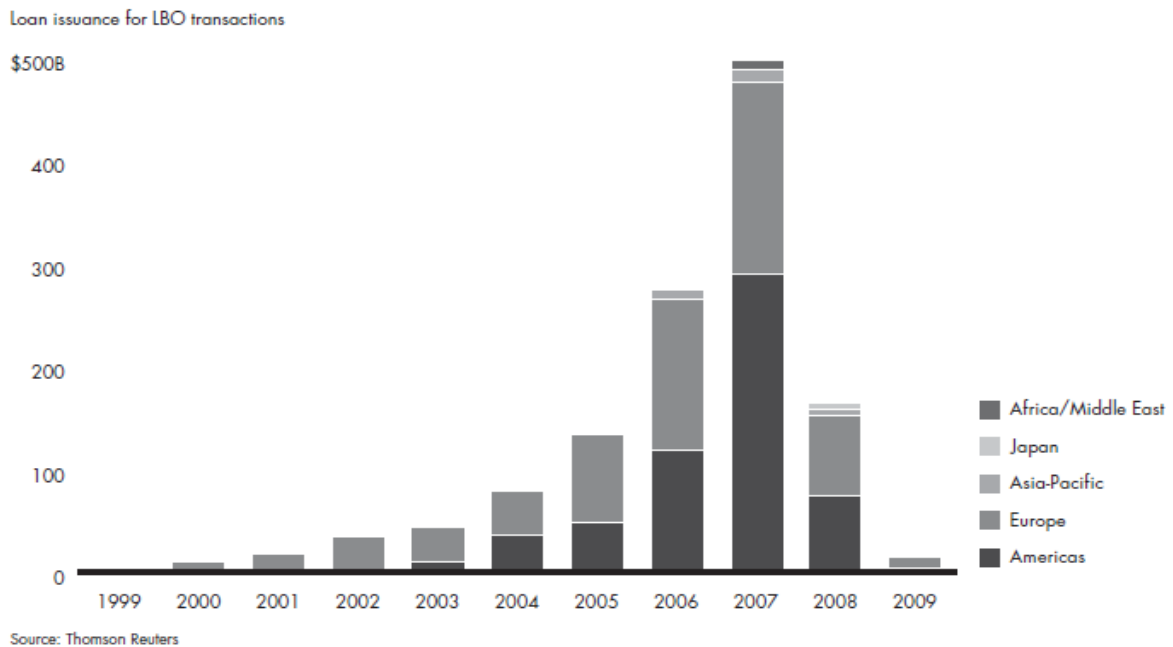
If one looks at the median size of fund, this is calculated at R639.7 million with the median funds invested calculated at R348.5 million. The maximum size of fund is R 30.7 billion which has been raised by Old mutual Investment Group, with the minimum size of fund registered at R31 million, which has been raised by the Median Group. The median percentage of fund invested was calculated at 67%.

The median percentage of fund invested was calculated on 41 of the 68 funds. This is due to the fact that not all the funds covered presented their funds invested at cost. The average current portfolio size is calculated at 33 companies. Again, this is significantly skewed by the 840 portfolio companies listed by the National Youth Development Agency and the 127 portfolio companies held by Old Mutual. The median portfolio size is calculated at 7.

The average maximum investment size is R 345.3 million, while the average minimum investment size is calculated at R54.6 million. The average maximum and minimum investment sizes are calculated 59 of the 68 funds. The average current investment size is calculated R127.9 million, while the median average current investment size is calculated at R40 million. The absolute maximum investment size is R 2.3 billion with an absolute minimum investment size of R1.09 billion, both the maximum and minimum investment size are listed by Pamodzi Resources Fund advisors.

7. South African Venture Capital and Private Equity Market Comparison with Developed Markets

The headline event for PE in 2009 – as for so much of the world’s economy – was the global credit crisis and the chilling effect it had on the number, size and types of PE deals concluded. The impact on PE’s access to leverage was quick and dramatic. Following a steep increase from virtually nothing in 1999, global loan issuances for leverage buyout transactions swiftly climbed to nearly \$500 billion at the business cycle peak in 2007. By 2009, total loans extended virtually disappeared falling to less than \$20 billion at year’s end.

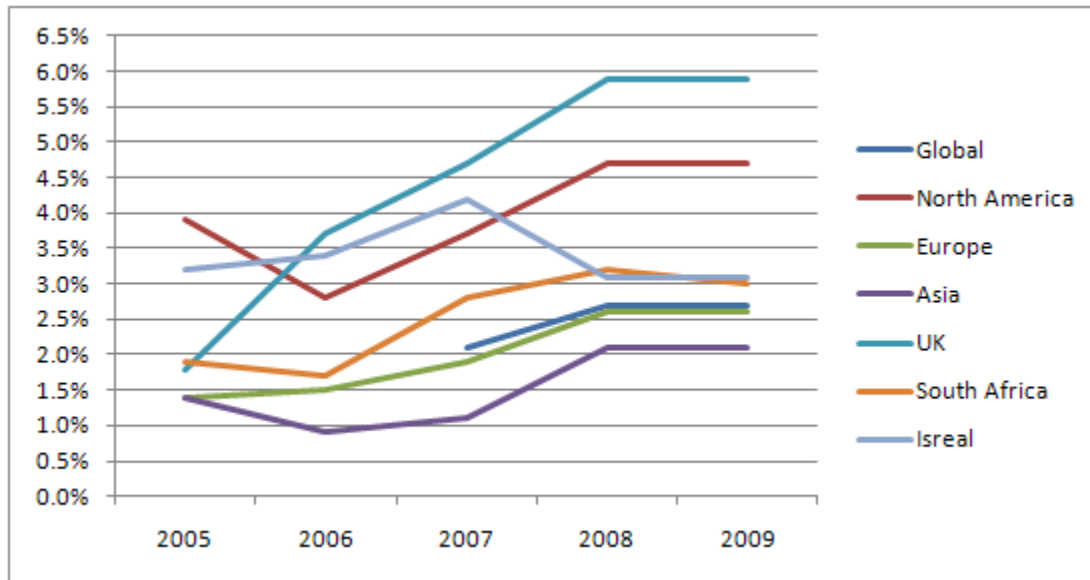


PE’s popularity with investors is reflected in the increasing flows of capital they have entrusted to PE fund managers over the past five years. Indeed, the \$1.8 trillion PE funds raised globally between 2006 and 2008 alone exceeded the total funds the industry attracted over the entire previous decade. That run came to an abrupt halt in 2009, when new funds raised worldwide tumbled to just \$248 billion—less than 40 percent of what the industry brought in during 2008.

Driver, Wood, Segal, and Herrington (2001) report that South African financial institutions have a history of dealing mainly with large corporations that undertake large projects. Their management skills in handling small businesses were not properly developed as they focused on large businesses with sufficient resources. They also state “fund managers have to show a good return on capital invested” and therefore focus on their own goals rather than that of the entrepreneur. There’s a lot of pressure because of that, especially as they are employees of large organisations and they get remunerated as employees. There is often not enough incentive for them to take the risk with a potentially high upside, because at the same time there could be a personal cost for them if they make the wrong investment decision. As a result, the situation moves the financier/investor to be more concerned with the downside risk while entrepreneurs tend to focus more on the upside risk (potential), and at that point the entrepreneurs and financiers miss each other.

The current profile of the private equity industry in South Africa is the result of various historical developments in the country and in global capital markets. In South Africa, the industry was boosted by the large number of leveraged buyouts and management buy-outs (LBOs and MBOs), resulting from the widespread disinvestment of multinationals from South Africa in the 1980s. These transactions were structured, financed and managed by the major commercial, merchant and investment banks of the time.

Although the South African private equity industry is small in comparison to those of the US and UK, it is significant in relation to many other countries



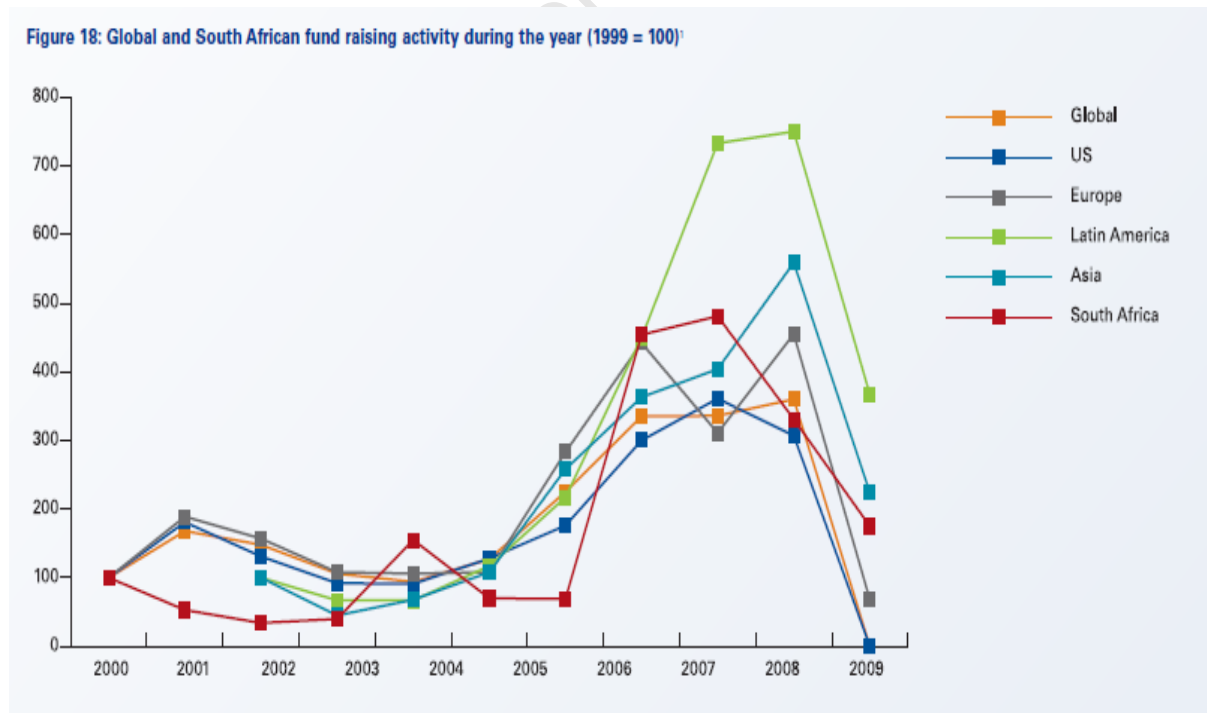
Source: SAVCA survey 2010

The above diagram shows that in terms of total funds under management relative to GDP, as surveyed over the 2009 period, South Africa's private equity industry at 3.0% was higher than the global average of 2.7%, higher than the European average of 2.6% and the 2.1% for Asia Pacific. It is still some way off that of North America (4.7%) and the UK (5.9%).

In South Africa the private equity industry benefited from the global trend towards recognizing the asset class as an attractive investment vehicle for investors, combined with its growing reputation as an effective means of economic development for governments and development agencies. It may be argued that South Africa has one of the most sophisticated private equity industries among emerging and developed markets, with different funds at all stages of business development, from start-up venture capital funds through to late-stage and buy-out funds. Globally in 2000 the vast majority of funds, over 77%, were focused on North America (2009: 37%), with Europe and Asia and Rest of the World accounting for 15% and 8% respectively. However, since 2000, private equity has steadily become a more global industry, with more than one-quarter of funds now focused on Europe, and the market share of Asia and Rest of the World growing at an even more rapid rate over the period. The United States, nevertheless, remains the main centre for private equity activity, with the majority of funds still

focused on the region. 2009 was a year of reduced investment, fund raising and exit activity in the South African industry. This is in line with global trends. The second half of 2008 saw an end to the record levels of fundraising that had been steadily increasing over the previous five years. Global fundraising for the industry was down dramatically in the second half of 2008 and for the whole of 2009 as the credit crunch began to affect investors' appetite and ability to invest in new fund opportunities: _ Global investment decreased (71%) from US\$658 billion during 2007 to US\$190 billion during 2008 to US\$147 billion in 2009

South Africa contributed 36% (2008: 22%) of funds raised during 2009. Funds raised from the US were 51% (2008: 18%). Cumulatively, the US still remains as the main source of fund raising to date (32%), ahead of South Africa (29%) and the UK (23%). When fund raising overseas, it is vital that local fund managers are able to demonstrate local support. With a 36% contribution to funds raised during 2009, local funders remain an important contributor of funds to the South African private equity industry.

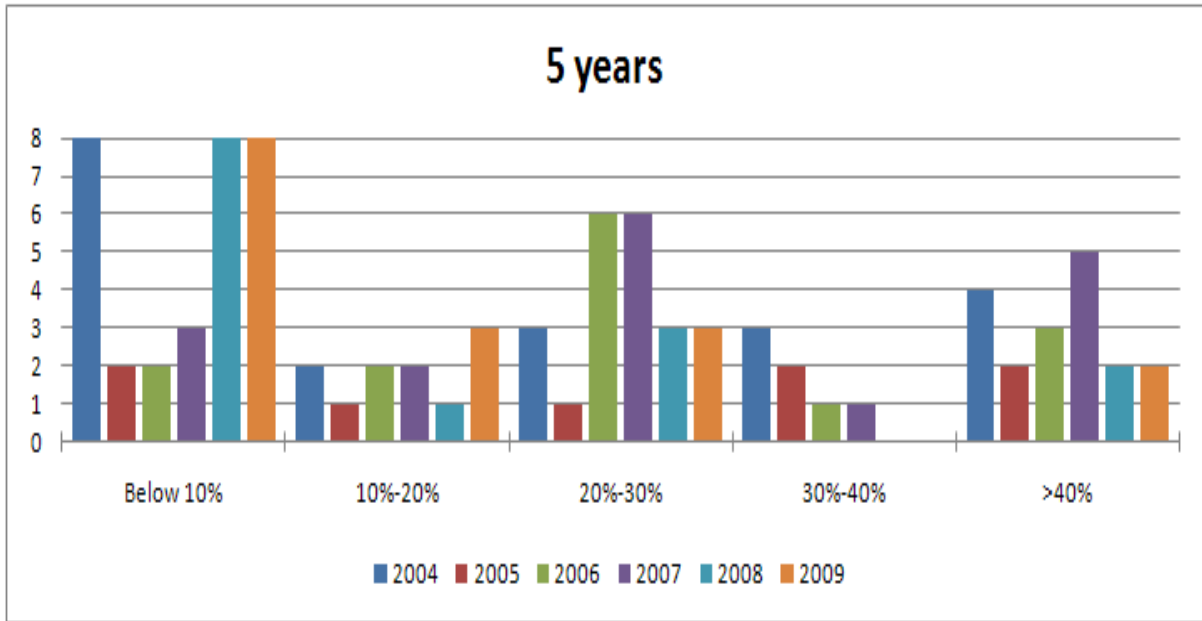


Source: SAVCA 2010 Survey

The diagram above indicates that South Africa has not always tracked the international trend when it comes to fund raising activity. Using 1999 as a base year, by 2005, South Africa was falling considerably behind the pace of fund raising of the rest of the world. In 2006, South Africa's fund raising trend-line jumped ahead of certain other regions and this was maintained in 2007. In 2008 and 2009, South Africa showed a meaningful decline in fundraising activity. Globally and in all regions for 2009, fund raising activity decreased significantly. South Africa has grown investment activity year-on-year since 2001. Following the decline in 2005, there was a strong rebound in 2006. As reported in this survey, 2007 was a record year for investment activity in South Africa. In 2008, investment activity in South Africa showed a decline although the decline was less than the decline shown by the global and US trend. In 2009, South Africa's decline was significant in comparison to most other markets.

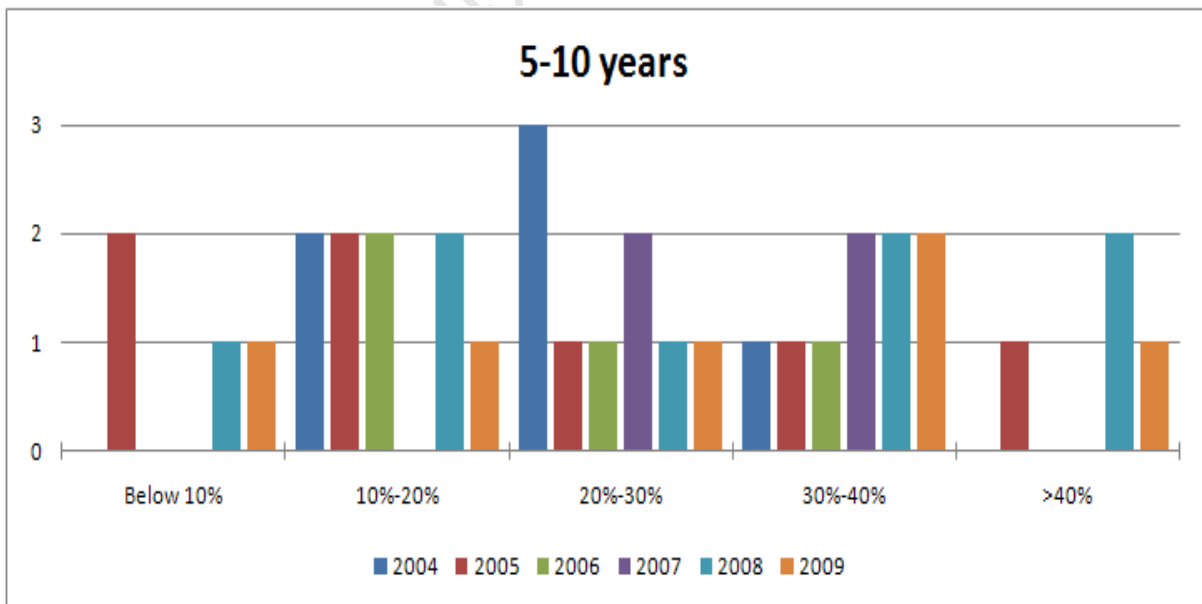
The 2009 results in the diagram below include the IRR levels for 45 respondents (2008: 44), managing R71.98 billion at 31 December 2009 (67.0% of total funds under management) (2008: R63 billion / 67.8%). Included is the response from 25 independents (2008: 24) managing 28.5% of the funds under management by independent fund managers at 31 December 2009 (2008: 20%).

In 2008 51 of the 59 funds that returned a completed questionnaire (88%) claimed compliance with the International Private Equity and Venture Capital Valuation Guidelines in terms of their valuation methodology applied to their unrealized investments.



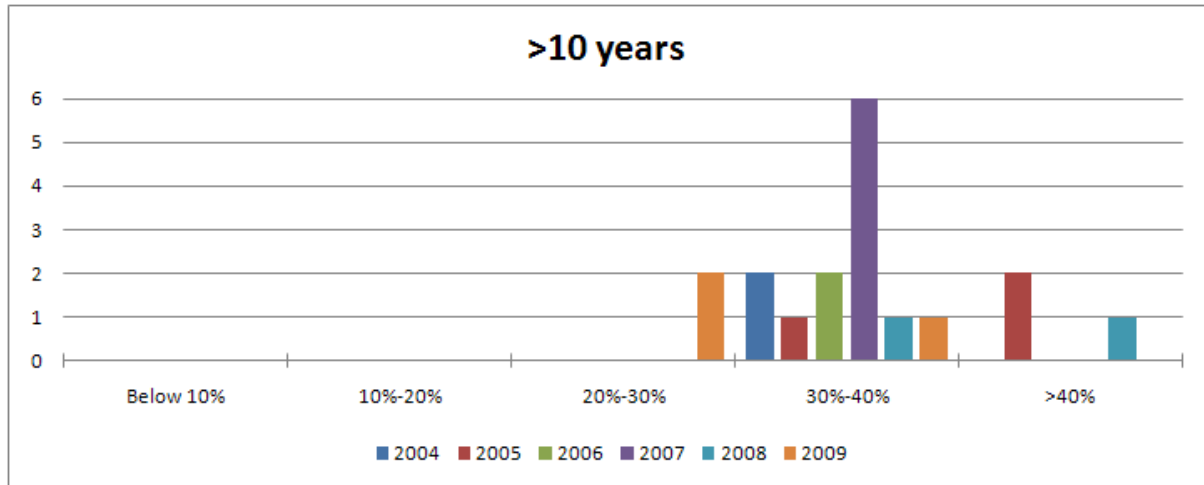
Source: SAVCA 2010 Survey

The highest respondents for the 5 year period as recorded in 2009, were from those projects that returned less than 10%. Although the respondents for projects yielding less than 10%, were down between 2005 and 2007, it can be assumed that these respondents were captured in those projects that yielded IRR's between 20% and 40%.



Source: SAVCA 2010 Survey

The highest number of respondents (2 respondents) for the 5-10 year return period were from those projects that returned between 30%-40%. Only 1 respondent recorded a project yielding more than 40%.



Source: SAVCA 2010 Survey

Over the 10 year period, the highest number of respondents were for projects that returned between 20%-30%, while only 1 respondent captured a project that returned between 30%-40%, while no respondents recorded projects that yielded more than 40%

In 2008 51 of the 59 funds that returned a completed questionnaire (88%) claimed compliance with the International Private Equity and Venture Capital Valuation Guidelines in terms of their valuation methodology applied to their unrealized investments.

The US was the most important private equity target by both volume and value with 99 deals worth \$20,466 million. In monetary terms, this was a year-on-year growth of 167% for the region against a 23% decline in volume. The UK was a major target region by volume, standing in second place with 23 deals to the US's 99, but did not feature among the top ten regions by value, suggesting small-scale investments were a feature of UK private equity activity.

There are two main issues with the financial market in Europe today. The first is that the market is fragmented, and that there are too many small funds operating with no critical mass to grow world-class companies. This is particularly true in the biotechnology sector. In comparison the SA market, due to the fact that it is still relatively new, has few large players.

Internationally, net returns achieved by private equity investments have outperformed public equity markets over the medium and long-term. The returns for various investment horizons for the US and Europe are shown below

US at 31 December 2008				
	3year %	5 year %	10 year %	20 year%
All venture capital	0.9	4.3	1.1	17.7
All private Equity	0.8	5.5	4	11.2

Source: SAVCA 2010 Survey

Europe at 31 December 2008				
	3year %	5 year %	10 year %	20 year%
All venture capital	-3.2	0.7	-1.9	1.5
All private Equity	-4.3	6.1	5.2	8.7

Source: SAVCA 2010 Survey

According to Thomson Reuters and the National Venture Capital Association (NVCA), US private equity performance showed positive returns across all investment horizons five years and longer for the period ending 31 December 2009 US private equity performance showed positive returns across all investment horizons five years and turned firmly positive in the one-year time horizon for the period ending December 31, 2009, according to Thomson Reuters.

With improving stability in the broader capital markets and a return for venture capital and private equity IPO and M&A exits, near-term horizon returns saw marked improvements over last quarter. The 10-year time horizon demonstrated weakening trends from last quarter and a year ago as the effects of the technology downturn are evidenced in fund performance. One year returns, which are most affected by the current market environment, moved in a positive direction registering a 15.3 percentage point

increase from last quarter for venture capital funds (-10.7%) and just over 20 percentage point increase for buyout funds (-9.6%). Longer-term time horizons held strongly positive for venture capital funds with a slight increase from the third quarter return in the 20- year time horizon to 17.7% compared to 17.0% a year ago. In the buyouts category, small and medium buyout funds in the longer term time horizons continued to drive performance, with double-digit performance figures. Overall, venture capital and buyout fund returns across most time horizons continued to outperform US public market indices, NASDAQ and the S&P 500, through December 31 2009.

According to a press release published by EVCA and Thomson Reuters on 5 May 2010, 2009 was a year of internal diligence and stewardship for the European private equity and venture capital industry, as investors concentrated on supporting existing portfolio of companies against a backdrop of recession and macro-economic uncertainty. The €21 billion of new equity invested during 2009 represents just 29% of the 2007 figure at the top of the boom. Even so, more than 4,000 companies benefited from private equity investment, just 17% fewer than in 2007. Around half, by both amount and number, were follow-on investments to support existing companies.

A virtual absence of mega buyouts accounts for much of the decline in investments since the boom, with just three investments over the €1 billion transaction value mark during the year. By contrast, the number of growth capital investments increased by 23%, surpassing the number of buyouts. Of all companies receiving private equity finance, just less than half (44%) were early stage companies. Private equity also played an active role in rescuing companies in distress, with an increase of 83% in the number of turnaround investments.

The amount divested at cost by private equity firms was 29% lower than in 2008, which itself was half that of the boom year of 2007. Write-offs, which had been running at very low levels through 2008, increased from a total of €870m in 2008 to €3.2 billion in 2009. Meanwhile, the cyclicity of the market for new fundraisings reached its lowest ebb, with just 184 funds reaching incremental closings, compared with 316 in 2008 and 338 in

2007. The total amount raised last year - €13 billion – was less than the largest two funds raised in 2008. However, if the outliers that closed at or above €1 in 2007-2009 are discounted, the average size of buyout, growth and mezzanine funds that reached final closes in 2009 is in line with the average size of funds closed in the previous two years

Findings

The study of private equity and venture capital decisions still remains relatively unexplored. The difficulty lies in the fact that the majority of the deals that are concluded are generally never publicized and the decision to finance a new venture involves the experience and sometimes the unquantifiable skill and personal flair of a venture capital practitioner.

However, the literature highlights the often reiterated position that a competent entrepreneur surrounded by a good team is more likely to be successful and that the actual product being produced is of less importance. Furthermore the data gathered suggests that a good team is likely to succeed even in poor economic, environmental and political circumstances.

A clear result from the work done with regards to the decision making criteria applied by VC's, is that the VC's attention is indeed very much focused on the entrepreneur, what type of personal and professional characteristics they are equipped with and their commitment to the business idea.

A primary conclusion from the research work is that the human capital of the founder is a critical factor in the success of the new venture and hence, VC's pay a significant amount of attention to assessing the entrepreneur. Human capital of the founder is often described as his or her relevant experience in both the new venture's industry and with previous start-ups. In general, VC's appear to mitigate investment uncertainty by backing individuals with superior human capital, exhibited by strong references and valuable experience.

Although a significant amount of literature both internationally and domestic exists on how critical the entrepreneur and his team are to the success of a new venture, very little evidence exists that domestic firms focus on this factor to any great extent. A majority of the firms surveyed do mention the entrepreneur as a factor however in presenting their criteria for successful ventures, few list the entrepreneur.

A suggested answer to this phenomenon is that South Africa is a relatively new market, and despite the relative sophistication of the market, the measurement of the human capital is still lacking. This study has also found that even though domestic fund managers recognize that the entrepreneur is a significant factor towards the success of a venture, that the measurement of the entrepreneur still remains a subjective evaluation, at best. This can be further explained by the fact that the actual measurement methods and techniques for the entrepreneurs ability to create and develop a new venture are by their very nature difficult to capture and measure, on any consistent basis. The majority, if not all, of the fund managers are practitioners still primarily focus on the “numbers” i.e the financials.

This study has found that in an effort to try and mitigate failure, that firms have tended to specialize in particular fields. This has enabled them to have a better understanding of the market in which the venture intends on operating. However despite these specializations, failure rates of new ventures still remains high.

8. Conclusion

VCS characteristically have a set of investment criteria that define the type of investments that they find attractive. These criteria are normally identified as the stage of the business, i.e. whether it is still at an early stage of progress or whether it has received financing before, the geography of the venture, the ultimate size of the deal, the industry and sector in which the venture intends to operate etc. Once these have been defined, the VC will modify the process to answer specific questions. The primary objective of the process is to highlight potential “pitfalls” with the deal.

VCS function in an environment where their relative efficiency in selecting and monitoring investments gives them a comparative advantage over other investors. Venture capitalists should be prominent in industries where informational concerns are important, such as biotechnology, computer software, etc., rather than in “routine” start-ups such as restaurants, retail outlets, etc. The latter are risky, in that returns show high variance, but they are relatively easy to monitor by conventional financial intermediaries.⁷⁹

Behind the due diligence process is a simple premise that a considerable amount of knowledge and information resides with the experience of the individual, not the firm. Many practitioners have typified the evaluation of proposals to be about “pattern recognition.” Therefore those individuals with significant experience tend to have an ability to identify successful proposals. It is understood that because this knowledge is hard to extract and codify, many firms struggle with consistently evaluating investment proposals. Either poor efficiency leads to delays in executing a deal or effectiveness fails in identifying potentially successful deals. Clearly there is an opportunity to improve the process. The ability to codify processes and routines become essential in being able to digest the volume of deals being reviewed for acceptance by venture firms.

⁷⁹ Nelson, H; Wainwright, F; Blaydon, C; “*Note on due diligence in venture capital*”, Tuck School of Business, Dartmouth College, 2004

When discussing the VC investment process, due diligence refers to a careful examination and appraisal of an investment opportunity before committing funds. The due diligence process is intended to decrease the investors' risk by understanding the issues and challenges with regards to a new venture. In essence, it involves asking and answering a series of questions, just as the screening process but in much greater intensity. This information is applied to decide if the deal warrants further deliberation in moving to the next phase of the process, valuation and deal structuring. Each firm must decide how they will execute the due diligence process. There are many alternatives depending on the resources available to the firm. The firm may allow practitioners to evaluate proposals based on their area of expertise or assign responsibility to associates to conduct a general screening of all proposals. One approach does not fit the needs of all firms, especially because of industry specialization. In addition, there is no single question that will answer the simple question, "Is this a winning investment proposal?" However, there are opportunities to formalize the process and take a general look at best practices that will facilitate due diligence for a firm. Despite the progress that has been made in the industry in developing processes and organizational routines to manage due diligence, a number of key challenges still remain.⁸⁰

These challenges are predominantly common in the larger firms. Various firms point out that their process is outlined and documented but tends to be more institutional. Formal documentation is not fully utilized. The aptitude to communicate and codify the basic elements of the screening and due diligence process should create valuable time to investigate the particulars of a potential investment opportunity.

As mentioned earlier, success in this industry is often characterized by "pattern recognition." Clearly experience is an advantage in this industry. Therefore, efforts to enhance one's learning curve become critical in facilitating the capture of knowledge. Often it becomes necessary to have knowledge that is "narrow and deep" to intimately understand a particular market / technology space. This intimacy with a particular space leads to improved handling of the due diligence process.

⁸⁰ Nelson H, et al; "Note on due diligence in venture capital" (2004)

Often firms are focused on their core skill set and are not capable of exploring new market spaces. Firms often remark that, if time allowed, they would like to devote capital to understanding new market space opportunities through growing their understanding and core competencies. The ability to not only to recognize new market space, but to also identify the particular companies, could create a considerable advantage for firms. Thus improving the process of due diligence should generate time and space to dedicate to other activities.

Perhaps the most important finding from the study is direct confirmation of the frequently iterated position taken by the venture capital community that above all it is the quality of the entrepreneur that ultimately determines the funding decision. In most cases the most important criteria had to do with the entrepreneur's experience or personality. There is no question that irrespective of the product, market, or financial criteria, it is the entrepreneur who fundamentally determines whether the venture capitalist will place a bet at all.

Venture capitalists domestically want pretty solid evidence that there is market acceptance for the product and that it enjoys a competitive edge. They will also want to know that there is a sufficiently strong need in the market, and that the market is in a growth phase. Local venture capitalists are looking for exceptional returns on investment to make their bet worthwhile. For this reason, the future valuation projections and the potential for high earnings growth will be carefully scrutinized.

The research done by van Deventer 2009 et al complies with the model suggested and further more is aligned to international findings. Overall the work done by van Deventer et al suggests that venture capitalists will be most concerned about the honesty and integrity of the entrepreneur.

To feel secure about their future returns, they will need to trust the person in charge. On top of this they will make sure that this person has a desire for success, is hard-working, has excellent management skills and experience, and shows leadership ability. A common thread amongst the local VC's is the requirement for a strong entrepreneur and strong management team.

The question is if this is the case, “then why is so much emphasis placed on the business plan?” In a business plan there is generally little to indicate the characteristics of the entrepreneur. It is generally devoted to a detailed discussion of the product, the market, and the competition. Such content is necessary, but not sufficient. The business plan should also show as clearly as possible that the entrepreneur has the necessary capabilities and staying power to lead the new venture, has a track record, can react to risk well, and has familiarity with the target market. Failing this, he or she needs to be able to pull together a team that has such characteristics, and show that he or she is capable of leading that team.

Conclusion on the domestic market

It is evident from the literature that the global financial crisis has left its mark on the domestic market, and therefore forcing the local managers to refocus their capabilities on actively managing their portfolio companies. Follow-on investments will be critical in ensuring the longevity and existence of some funds. Managers will have to endeavor to strengthen, recapitalize and restructure portfolio companies and possibly finance strategic bolt-on acquisitions.

The crisis has now required managers to find ways to drive superior returns from their portfolio companies. This has meant that managers have to “actively” manage their investments as the majority of their assets were acquired at the top of the market and for relatively “full” prices, which has subsequently resulted in earnings pressure through the economic downturn.

Having contemplated the process change within venture firms, the question then becomes what is it that these firms have to act upon in order to respond to this structural change. Firstly, due to the skills required to embark on actively managing assets, means that strategic and operational excellence with regards to deal structuring and deal making competence will need to be enhanced.

An outcome of the very difficult financial environment domestically has been smaller average deal size, which has led to a more competitive middle sector. However, the increased competition has meant that the number of collaborative deals, where funders team up, has increased. Another trend that emerged was a new focus on particular sectors that might be more resilient to downturns.

What has arisen as a positive from the financial chaos is the level of conservatism within the domestic private equity market relative to its overseas peers. This has resulted in no large deal failures. This is somewhat perplexing given the current structure of the market, where debt and leverage significantly add to risk and as a result reduces the margin of error. This therefore suggests that the domestic PE market deals that have been completed have been robust, despite the economic environment.

The KPMG survey shows that while the total investments made in the private equity industry dropped, BEE investments have risen significantly, with industry charters providing the drive towards empowerment investment. A vast majority of investments concluded by the private equity industry have a significant BEE component and the majority of private equity fund managers come with a sizeable BEE shareholding.

9. Appendices

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InvenFin - InVenFin is a seed and early stage venture capital fund. As part of Remgro Ltd, they have an established, global business network with a proven track record.

Business Partners - Business Partners Limited is a specialist risk finance company for formal small and medium enterprises (SMEs) in South Africa, and selected African countries. The company actively supports entrepreneurial growth by providing financing, specialist sectoral knowledge and added-value services for viable small and medium businesses.

Horizon Equity - One of South Africa's longest established private equity firms, with an investment track record in the country dating back to 1992, Horizon Equity Partners is widely recognised as a leading provider of development and buyout capital to small and medium sized enterprises. Key executives have collectively initiated and managed over 50 private equity investments and the firm has invested in over 30 companies, of which 22 have been fully or partially realised, including a number of successful JSE listings.

Brait - Brait's business is the structuring, raising and managing of investment funds that are typically classified as Alternative Assets. The current product-set includes private equity funds, mezzanine debt funds and a range of hedge fund solutions. Additionally, Brait deploys its capital in proprietary investment programmes in these product areas.

These investments are made predominantly in South Africa and its region. Investors include leading global and South African institutions. Brait's operations incorporate activities in the private capital markets and in the public, or highly traded securities markets. Brait is an Authorised Financial Services Provider.

Imbewu - Imbewu (which means "seed" in Zulu) Capital Partners (Pty) Ltd ("Imbewu") is a black owned and controlled private equity and investment holding company. Imbewu invests, structures and raises funding for management buy outs, leveraged buy outs and strategic Black Economic Empowerment ("BEE") transactions in partnership with management teams and shareholders.

University of Cape Town

Domestic Venture Capital Market Matrix

Name of Fund	Size of fund (R's)	Funds invested to date at cost	% of fund invested	Current Portfolio Size	Max Investment size	Min Investment size	avg current investment size
Absa Capital Private Equity	5,000,000,000	3,000,000,000	60%	5	1,000,000,000	250,000,000	600,000,000
Actis	13,158,700,000	7,066,400,000	54%	35	1,817,500,000	363,500,000	363,500,000
Advelo Capital					218,100,000	21,810,000	
AMB Private Equity Partners	815,000,000	815,000,000	100%	2	100,000,000	25,000,000	
Aureos South African Advisers	2,769,870,000	1,017,800,000	37%	18	276,260,000	14,540,000	
Biotech Venture Partners	80,000,000	76,000,000	95%	3	12,000,000	2,000,000	
Brait Private Equity	10,566,030,000	10,000,000,000	95%	23	1,000,000,000	5,000,000	
Business Partners		5,420,000,000			20,000,000	250,000	1,750,000
Capricorn Capital Partners	600,000,000	450,000,000	75%	12	150,000,000	10,000,000	35,000,000
CapitalWorks Investment partners	1,500,000,000			2	450,000,000	70,000,000	180,000,000
Coast2Coast	100,000,000	80,000,000	80%		300,000,000	20,000,000	40,000,000
Collins Private Equity Holdings	150,000,000	115,900,000	77%	7	25,000,000		13,100,000
Convergencs Partners	500,000,000						
Decorum Capital Partners	563,700,000	347,000,000	62%		85,000,000	5,000,000	33,000,000
Development Bank of Southern Africa		2,000,000,000			700,000,000	25,000,000	
Enablis Financial Corp	50,000,000	42,000,000	84%		5,000,000	100,000	980,000
Ethos Private Equity	9,020,000,000				800,000,000	100,000,000	
Freetel Capital					100,000,000	10,000,000	
Glenhove Fund Managers	128,000,000	85,000,000	66%				
Global capital	200,000,000	500,000,000	250%	12		20,000,000	
Hasso Plattner Ventures Africa	330,000,000	100,000,000	30%	6	33,000,000	5,000,000	16,000,000
HBD Venture Capital	126,000,000	126,000,000	100%	7	25,000,000	10,000,000	18,000,000
Horizon Equity Partners	750,000,000	300,000,000	40%	6	100,000,000	20,000,000	30,000,000
Imbewu Capital Partners		24,000,000		11		1,000,000	2,000,000
Industrial Development Corp of SA							
Inspired Evolution Investment Management	700,000,000	52,500,000	8%		100,000,000	10,000,000	50,000,000
International Housing Solutions	1,700,000,000	310,000,000	18%		250,000,000	25,000,000	50,000,000
Invenfin	50,000,000			4			5,000,000

Name of Fund	Size of fund (R's)	Funds invested to date at cost	% of fund invested	Current Portfolio Size	Max Investment size	Min Investment size	avg current investment size
Investec Private Equity	1,000,000,000	350,000,000	35%	5	100,000,000	50,000,000	75,000,000
Kagiso Venture Private Equity Fund	150,000,000	88,500,000	59%	6	3,000,000	150,000	218,100,000
Kingdom Zephyr Africa	4,471,050,000	86,300,000	75%	7	28,750,000	5,000,000	21,600,000
Leaf Capital	115,000,000	86,300,000	51%	17	750,000,000	50,000,000	250,000,000
Lireas Holdings	125,000,000	125,000,000	50%	7	5,000,000	500,000	3,000,000
Marlow Capital	363,500,000	101,780,000	28%	12	500,000,000	75,000,000	150,000,000
Mecene Investment Company	1,150,000,000	101,780,000	62%	9	36,350,000	3,635,000	10,905,000
Medu Capital	31,000,000	710,000,000	100%	1	175,000,000	30,000,000	750,000
Median Fund	1,000,000,000	500,000,000	50%	7	1,000,000,000	50,000,000	750,000
Mezzanine Partners	5,000,000,000	122,000,000	72%	6	100,000,000	20,000,000	45,000,000
National Empowerment Fund	787,000,000	1,370,000,000	27%	840	100,000,000	100,000	1,000,000
National Youth Development Agency	2,000,000,000	120,000,000	133%	20	120,000,000	30,000,000	70,000,000
Old Mutual Investment Group	1,500,000,000	30,753,000,000	16%	127	500,000,000	5,000,000	1,497,620,000
Pamodzi Resources Fund Advisors	9,451,000,000	1,497,620,000	16%	55	2,362,750,000	1,090,500,000	20,000,000
Public Investment Corp	2,720,000,000	100,000,000	100,000,000	10,000,000	10,000,000	20,000,000	20,000,000
Phatisa Group	2,720,000,000	100,000,000	100,000,000	10,000,000	10,000,000	20,000,000	20,000,000
RMB Corvest	2,720,000,000	100,000,000	100,000,000	10,000,000	10,000,000	20,000,000	20,000,000
RMB Private Equity	2,700,000,000	9,700,000,000	67%	22	300,000,000	50,000,000	60,000,000
RMB Leveraged Finance	1,000,000,000	336,000,000	67%	20	40,000,000	7,500,000	20,000,000
RMB Ventures SA	350,000,000	336,000,000	67%	10	40,000,000	15,000,000	60,000,000
Sabvest	4,000,000,000	2,000,000,000	50%	5	250,000,000	100,000,000	100,000,000
Sanlam Private Equity	303,000,000	303,000,000	100%	5	75,000,000	20,000,000	50,000,000
Shanduka Fund Managers	170,000,000	596,140,000	93%	5	72,700,000	7,270,000	18,175,000
Southern Africa Enterprise Development Fund	700,000,000	170,000,000	24%	5	20,000,000	20,000,000	34,000,000

Name of Fund	Size of fund (R's)	Funds invested to date at cost	% of fund invested	Current Portfolio Size	Max Investment size	Min Investment size	avg current investment size
Sphere Private Equity	302,000,000	201,000,000	67%	1			
Spirit Capital		10,000,000		6	100,000,000	5,000,000	16,000,000
Standard Bank Private Equity				9		50,000,000	800,000,000
Standard Chartered Principle Finance		908,750,000		2	1,090,500,000	145,400,000	454,375,000
Trinitas Private Equity	430,000,000	50,000,000	12%	1	150,000,000	40,000,000	50,000,000
Treacle Private Equity	463,000,000	316,000,000	68%	4	90,000,000	10,000,000	80,000,000
Trium Investments		32,000,000		6	20,000,000		5,200,000
Triumph Venture Capital	120,000,000	120,000,000	100%	3	18,000,000	3,000,000	12,000,000
Vantage Risk Capital	1,000,000,000	980,000,000	98%	5	350,000,000	40,000,000	
Vunani Private Equity Partners	1,200,000,000	1,200,000,000	100%	6		50,000,000	
Statistics							
count	68	54	41	44	55	59	47
average	2,492,970,426	1,207,216,481	69%	33	345,311,091	54,609,407	127,958,617
median	639,760,000	348,500,000	67%	7	100,000,000	20,000,000	40,000,000
max	30,753,000,000	10,000,000,000	250%	840	2,362,750,000	1,090,500,000	1,497,620,000
min	31,000,000	10,000,000	8%	1	2,000,000	-	750,000

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