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The Role of Venture Capital Financing to SME Development in Namibia

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requirements for the degree of Master in Corporate Financial Management**

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ABBREVIATIONS

AFMINCO	=	African Mining Development Company (Pty) Ltd
ARD	=	American Research and Development
BEE	=	Black Economic Empowerment
BVCA	=	British Venture Capital Association
CISDM	=	Center for international Securities and Derivatives Market
DBN	=	Development Bank of Namibia
EU	=	European Union
EVCA	=	European Venture Capital Association
FDI	=	Foreign Direct Investment
GDP	=	Gross Domestic Product
GEM	=	Global Entrepreneurship Monitor
GIPF	=	Government Institution Pension Fund
HBS	=	Harvard Business School
IDBI	=	Industrial Development Bank of India
IFC	=	International Finance Corporation
IMF	=	International Monetary Fund
IPO	=	Initial Public Offering
IPPR	=	Institute for Public Policy Research
JCC	=	Joint Consultative Council
NCCI	=	Namibian Chamber of Commerce and Industry
NDP2	=	National Development Plan 2
NEF	=	National Equity Fund
NEPRU	=	Namibian Economic Policy Research Unit
NIB	=	Namibia Investment Bank
NPL	=	Non-performing Loans
NSX	=	Namibian Stock Exchange
OECD	=	Organisation for Economic Co-operation and Development
R & D	=	Research and Development
RESA	=	Employee Retirement Income Security Act
SBCGT	=	Small Business Credit Guarantor Trust
SBIC	=	Small Business Investment Company
SIDBI	=	Small Industries Development Bank of India
SMMEs	=	Micro, Small and Medium Enterprises
SMEs	=	Small and Medium Enterprises
UK	=	United Kingdom
USAID	=	United States Agency for International Development
US	=	United States
VAT	=	Value Added Tax
VC	=	Venture Capital

ABSTRACT

This research was conducted to establish whether venture capital could reliably serve as a source of finance for SMEs given that there is a problem of access to finance in Namibia. This is important because SMEs in Namibia are generally in dire need of finance. Evidence therefore shows that venture capital as a source of finance serves as an ideal type of instrument for the development of SMEs internationally. The study assessed the importance of venture capital financing in the context of the SMEs in Namibia, specifically focusing on addressing the problem of lack of much needed capital and skills to the SME sector. The second objective was to assess whether venture capital financing can be effectively utilised to enhance managerial skills within SMEs in Namibia. Unlike other sources of funding, venture capital has been identified internationally as a type of financing instrument that can impart or contribute to the enhancement of management and technical skills within the SMEs.

In order to answer the research question and achieve the above-mentioned objectives the author thought it necessary to conduct a study that focuses on a small sample of SMEs. The key factor in the selection process applied to all enterprises in the sample was a feasible business model meaning that the enterprise should have the potential to grow. Other factors such as staff compliments, turnover, and products exportability were considered due to their importance towards attracting venture capital financing, and the characteristics of SMEs with regard to employment creation. In addition to a viable business model and product potential for export market, for an SME to be included in the sample it must have a staff compliment of ten or more people, with a monthly turnover of not less than N\$1¹ million and/or a total asset base of N\$5 million. For example the SMEs in the sample have a total number of personnel of close to 500, and a monthly turnover of about N\$200 million. Other stakeholders in the SME sector like banking institutions, government ministries and agencies were interviewed to assist in answering the research question.

For uniformity purposes, the author assessed the definitions of SMEs by different institutions, as well as looking at the international characteristics of SMEs, and compared that to the Namibian definitions and attributes of SMEs. The initial definition of SMEs in Namibia had a narrow range of number of employees classified per SME category. The

¹ USD1 is equivalent to N\$7.1975

author realized that this definition made Namibian SMEs incomparable to other SMEs in different countries as per different definitions. The new Namibian definition of SMEs is generally in line with most international definitions and is more appropriate than the initial definition that combined the number of employees with companies' turnover. Therefore this research used the Namibian new definition as a guide, but not conclusive.

The research established factors that contribute to the SMEs' dilemma of securing funding. As the main providers of capital in the economy and due to the banking sector's previous experience in financing SMEs, the author identified the type of challenges that banks experienced when financing SMEs. The main common problems towards securing funding relevant to venture capital funding as identified by banking institutions are the lack of audited financial statements, which SMEs fails to compile, as they cannot afford to employ qualified bookkeepers and pay audit fees. Financial accounting and control systems are crucial for SMEs because these can be used for purposes of diagnosing possible problems or hidden advantages like the level of financial leverage in the company. Others factors identified by banking institutions include inability of SMEs to write bankable business plans, lack of financial discipline, and unwillingness of SMEs to give-up equity stake in their businesses and share decision-making powers with other investors. This will hinder the process of value addition to these enterprises, and will discourage other investors like venture capitalists in investing in the sector.

The lack of access to capital, especially equity capital, was identified as a major constraint to the development of SMEs. The research then evaluates if there are any opportunities that can contribute to the transformation of the SME sector so that these businesses can operate at their full potential. The maximum amount that a bank can currently grant to an SME exceeds N\$1 million, with the highest amount totaling N\$5 million. However, an enterprise with a funding requirement of N\$100 million may not find it easy to raise the needed funds through the sources currently available, and may therefore need other investors to fill that void. Investors on the other hand are in need of Namibian companies with potential growth to invest in. Therefore opportunities are available for the investors and SMEs, but can only be realised with the existence of both parties. The study then assessed if there are any SMEs that can attract and are willing to consider equity capital financing as a source of funding for their businesses. This research established that there is a demand for equity capital in the SME sector, but the supply of this capital is very limited in the Namibian market.

The study went further to establish if venture capital investment could be a viable source of funding for SMEs, given the role that these investors played in growing the SME sector in other countries. Of those sources of funding available, venture capital financing is the only one that can address the SMEs problems of lack of capital and skills shortage due to venture capitalists' main characteristics, as these investors will take an active role in the management of those enterprises they fund, therefore contributing professional and seasoned management experience to the specialised knowledge and skills of an enterprise's owners. Although the venture capital industry in Namibia is highly underdeveloped, there are SMEs that match the characteristics of venture capital investments as identified in the literature review. Venture capital has also been identified by banking institutions, SMEs and venture capitalist as a vital element in the rapid economic growth in Namibia.

The research identified challenges facing the establishment and development of venture capital funds in Namibia. Amongst those identified include the lack of skills and capital, coupled with non-existence of laws and regulations to guide the operations of venture capital funds and ensure efficient administration of the industry. Other issues currently lacking in the Namibian economy such as a large mass-manufacturing base, large domestic markets, capital and innovation are some of the key fundamentals needed for venture capital prospects.

The author then made recommendations on how to develop the venture capital market that can assist in growing the SMEs in Namibia, by providing risky capital to small and medium enterprises. The research also evaluates government support availed to SMEs in order to attract equity capital, especially venture capital in order to augment SMEs' self-sustainability. It was established through interviews that currently there are no direct government supports earmarked for venture capital funds. Therefore, in order to develop the venture capital industry the government should develop and adopt policies that are focused on promoting entrepreneurship. Government can affect the supply of money to the venture capital funds through the extension of loans or loan guarantees directly or through their agencies, especially the Namibian Development Bank, to registered venture capital funds that will invest within government guidelines. Direct means that the government can apply to encourage venture capital investments include the provision of financial incentives for investing in venture capital funds or small and medium enterprises, through its fair and effective tax system. Another driver of the investment activities that can attract venture capital investors is the Government's consideration of the privatisation

of some of its state-owned enterprises, especially the profitable ones. Besides these initiatives, a market needs to develop businesspersons who can work as role models in order to inspire and motivate students to seek an entrepreneurial career in business.

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CHAPTER 1

BACKGROUND AND RESEARCH OBJECTIVES

1.1 BACKGROUND TO THE STUDY

Prior to independence the financial sector in Namibia was mainly integrated with that of South Africa, because Namibia was treated as one of South Africa's Provinces. During that time, commercial banks in Namibia operated as branch offices of their South African parent companies. After independence both Government and local pension funds changed the face of the financial sector in Namibia by insisting on localising banks that operated in Namibia. Namibian laws and regulations were promulgated which resulted in the creation of more opportunities to serve the needs of the Namibian people and their economy.

There are four banking institutions currently operating in Namibia, of which three are mainly South African-owned. Their main focus is on retail banking, with other banking services offered through their parent companies in South Africa. These are the main source of funding for many businesses and other economic activities in the country. Growth in the banking sector has been strong since 1990, when commercial banks opened branches and agencies in what were previously regarded as unbankable areas.

Anecdotal evidence shows that the financial sector remains a viable sector for the funding of small and medium enterprises (SMEs). Research shows that the contribution of SMEs in promoting economic growth and employment creation is very important. For example, SMEs in the Organisation for Economic Co-operation and Development (OECD) and emerging countries account for a large share of their economies, representing 97% and 60% respectively of the total number of enterprises. SMEs also make an important contribution to overall employment, accounting for 60 – 70% of the manufacturing total in most developed and fast developing economies (Gaomab II, 2005).

In the case of Namibia, SMEs show significant growth as well. For example, the small business sector's contribution to the Gross Domestic Product (GDP) increased from 8.04% in 2002 to 11.01% in 2003. In terms of employment, its contribution increased by

4.8% in 2002 to 19.8% in 2003 (Arnold *et al*, 2005). However, compared to the international trend, the development of the SMEs is still negligible.

The Namibian SME sector is fragmented and most investors fail to see the sector's growth potential and wealth creation. SMEs are still experiencing difficulties in securing financial support from commercial banks and other financial providers. Namibian SMEs rely mainly on family members, friends and their own savings to fund their businesses. Usually these sources cannot provide enough funds to develop organizations into fully - fledged business entities. SMEs and many service providers are well aware that finance for growth is not readily available to SMEs (Tjituka and Harris, 2005). Lack of access to finance was identified by the Government as one of the key constraints to the growth and development of formal and informal SMEs' (Ministry of Trade and Industry White Paper, 1997).

Formal financial institutions in Namibia have been reluctant to give credit and finance facilities to small business owners due, among other things, to a lack of the required security that small entrepreneurs should cede to secure credit and finance facilities (Uanguta *et al.*, 2005). To alleviate this problem, the Namibian Government, together with other international agencies, set up a credit guarantee facility for SMEs to facilitate and assist the small entrepreneurs in gaining access to commercial loans from formal financial institutions. Nonetheless, the establishment of the Small Business Credit Guarantor Trust (SBCGT) in 1999 proved not to be a feasible solution to the dilemma of access to finance experienced by small business entrepreneurs, mostly due to the fact that the Trust can guarantee only a small loan limit of N\$250 000.

Another issue that contributed to lack of finance in the SME sector was the huge capital outflow in Namibia, especially through the pension and insurance companies that are operating in Namibia but are wholly owned by South African parent companies, (Uanguta *et al.*, 2004).

To address this crisis of capital outflow the Government gave full moral and legislative support to the establishment of the Namibian Stock Exchange (NSX) in September 1992. From its inception until the Asian crisis in 1998, the NSX experienced rapid growth in terms of companies listed and values traded. Since then the market has been

under pressure with volumes declining, local stocks deteriorating in terms of valuations and a move towards delisting rather than listing.

A study conducted by the Ministry of Finance and the Bank of Namibia in 2003 revealed that the establishment of the NSX did not fully address the capital outflow dilemma. This study concluded that there had been massive capital outflow, mostly to South Africa, in the form of pension funds, life insurance and short-term investment through transactions between local commercial banks and their parent banks in South Africa. This resulted in capital account deficits averaging N\$404 million or U\$56 million¹ per annum between 1994 and 2001.

A report by the International Monetary Fund (IMF) confirmed the continued strong outflow of Namibian capital to South African financial markets, and the IMF's advice was to develop the domestic investment opportunities and market-based strategies in order to curb this outflow.² In their report Sherbourne and Stork (2004) revealed that the NSX had lost significance with respect to financing investments in Namibia. Only about 2% of Namibian pension fund assets were invested in primary listings or property, i.e. investments that directly contributed to economic growth and employment. These capital outflows resulted in capital scarcity and poor investment growth, and contributed to low economic growth. In other words, the Namibian asset requirement had thus failed to channel contractual savings into productive Namibian investments. Lack of investment opportunities was highlighted as one of the main hindrance factors in the savings–investment translation of process. The Government realised the necessity for a policy response to curtail capital outflow and create investment opportunities in order to utilise more of the country's savings for domestic investment.

In the Cabinet meeting that took place on the 27th of July 2004, the Government gave approval to the Ministry of Finance to introduce a number of policy recommendations for future implementation. These recommendations include *inter alia* the following:

- a. To reduce the percentage of investment in dual-listed companies that qualifies as domestic investment to 10% over five years.

¹ At an exchange rate of N\$7.1975

² Staff Report for the 2006 Article IV Consultation, prepared by the Staff Representatives for the 2006 Consultation with Namibia, approved by Thomas Krueger and Anthony R. Boote

- b. To prescribe to all institutional investors a 5% minimum investment in unlisted Namibian companies.

Pension assets accounted for 60% of Namibia's GDP, and life- and short-term insurance and unit trusts accounted for 20% in 2001. The total funds available in Namibia by 2006 were in the region of R55 billion (Mwinga, 2007)³, about R26 (GIPF Annual Report, 2006) billion of which was from the Government Institution Pension Fund (GIPF).

The Government engaged in consultation with various stakeholders in the market to seek their comments on the proposed changes to the legislation. Although key players in the industry supported the government's policy stance, investors were more concerned about the effect of the policy on returns on their investments and on NSX liquidity, fearing that dual-listed companies that provide liquidity to the exchange may just as well delist, as they would lose local investment status. Another main concern of these capital providers was the shortage of unlisted investment opportunities in the Namibian market. The argument concerning lack of unlisted investment in the economy, however, is not really valid as investment in unlisted entities includes investment in small and medium enterprises (SMEs) that are not listed in any exchange, but are currently operating in the country.

The implementation of the proposed government recommendations will definitely benefit small businesses, especially those with feasible business models, since investors will be obliged to vigorously seek investment opportunities within Namibia in order to absorb their excess funds that could not be invested in the dual listed stocks. This will compel them to consider available SMEs as an alternative investment asset class to add to their portfolios.

In 2004 the Bank of Namibia conducted a survey and compiled a report on "*The Structure and Nature of Savings in Namibia*". During this survey interviews were carried out with key players in the industry such as unit trust management companies, asset managers and insurance companies, where the same sentiment concerning lack of quality investment instruments in the country was identified as the main contributing

³ This paper was presented at the GIPF's Unlisted Securities market conference in August.

factor in the savings-investment translation process. These stakeholders confirmed that lack of relevant expertise and finance had been an aggravating factor, and alternative investments could be used to create quality investment opportunities in the market.

The above analysis shows that the two factors identified, namely lack of finance and managerial skills, seem to be a constraining factor on the development of SMEs in Namibia. Apart from bank loans there are also common instruments that have been explored by SMEs to fund their operations. These common instruments include bond issuance, trade credit (Love *et al.*, 2006), factoring and invoice discounting (Bakker *et al.*, 2004) and leasing (Verschoor, 2001). However, a review of the literature shows that these types of financing are unattractive to SMEs because of the high cost of acquiring funds by these instruments, the negative impact on the enterprises' cash flow especially with leasing, the issue of collateral required when acquiring a bank loan and the failure of the providers of this capital to provide the necessary skills. International evidence shows that there is another type of financing instrument that has proved empirically to solve the twin problems of lack of access to finance and lack of managerial skills for SMEs. This type of financing is referred to as venture capital financing. Venture capital investment is defined as being an investment in unquoted enterprise, usually associated with high risk, and in its original sense primarily directed towards young, often technology-based firms with a high growth potential (Christensen and Christensen, 2002).

According to Berlin (1998), venture capitalists usually take an active role in the management of the projects or companies they fund, thereby contributing professional, seasoned management experience to the specialized knowledge and skills of the project's initiators or company owners. Venture capitalists also work in close collaboration with the stock market to take the company or project they fund public, therefore increasing the amount of capital available to these ventures, and creating opportunities for the public to share in the wealth of successful projects or companies.

1.2 RESEARCH OBJECTIVES AND RESEARCH MOTIVATIONS

The purpose of this research is to provide an analytical insight into this question:

In what way can venture capital financing contribute to the development of small and medium enterprises (SMEs) in Namibia?

The development of the SME sector will create more investment opportunities and the participation of venture capital in this sector is therefore critical to the success of these small businesses.

This research aims to address the following objectives:

- a) To establish whether venture capital can reliably serve as a source of finance for SMEs given that there is a problem of access to finance in Namibia. This is important because SMEs in Namibia are generally in dire need of finance. Evidence shows that venture capital as a source of finance serves as an ideal type of instrument for the development of SMEs internationally. The study will therefore assess the importance of venture capital financing in the context of the SMEs in Namibia, specifically focusing on addressing the problem of lack of much needed capital in the SME sector
- b) To assess whether venture capital financing can be effectively utilised to enhance managerial skills within SMEs in Namibia. Unlike other sources of funding, venture capital has been identified internationally as a type of financing instrument that can impart or contribute to the enhancement of management and technical skills within SMEs.

1.3 ORGANISATION OF THE STUDY

The research will be divided into five chapters. The second chapter will look at the literature review on general characteristics of SMEs including those of Namibian SMEs, and the role that SMEs have played in economic development, the overview of other common sources of funding available to SMEs, the venture capital investment concept, including its historical development, the investment process and its benefits at the macro level as witnessed in other countries. Chapter 3 will introduce the research methodology and sampling techniques used in data collection and analysis. Chapter 4 will analyse the collected data, with the last chapter concluding with policy recommendations and summarising the research.

CHAPTER 2

LITERATURE REVIEW

2.1 CHARACTERISTICS OF SMALL AND MEDIUM ENTERPRISES (SMEs)

2.1.1 Introduction

This section looks at the definition of SMEs both at international and national level to determine whether the Namibian definition of SMEs is comparable to global definitions. The section also looks at the distinctiveness of SMEs in different countries and their contributions to economic growth as this research's main objective is to find ways to develop the SME sector by providing skills and capital in order for it to contribute to the country's GDP, employment creation and skills development. The section then gives a brief overview of finance-related problems and their relationship to the overall development of the SME sector.

2.1.2 Definitions of SMEs

The term SME has been variously defined and it covers a wide range of definitions and measures, varying from country to country. Some of the commonly used criteria are the number of employees, total net assets, sales level per sector, investment level and the number of partners in the organization. However, the most common definitional basis used is employment, and here again, there is variation in defining the upper and lower size limit of an SME. Despite these variances, a large number of sources define an SME as having a cut-off range of 0 - 250 employees. SMEs are defined as formal enterprises and are thus different from informal enterprises.

As from 1 January 2005, the European Union (EU) commission categorized the SME sector in three components:

1. Micro enterprises which include enterprises with 0 to 9 employees
2. Small enterprises which include enterprises with 10 to 49 employees
3. Medium enterprises which include enterprises with 50 to 499 employees

Furthermore, according to the EU's definition, SMEs are also classified based on the size of their turnover and balance sheet. Micro enterprises are those with a turnover or

balance sheet size less than or equal to €2 million euro. For a company to qualify as a small enterprise it should have a turnover or balance sheet equal to or less than €10 million euro, whilst companies with turnover equal to or less than €50 million or a balance sheet of less than or equal to €43 million qualify as medium-sized enterprises (*Enterprise Europe*, 2003).

The Swiss Contact Foundation has classified SMEs based on the definition that SMEs include businesses or individuals with total assets excluding land and buildings of up to US\$ 112,000, with total annual sales of up to US\$ 1,680,000 (Rudjito, 2003).

As one can see, this definition is mainly based on employment and does not assume that SME groups are homogenous. The definition of SMEs by the United States Agency for International Development (USAID) is based on employment and sales volume. As per its definition, SMEs include companies with less than 50 employees with at least half their output being sold.

The World Bank defines SMEs as entities with fixed assets (excluding land) of less than USD250, 000 in value (Kayanula and Quartey, 2000). The International Finance Corporation (IFC) classifies SMEs based on total assets, total annual sales and number of employees. The IFC defines micro enterprises as individuals or entities with total assets of up to US\$ 100,000, with total annual sales of up to US\$100,000, employing up to 10 people. Small enterprises are defined as individuals or enterprises with total assets of up to US\$ 3 million, total annual sales of up to US\$ 3 million with up to 50 people in employment. Medium enterprises are defined as individuals or organisations with total assets and annual sales of up to US\$15 million each, and a total number of employees of up to 300 (Rudjito, 2003).

SMEs in Namibia are defined based on their business activities or economic sector. In its policy paper entitled "Namibia: Policy & Programme on Small Business Enterprises"(1997), the Namibian Government through the Ministry of Trade and Industry defines small enterprises as follows:

- a) **Manufacturing sector:** Refers to an entity with fewer than 10 people in employment, with a turnover below N\$1,000 000 and capital employed not greater than N\$500 000.
- b) **All other sectors:** The definition includes companies with less than 5 people in employment, with a turnover below N\$250 000, and the capital employed not greater than N\$100 000.

The Joint Consultative Committee (JCC) and the Namibia Economic Policy and Research Unit (NEPRU) reviewed this definition to be on parity with international definitions of SMEs (Stork *et al.*, 2003). The proposed definition defines sizes of businesses in a way that is independent of inflation and makes a clear distinction between formal and informal businesses. It categorizes businesses according to the number of employees and classifies SMEs into micro, small, medium, large and extra large. Businesses in the primary and manufacturing sectors like agriculture, fisheries, forestry and mining that employ

- 1 to 10 are regarded as being micro enterprises
- 11 to 25 falls under small entities
- 26 to 75 are regarded as medium enterprises
- 76 to 250 are classified as large enterprises and
- more than 250 employees are classified as extra large entities.

The definitions differ slightly for businesses in the service sector since entities with a staff compliment of between 26 and 150 are regarded as being large, and enterprises with more than 150 employees are classified as extra large entities. One can conclude from the above definitions that the definition of SMEs varies across countries, and across sectors even in the same country, and mainly depends on the domestic conditions in each country.

The new definition of SMEs in the Namibian context is more in line with most international definitions and is more appropriate than the initial definition which combined the number of employees with companies' turnover, mainly for the following reasons:

- As mentioned in NEPRU's and JCC's reports, companies' turnover can be affected by the rate of inflation, which can give an impression that the company has grown in size as reflected by its revenue but it may not necessarily be the quantity produced and sold which has increased, but rather the price per unit.
- Secondly, one person may operate a company with a huge turnover, without employing anyone else beside himself. This company may then be classified as a medium to large SME, depending on its annual turnover, although the company employs only one individual. Whilst this may not necessarily be wrong, this company does not contain the main feature of SMEs, i.e. that of labour intensity and employment creation which is key to the Namibian economy due to the high rate of unemployment.
- Thirdly, companies' turnover and balance sheet sizes can be influenced by each country's population size, taking into account the percentage of the economically active citizens together with other demographic statistics that have an effect on wealth creation. A country's economic size or budget, available resources and currency strength can also influence companies' turnover and balance sheet sizes. It would be very difficult to compare SMEs in different countries by looking mainly at the size of the entity's performance or magnitude as translated in monetary values, as these amounts will be reported in local currencies, and one can do injustice to SMEs from developing countries with weak currencies by converting these key indicators into hard currencies. This is especially true of companies from countries with a low GDP per capita. Results after conversion may be meaningless to an outsider, but can mean a lot in local terms. Hence the definition as per NEPRU and JCC is justifiable and the application of SMEs as per this report has taken the new definition into consideration.

However, as per this definition, Namibian SMEs may not be comparable to other SMEs in different countries according to different definitions given above because of the narrow range of number of employees per company in the Namibian context. For example, it would be unfair to compare a Namibian labour-intensive medium entity with up to 75 employees with a labour-intensive medium entity as per the EU definition, which defines a medium entity as a company with up to 499 employees. This research uses the Namibian definition as a guide, but not exclusively. A company's financial strength is quite critical to capital providers, not necessarily the number of employees in

that specific company. For these reasons, when one looks at venture capital investment as a source of finance, the number of people employed becomes immaterial, as the main focus is on the size of the business transaction, which is mainly based on the company's financial position and its business model. The target population interviewed for this report focused mostly on SMEs that may attract venture capitalists. The concentration was on small and medium enterprises that manufacture and provide products and services with exportable potential.

2.1.3 Characteristics of SMEs

SMEs can be categorized into urban and rural enterprises. Urban enterprises can be either organised, with registered offices and a significant number of salaried employees or unorganised, with artisans operating from open spaces, temporary structures or mainly working from home with a very small number of paid employees or unsalaried workers. Sometimes these urban enterprises rely on family members or trainees who assist in running the businesses. Since most of these businesses are run by family members and are home based; the business growth strategies are normally affected by household responsibilities with only little time sometimes being dedicated to business affairs (Liedholm and Mead, 1987; Osei *et al*, 1993; World Bank, 1992).

Rural enterprises, on the other hand, are mainly made up of family members, individual artisans and women who are principally engaged in food production from local crops. They are commonly small in size with movable informal structures and require very little start-up capital, but as they expand their operations, the need for more financing arises. Most rural SMEs are self-financed by the founders, their families and friends (Fluck *et al.*, 1998). Most of the rural entrepreneurs have little or no formal education. They are concentrated in market sectors that have low barriers to entry and low levels of outside communication. Their main focus is on trade, services and light manufacturing activities. Their businesses are generally smaller than others with not more than ten people in their employment. The owners have moderately little previous working experience, and they use traditional technologies to run their businesses (Rudjito, 2003).

Despite the fact that SMEs have the potential for building stable economic growth, the development of an SME is quite difficult and innumerable problems need to be addressed before SMEs reach their full potential in economic development. The most

common problems for SMEs are lack of access to market information, lack of access and inability to keep up with current technology, low quality of human resources and lack of access to capital. SMEs in other African countries have also experienced the problem of financing. A World Bank study found that about 90% of African small enterprises surveyed stated that credit was a major constraint to new investment (Parker *et al.*, 1995).

Most SMEs do not understand the type of products needed by the market. They do not know the size of the market they are producing for, or when these products are needed, neither do they know how to deliver these products to the intended market or consumers. SMEs also have weakness in bargaining power, particularly when dealing with big buyers. Even if they understand the market, they sometimes find difficulty in acquiring raw materials either because of lack of supply or affordability (Rudjito, 2003).

Rudjito (2003) states that there is a common misunderstanding that banks are reluctant to lend money to SMEs since the banks believe that lending to SMEs is not commercially viable for them. For some banks, financing SMEs may be very difficult. This is not surprising as some problems arise which are beyond the capability of the banks to handle. Issues like unfavourable business environments or systematic risk in the financial sector are amongst those problems that banks have little or no control over.

The equity gap within the SME sector has been a problem in the developed countries as well. Concerns about the difficulties encountered by small enterprises in the United Kingdom (UK) in raising loan and equity finance can be traced back some 70 years to the Macmillan Report (Harris, 1995). The majority of small- to medium-sized enterprises in the UK rely on self-financing through the personal capital of the owner and his/her family as well as retained profits, supplemented in most cases by bank overdrafts, loans and trade credit (Reid, 1992). Although equity accounts for only a small proportion of the overall finance used by SMEs, its availability is nevertheless of considerable significance for the vitality of the enterprise economy.

Constraints on the availability of equity finance for SMEs in the UK have been compounded by changes in the lending practices of the major clearing banks, which are

by far the most important source of external funding in the UK (Binks *et al*, 1992; Cosh and Hughes, 1994). The banks have sought to rebuild their capital base following substantial losses arising from Third World debts, international property debts and corporate and SME failures (Gapper, 1993a). The need to restore their capital base was made more pressing by the new minimum capital adequacy ratio requirements of the Bank for International Settlements (Plender, 1993).

The banks have become more cautious in their lending decisions and have tightened their lending criteria (Bank of England, 1994). Banks now require greater security for loans and are placing greater importance on the level of gearing. A high level of gearing increases the need for enterprises to raise additional equity finance beyond that which can be raised from the personal resources of small business owners (Deakins and Hussain, 1994). The banks have also sought to limit access of small enterprises to overdraft facilities because of their frequent use by undercapitalised businesses as a substitute for equity rather than as working capital (Plender, 1993; Gapper, 1993a, 1993b). The implication is that businesses can no longer expect to obtain overdraft but what is in effect equity finance but at overdraft rates of interest (Batchelor, 1993).

Recession has also encouraged banks to develop more sensitive risk pricing systems and there is some evidence that the better quality proposals are getting lower margins (Bank of England, 1995). Business size and the associated perception of security is an important determinant of bank attitudes in its own right, with bank managers regarding the bigger businesses as better than the smaller ones (Vyakarnam and Jacobs, 1991).

The banks are increasingly taking the view that lending decisions should be based primarily on an analysis of the borrower's cash flow and business plans, with the availability of security being regarded as an important but secondary consideration (Bank of England, 1994). However, this requires increasing monitoring of the borrowers, which imposes additional costs on the banks and will, inevitably, result in an increase in bank charges.

Another major constraint to the SME sector development is the lack of entrepreneurial and business management skills. Kayanula and Quartey (2000) state that lack of managerial know-how places significant constraints on SME development. According to

their report, the scarcity of management talent prevalent in most African countries has a magnified impact on SMEs. In Singapore, about 71% of all small and newly registered companies fail within the first five years of incorporation. Lack of entrepreneurial and managerial skills has been identified as the major cause of SME failures (Ngiap and Joseph, 2004). The Szabó (1996) report on European Union SMEs confirmed that new entrepreneurs face problems due to the lack of skills, lack of know-how, language problems and cultural differences.

SMEs in Namibia are not that different from SMEs elsewhere. The activities of SMEs in Namibia vary between informal and formally established businesses. The informal sector includes a large number of people in rural areas who sell their agricultural produce or handicrafts both on a full-time and part-time basis. Their main source of livelihood is agriculture, with little income derived from these agricultural activities. The activities of those engaged in the full-time informal sector also produce low incomes mainly from low value-added retailing and catering. Most businesses in the informal sector are operated as one-person entities with a very limited working capital with which to purchase trading items. These entrepreneurs range from garage owners, plumbers, builders, electricians, welders, carpenters, tailors, hairdressers, to providers of cleaning and laundry services. There are also small manufacturers who make and sell handicrafts and those that make consumer and industrial products.

In the formal sector retailing covers a much wider range of consumer and industrial products, with small scale mining being an important business activity. The formal sector businesses are larger in terms of both employment and turnover. For example, the average number of employees per manufacturing establishment among the small businesses is seven, with an annual average turnover of just over N\$500,000 (Ministry of Trade and Industry white paper, 1997).

Namibia's small formal businesses have a higher labour intensity than their larger counterparts. For every Namibian dollar invested in them, they create more jobs than larger businesses; hence a higher proportion of investment in small businesses is seen as having potential benefits to the country since employment creation is one of the country's national priorities (Ministry of Trade and Industry white paper, 1997).

SMEs in Namibia also face constraints with regard to their development and growth, with a high rate of business failure. Before independence small businesses in the informal sector mainly confined their access to resources and spheres of activity to a very narrow part of the economy. SMEs in the formal sector suffered from structural weakness of the economy since wealth generation was concentrated in only a limited number of sectors with weak linkages to the rest of the economy. These businesses now have to compete with established competitors from South Africa, whose greater size enables them to use predatory business practices to supply the Namibian market with consumer products.

Lack of finance has been identified as one of the main constraints to the development of small businesses in Namibia. The capital needs and lack of skills facing the Namibian SME sector has been constant because those SMEs that desire to grow never have enough capital or skills to do so. This was confirmed by a number of research studies conducted by different stakeholders in the market. In its 1997 paper on “*Namibia: Policy and Programme on Small Business Enterprises*” the Namibian Government acknowledged that the availability of finance to small businesses remains poor and lack of finance is still the major stumbling block to the sector’s inability to realise its potential social and economic role.

In his paper on “*The Challenges Facing SMEs in Namibia and the Global Village*”, which was presented at the Joint Consultative Council’s annual general meeting, 2004, Gaomab II wrote that the issue of access capital is amongst those challenges faced by SMEs as they develop into viable economic entities.

In their report of September 2001 entitled “*Venture Capital for Medium – Scale Namibian Enterprises*”, Tom Gibson and Christopher Davis established through interviews conducted that commercial banking practices in Namibia are strongly conservative and long-term, while unsecured lending for younger companies is extremely rare or nonexistent.

Michael Tjituka and Andrew Harris of JCC conducted a survey and compiled a report entitled “*Monitoring and Evaluation in the Small Business Service Sector 2004/5*” in

which they confirmed that SMEs and many service providers are well aware that finance for growth is not readily available to SMEs.

As mentioned earlier, Namibian banks are not that keen to lend to small businesses. Small businesses need access to both loan finance and seed capital to enable them to fulfil their potential. Other limitations facing this sector include issues like lack of access to the wider market, lack of access to competitive purchase inputs, non-availability of technologies and lack of formal education which has led to most entrepreneurs being illiterate. Shortage of skills amongst small business entrepreneurs was also identified as an encumbrance to the success of SMEs in Namibia. The Government's policy document entitled "*Namibia: Policy and Programme on Small Business Enterprises*" identified amongst others "*the shortage of suitably-trained entrepreneurs in either vocational or business disciplines*" as a major disadvantage to the small business sector. The shortage of skills in the Namibian private sector was also confirmed by the IMF Consultation Report (2006) where it was stated that there is a need to facilitate the entry of skilled foreign workers into Namibia in order to bridge the skills gap until education reform produces enough qualified local workers. This report also confirmed that the Namibian authorities recognized that transferring skills from abroad is important but stressed their intention to balance the entry of skilled workers against the objective of developing local capacity and improving the employability of Namibian workers. The challenge to the Namibian Government and business community is to identify a workable model that can allow for the transfer of skills to the Namibian workforce.

The literature review in this chapter confirmed that the problem of unavailability of capital and the shortage of skills is not just confined to the Namibian SME sector, but is rather a common problem within the sector in some other countries as well. With so many constraints affecting growth, SMEs will have to face greater challenges in the highly competitive business world. Strengthening SMEs must be a priority in order to prepare to face these challenges, and it will be difficult to address this without having real capital. This section confirms that SMEs do not easily succeed in raising capital and that banking institutions are not keen to lend to SME because of the high risk of failure within the sector. It is therefore critical to explore other sources of capital instead of concentrating too much on the banking sector, as history has proven that banking

institutions have tried to solve the problem, but the gap continues to widen and SMEs are still fighting to expand their operations.

2.1.4 The role of SMEs in economic development

Small and medium-sized enterprises (SMEs) are considered to be among the principal driving forces in economic development. They stimulate private ownership and entrepreneurial skills; they are flexible and can adapt quickly to changing market demands and supply situations; they generate employment, help diversify economic activity and make a significant contribution to exports and trade (Szabó, 1996).

Besides the relative weight of SMEs in total employment, other reasons have been suggested to justify why policy-makers have given special attention to the SME sector. Although some available experiential evidence shows that labour intensity is more related to industry types rather than enterprise size (Snodgrass and Biggs 1996), Anheier and Seibel (1987) confirmed that SMEs are more labour-intensive than large corporations. Labour-intensity results in a lower capital cost being associated with job creation. According to their findings, SMEs "labour-intensiveness" is also responsible for SMEs being closely linked to "labour force supply-driven" survival strategies, most common during recessions, natural disasters, conflict and post-conflict situations. It has also been observed that small and medium enterprises make better use of scarce resources than large-scale enterprises (Kayanula and Quartey, 2000).

Another factor is that SMEs are more able to succeed in smaller urban areas and in rural areas. The regional reach of SMEs is one of the critical factors for African countries where agriculture represents up to 46% of the GDP and where it employs on average 72% of the economically active male population and 85% of the female population. SMEs are therefore responsible for a more even income distribution and also play a very important role in stopping migration flow from rural areas to metropolitan areas (Kayanula and Quartey, 2000).

It is somewhat difficult to assess the impact of SMEs in most of the developing world's economies because of lack of statistical data and research on industrial structures in developing countries, albeit that, SMEs are normally considered to employ a significant part of the working population in developing countries. Liedholm's (2001) review of

national surveys conducted in several African countries estimates that about 17% to 27% of the working age population is employed in micro and small enterprises, being nearly twice the employment of large-scale enterprises and the public sector. USAID considers that micro enterprises often employ a third or more of the labour force in low-income countries. In Uganda, for example, a survey of small and medium enterprises commissioned by USAID in 1995 established that 22% of all households in the country were engaged in some sort of small business activity and that these activities employed around 29% of the country's labour force.

The positive economic impact of SMEs has also been witnessed in other African countries. Kaufmann (2005)⁴ wrote that in 2003 micro and very small enterprises provided more than 55% of all jobs in South Africa, and contributed about 22% of the country's GDP. Small enterprises accounted for 16% of both jobs and production and medium and large enterprises for 26% of jobs and 62% of production. SMEs also proved to be vital to the Nigerian economic development, as about 95% of formal manufacturing activities were mainly in the hands of SMEs. SMEs in Kenya employed some 3.2 million people in 2003 and accounted for 18% of the national GDP, whilst the Senegalese SME sector contributed about 20% towards the country's national value-added during the same year. In Morocco, 93% of all industrial enterprises were SMEs and accounted for 38% of production, 33% of investment, 30% of exports and 46% of all jobs.

The role of SMEs in economic growth was also evident in Asia. There is empirical evidence that in the Asian economic growth of the post-1960 period, Taipei, China with its greater reliance on SMEs grew as fast as the Republic of Korea, which stressed large-scale enterprises in its early phase of industrialisation (Migara and De Silva, 2003)

SMEs played a significant role measured in terms of both employment generation and value-added. In Japan for example, the SMEs' share of employment remained fairly stable ranging from 70% - 74% in the manufacturing sector. SMEs' shares in value-added and output showed similar stability. In Korea, the role of SMEs has undergone a dramatic change as highlighted by the sector's share of employment in the manufacturing sub-sector that increased from 46% in 1975 to 69% in 1999. Migara and

⁴ Kaufmann 2004/5 African Economic Outlook

De Silva (2003) stated that the value-added increased from 32% to 47% during the same period. According to their research, during the 1997 Asian crisis most conglomerates especially in the South East Asian region collapsed while many micros, small and medium businesses remained stable and grew. This contradictory situation has led to governments giving more attention to enforcing the role of micro, small and medium enterprises (SMMEs) in national development programmes. The growth of micro, small and medium businesses was strongly proven to support the sustainable growth of some banks during this crisis. By 2003, the economic growth was driven by domestic consumption and enhanced by micro, small and medium enterprises activities, which focused on local resources.

Veselka (2005) confirmed the contribution of SMEs to economic growth by focusing on a number of different Asian countries. In his research he states that in China, Japan, Taiwan, Thailand and Vietnam, SMEs play a major role and account for over 70% of total employment; the equivalent figure is around 40% in Indonesia and Malaysia. In Singapore, even though SMEs are not that significant in numbers relative to some of the other countries, they are important in providing a flexible skills production base that attracts foreign direct investments (FDI). In 1976, SMEs accounted for 61% of total employment in Taiwan; by 1989 this had risen to nearly 71%. The majority of SMEs were in the manufacturing sector, which, in 1992, accounted for 43% of Taiwan's economy. In 2003, almost 98% of the approximately 1.2 million enterprises were classified as SMEs, which realised 31.5% of the total sales and employed 77.5% of the country's workforce. Furthermore, SMEs accounted for 99.4% of the 112 154 newly established enterprises in Taiwan. Between 1965 and 1990 the average GDP growth in Taiwan was 8.9%. In 1989 SMEs employed 70.8 % of all those employed in Taiwan, and the average capital / labour ratio was 1.305 in large enterprises and 0.187 in SMEs. Clearly SMEs, with their small-scale labour intensive production, generated income for a vast number of families. Subcontracting resulted in a constellation of SMEs ranging from relatively high tech enterprises right down to home-workers (most of whom were unskilled female workers).

In Thailand during the high growth period of 1987 to 1990, employment in large enterprises grew the fastest at 24% a year, followed by the growth of employment in the medium-sized enterprises (14%), small-sized enterprises (9%), and micro industries

(5%). During the slower growth period of 1990 to 1995, employment in the medium-sized enterprises grew the fastest at 16%, followed by the employment growth of the large enterprises (13%), small enterprises (13%) and micro industries (8%). Finally, during the stagnation period of 1995 to 1996, employment grew at the fastest rate of 9% in the small industries, followed by the growth rate of micro industries at 8%. Employment in medium and large enterprises grew at rates of only 6% and 4%, respectively.

According to Veselka (2005), Thailand's experience suggests that the contribution of SMEs to employment growth is related to industrial growth rates. During the high growth period, large and medium enterprises seemed to contribute more in terms of employment growth because many small enterprises graduated to become larger enterprises. The employment generation of a previously small enterprise became the contribution to a medium or a large enterprise. During the period of slowest growth or stagnation, not only did employment of large enterprises grow most slowly, but many enterprises also lay off workers and some even ceased operations altogether. In this situation, it is possible that the growth of many small enterprises resulted from the efforts of former employees of a medium or a large enterprise. In this sense the experience of some newly industrialized economies, rather than suggesting that the SME sector drives growth, might depict SMEs, particularly the small ones, as crisis shock absorbers that not only help provide employment during difficult times, but also prepare new entrepreneurs for graduating to running a larger enterprise when the economy recovers.

Sinha's (2003) research assessed the impact of SMEs in Asian countries like India, Nepal, Pakistan and Thailand and revealed that in India for example, the development of the SME sector has been a consistent element of industrial and employment policy since the 1970s, with the objective of creating jobs and reducing economic imbalance, notably in rural and less developed areas. By 2003, small-scale industry accounted for some 95% of all industrial units, 40% of industrial output and 35% of national exports. This suggests some success in implementing SME policy, although poverty and lack of employment opportunities were still prevalent.

Whilst for long periods SMEs were considered to be of little more than minor significance by the government in Nepal, they have since become a significant part of the country's private sector. Evidence indicates that more than 80% of the national value addition in the manufacturing sector comes from SMEs, the share possibly being even higher in the non-manufacturing sectors. SMEs employ 98% of the non-agricultural labour force and attract around 40% of all industrial investment (Sinha, 2003).

Similar trends are apparent in Pakistan where, in the past 50 years, government policies have not been supportive of SMEs and have in many ways impeded the growth of the sector. Despite this lack of positive support, and although only 20% of investment is made in SMEs, the sector has generated around 70% of total employment, contributing more than 30% to the GDP and absorbing more than 80% of non-farm employment. Units employing between 10 and 99 workers absorb an additional 20% of labour in the manufacturing, service and trade sectors (Sinha, 2003).

Of all the businesses operating in Vietnam, 96% are small to medium-sized. Their productivity accounts for 40% of the country's gross domestic product and some 12 million people are working in these companies (Nguyen, 2006). In Indonesia, SMEs have played a significant role in the economy of that country which has the fifth largest population in the world. The statistics of 2002 show that of more than 40 million enterprises in Indonesia, 99.99% were small and medium enterprises while large corporations accounted for a mere 0.01%. Millions of people who were engaged in these productive businesses together with SMEs employed about 99.45% of people working in the private sector. Their contribution to the country's GDP amounted to 54.74% (Rudjito, 2003). This evidence from most developing countries validated the SMEs positive effect on employment, family incomes, economic stability and growth of many manufacturing sectors.

Namibian SMEs also play a vital role in the country's economic development. The role of SMEs in Namibia has been quite evident, especially after independence when research on SME development and impact assessment started to be conducted. Despite difficulties in accessing finance and business support, the SME sector in Namibia has maintained positive growth trend over the past years. The Namibian

Government has identified the SME sector as one of the key support areas to achieve national development objectives. In the Government's National Development Plan 2 (NDP2) policy document, SMEs are expected to contribute between 5% and 10% to the country's GDP by 2006. The sector is also expected to increase investment by 4.1% between 2001 and 2006, and increase employment by 2.6% per annum from 1999 – 2006 (Stork *et al.*, 2003).

To measure up to these targets the contribution of SMEs to the Namibian GDP has increased from 8.04% reported in 2002 to 12.11% in 2004. The construction and hospitality industries reported above average contributions as compared to some other industries. The share of the Namibian labour force employed full-time in the small business sector increased from 15% in 2002 to 19.8% in 2003. This represented an increase of 4.8%, which is above the 2.6% growth target of NDP2. Equally, the contribution of SMEs to the country's Gross Fixed Capital Formation amounted to 8.54% in 2003 (Stork, *et al.*, 2003).

2.1.5 Conclusion

The literature review in this section confirms that SMEs dominate the world's private sector and play an essential role in job creation and economic development. Well-designed assistance programmes to support private sector development in the country will be critical, especially those targeting SMEs. To grow, these enterprises need stronger business environments and access to the right kinds of financial and other non-financial support. The development of SMEs is critical and their impasse of access to capital and managerial and technical skills needs to be dealt with at national level for the sector to fully contribute to the country's economic growth. Because Namibia's current financial institutions have failed to fully address the issue of SME business funding, it is imperative that other means of finance are promoted in order to attend to the need of small businesses for sources of funding and to address their lack of skills. The following two sections will look at the available sources of finance for SMEs, most of which have been commonly used in developed and developing countries.

2.2 COMMON SOURCES OF FUNDING FOR SMEs

2.2.1 Introduction

This section focuses on the most common instruments that can be explored by SMEs to fund their operations. The section assesses the prospect of addressing the SME problem of unavailability of capital and skills development through bank loans, trade credit, factoring, invoice discounting and leasing. It also looks at the advantages and disadvantages of sourcing funds through each source of finance as mentioned above.

2.2.2 Bank loan and bank overdraft

The most common source of funding for small to medium businesses has been through banking institutions in the form of bank loans. Commercial banks have been the leading supplier of debt capital to small enterprises in the United States (Ou, 2006).

An SME study conducted in Ghana showed that smaller enterprises have a greater problem with credit than larger enterprises, as 42% of the micro enterprises in the study listed credit for working capital among their major constraints, against 38% of small-scale enterprises and 25% of the medium-sized enterprises. The study observed that the success ratio for large enterprises applying for bank loans was almost 70% as compared with 45% for small enterprises and 34% for micro enterprises (Aryeetey, 1994). A large number of Namibian enterprise owners consulted during the research conducted by NEPRU and IPPR (2005) expressed their unwillingness to acquire bank loans because they had negative perceptions towards obtaining credit (Arnold *et al.*, 2005).

Because of the high credit risk involved with regard to most borrowers, be it institutional or individual, banks have been very stringent with their credit policies. This has made it difficult for most institutions, especially those in the SME sector, to make it onto the list of those candidates qualifying for a bank loan, which becomes a critical determining factor in any company's growth.

The introduction of risk management guidelines within the banking system by the Bank for International Settlement in Basle, Switzerland, has led to banking institutions being

more careful and prudent in risk taking in their banking operations. Issues of capital adequacy requirement have forced banks to concentrate on bankable clients who have sizable wealth, which the bank can use as collateral for any loan extended to them. Other issues that have contributed to tighter credit policies include lack of adherence to corporate governance, which has led to the bankruptcy and collapse of big corporations. It is mainly for these reasons that it has become quite difficult for SMEs to access bank financing through bank loans.

Apart from bank loans, SMEs use bank overdrafts to finance their activities. In general, bank overdrafts are more expensive, but are often preferred by SMEs because of cost and flexibility (Voithofer, 2003). Like interest on a long-term bank loan, interest on a bank overdraft is tax deductible, reducing the cost of funding for the company, as compared to other sources of funding such as equity.

A bank overdraft is generally used to supplement the working capital shortfall. As a bank overdraft is payable on demand, it is not advisable to use the funds in acquiring non-current assets such as machinery or other production equipment. Financing of such assets should be done through long-term finance. Any plans that involve an overdraft or a short term loan should therefore refer closely to the company's cash flow analysis so that it is quite clear how long the funds will be needed and when they can be repaid. Bank overdrafts can also be used to meet seasonal fluctuations in trade. The banks assist in providing temporary funds to finance production on the assumption that the goods or products will be sold during a later season. Agriculture is the obvious example of an industry where this type of borrowing is needed.

Bank loans and overdrafts can be used as sources of financing by SMEs, but would not be ideal in financing long-term projects of a capital-intensive nature. These types of financing do not address the issue of lack of managerial and technical skills, another critical success factor in the operations of any enterprise, including SMEs. In the previous section it was mentioned that SMEs experience problems with market knowledge, failing to identify products needed by the market. Unfortunately banking institutions do not assist SMEs with access to market mechanisms and proper networking. For this reason bank loans and overdrafts cannot be regarded as a solution to lack of financing and skills in small and medium enterprises.

2.2.3 Trade Credit

Trade credit is credit extended by a firm's suppliers when the supplier sells the firm goods or services on account. Instead of paying for the goods and services with cash (i.e., immediately), the firm pays its suppliers with a lag which creates the equivalent of a loan (i.e., trade credit) from the suppliers to the firm (Bakker *et al.*, 2004). Trade credit is an important source of financing relative to bank lending during periods of financial distress (Love *et al.*, 2006) and is generally regarded as a legitimate financial instrument that may be used by SMEs when banks are unwilling to finance them and/or to avoid direct bank costs and the complexity of bank credit. For this reason, micro enterprises use trade credit more often than small and medium-sized enterprises (Voithofer, 2003).

Trade credit is the basic source of finance, and many entrepreneurs do not realise that by acquiring items on credit they are obtaining short-term finance. In some countries and sectors the use of trade finance is even more common than bank financing since it can be acquired without much difficulty as compared to a bank loan. The use of trade credit is widespread among European SMEs. In the United States, for example, trade credit accounts for 16% of SME financing (Berger and Udell 1998). Van Horen (2005) studied the use of trade credit in 39 countries and found that trade credit is used as a competitive tool, particularly in small and young enterprises. McMillan & Woodruff (1999) studied the use of trade credit in Vietnam and found that small enterprises were more likely to both grant and receive trade credit than large enterprises. However, trade credit can be expensive to the customer or credit user. The supplier charges financing costs and a risk premium. Normally suppliers offer cash discounts for immediate payment, which if not used by the customer, result in an additional cost.

Terms of credit vary considerably from one industry to another. Theoretically, the following four main factors are considered when determining the length of credit allowed:

- The first factor is the economic nature of the product: Products with a high sales turnover are sold on short credit terms. If the seller is relying on a low profit margin and a high sales turnover, he cannot afford to offer customers a longer time to pay.

- The second factor to consider is the financial circumstances of the seller. If the seller's liquidity position is weak he will find it difficult to allow very much credit and will prefer an early cash settlement.
- The financial position of the buyer is also critical to the credit terms agreement. If the buyer is in a position of weak liquidity he may take a long time to settle the balance.
- Cash discounts are also important in the decision of acquiring stock on credit. When the opportunity costs of foregoing cash discounts are taken into account, the cost of capital can be surprisingly high.

An advantage of this type of financing is that an enterprise will acquire the goods or stock on credit, with the agreement to pay later. An enterprise with a high stock turnover will be able to generate revenue from the acquired stock and only pay at a later stage. It may even be able to generate income through interest from these funds if the time given to pay back is longer. The disadvantage, however, is that a company with a poor track record will always face difficulties in negotiating for more days; hence it will be given a short credit payment period. A company that acquires stock on credit will also forfeit any cash discount available for immediate cash purchases. Another drawback with this kind of financing is that it cannot be utilised to finance long-term investments since its repayment is of a short-term nature that requires regular cash generation.

The ability of any enterprise to obtain trade credit, especially with small businesses, depends on the quality and reputation of its management and the relationship it establishes with its suppliers. Chapter 1 of this research identified through the literature review the challenges of lack of managerial skills facing SMEs. Thus, SMEs may not find it easy to negotiate term credit with suppliers. Many SMEs are not able to pay their suppliers before their customers pay them due to liquidity constraints. Persistent late payment or non-payment may cause the suppliers to cut off delivery or insist on a cash-on-delivery basis. Hence this kind of financing is only ideal for a cash generating business and may not be suitable for a small enterprise which is at the level of aggressive growth. The providers of trade credit are equally not obliged to provide other services like management skills; neither can they assist in access to markets to enable the SMEs to penetrate a wider market network. Short-term financing may be available, but technical and managerial skills cannot be provided through this means of financing.

2.2.4 Factoring and invoice discounting

Factoring is a type of supplier financing in which an enterprise sells its credit-worthy accounts receivable at a discount (generally equal to interest plus service fees) and receives immediate cash (Klapper, 2006). It is one of the oldest forms of commercial financing as some scholars trace its origins back to the Roman Empire (Rutberg, 1994), and some even further back to the Hammurabi, four thousand years ago (Papadimitriou, Phillips and Wrap, 1994). Voithofer (2003) defines factoring as a debt financing method for working capital that refers to the sale of accounts receivable by a company to a factor institution on a continuous basis, normally for immediate cash. However, instead of borrowing and using receivables as collateral, the receivables are sold at a discounted value to a person or enterprise called a factor. The factor institution provides the sales accounting functions, manages the sales ledger and the collection of accounts under the terms agreed by the seller. It may also assume the credit risk within agreed limits. Factoring is thus a composite product offering a mix of finance, credit insurance, and financial management services. Around the world, factoring is the dominant form of asset-based finance and an important source of external financing for corporations and small and medium-size enterprises (Bakker *et al.*, 2004).

When a factor provides financing, the company that sells receivables agrees with the factor to undertake a continuous process. As the business receives orders, the factor

- evaluates the creditworthiness of the customer and approves (or not) the extension of credit.
- advances 70%⁵ (Klapper *et al.*, 2004) of the invoiced amount to the business; the amount retained by the factor provides for a reserve for contingencies such as rejection of the goods by the buyer. The factor usually remits the balance to the business once they collect the account.
- assumes the risk of collecting on the receivables.

The main characteristic of factoring as per the above definitions is that factoring is in effect the outsourcing of credit and collection functions by the SME to the factor. Factoring is used in both developed and developing countries. In 2005, the total

⁵ percentages differ, but is always less than 100%

worldwide factoring volume was over US\$1 trillion, including over US\$5 billion in China, Mexico, Turkey and Brazil (Klapper, 2006). About 11% of SMEs in Europe use factoring (Voithofer, 2003). Unlike traditional factoring, small businesses retain title to the receivables, and can pledge them to a lender if desired. The factor can also handle paperwork and provide reports to the client. According to the Enterprise Publications (2003), factoring enterprises offer credit guarantees and will buy clients' overdue receivables sometimes at full value at an average fee of 0.5% to 2% of the gross value of the accounts receivable for both services and guarantees. These fees vary according to business size and industry sector, with smaller enterprises generally paying rates at the higher end of the range, but fees can mount if the enterprise is not paid the receivables when due. For overdue accounts, the cost of factoring is approximately 1% of sales-per month. This fee level can be significantly high, particularly for low margin businesses and smaller enterprises. However, fees can still compare favourably with the internal cost of maintaining a credit department. Companies generally use factoring during critical growth periods and when requiring immediate cash to solve a cash problem.

The advantages of factoring are that those enterprises using a factoring service will:

- avoid the tying up of working capital cash in accounts receivable for the full credit period.
- eliminate the necessity for credit and collection departments.
- have access to an alternate credit source to finance inventory, fixed assets etc.
- may receive valuable advisory services including advice on budgeting, planning, operations, etc.

The disadvantages are that the cost of discounting may be considered disproportionately high relative to other forms of financing, and customers of enterprises using a factoring service may perceive the existence of a state of financial instability and may opt for another supplier.

Invoice discounting on the other hand is factoring for larger businesses where the responsibility for collecting payment stays with the company. Invoice discounting is

increasingly viewed as the fastest growing alternative to bank overdraft funding, yet it has rarely been made available to smaller businesses (Greater London Enterprises Ltd, 2003). Through invoice discounting, money is being lent to an SME against the value of its sales invoices. These funds can then be used for a wide variety of purposes including financing growth, restructuring, management buy-outs, management buy-ins and acquisitions. The two parties will agree to what is referred to as a prepayment facility against those invoices. Vital cash is released immediately; ready to be put to work where the company needs it most. Invoice discounting operates without the limitations imposed by traditional bank thinking. Further, invoice discounting means sometimes that the SME can reduce the cost of financing if the debtors are large enterprises with high credit ratings.

An Invoice discounting service:

- generates immediate working capital for the company
- reduces the pressure on the company's cash flow
- links funding to sales, thus providing the freedom to grow without restrictions
- is typically confidential, meaning that customers are completely unaware of the company's financial arrangements
- provides the company with total control over its sales ledger and retains its customer relationships
- helps secure preferential early settlement discounts

Factoring may not be regarded as the cheapest way to obtain capital, although it turns receivables into cash and can provide cash to a growth-oriented company. It is also not suitable for all businesses as not all debts can be factored. Depending on the size of the business, many small businesses may not have receivables to sell; hence this source of funding is not always readily available. Factoring cannot be used in the initial phase of operation to finance acquisition of fixed assets which are mainly needed to generate revenue, especially in high capital-intensive enterprises, but is rather a working capital source of funding. The cost of funding the business for SMEs through factoring also contributes to its unattractiveness to these entities. For example in Europe, interest charges on these funds range between 2% to 3% above bank base rates (Greater

London Enterprises Ltd, 2003)⁶. Another drawback is that a factor is not under any obligation to provide management or technical expertise to the SME. Therefore, factoring may ease the financing problem, but may not be able to transfer the needed skills to the SME. As already discussed in Chapter 1 of this research, small enterprises are faced with the problem of raising capital to buy equipment to allow them to produce their first sales consignments. Without any stock to sell, an entity will not be able to enter into an invoice discounting financial arrangement, and the discounting firm will not provide the needed skills, another challenge to most SME. Hence this type of financing is equally not feasible for small and medium enterprises, especially in a developing country like Namibia with a huge need for skilled people to operate the discounting house efficiently, combined with SMEs difficulty in penetrating the market.

2.2.5 Leasing

Verschoor (2001) defines leasing as an agreement in which one party, referred to as the "lessor", gains a long-term rental agreement, and the other party, known as the "lessee", receives a form of secured long-term loan. The contract will then give the lessee the right to use the equipment in return for a number of specified payments over an agreed period of time. It is a common financing method for fixed assets.

The most commonly used types of leasing are capital and operating leases. A capital lease is usually employed to finance equipment for the major part of its useful life, and there is a reasonable assurance that the lessee will obtain ownership of the equipment by the end of the lease term. A capital lease has similar characteristics to a term loan and a conditional sales contract. An operating lease usually finances equipment for less than its useful life, and at the end of the lease term the lessee can return the equipment to the lessor without further obligation (Verschoor, 2001).

Asset base financing (another form of leasing) refers to loans granted, usually by a financial institution where the asset being financed constitutes the only security given to the lender. A typical example might be a commercial building in which the space is occupied by one or more tenants who are under contract to the owner under long-term leases. In these situations, the lender is satisfied that the asset provides adequate

⁶ This report was commissioned in January 2002 by the European Commission Directorate General for Enterprise

security value and that the revenue derived from it will repay the loan over time. In the event of non-payment, the lender has no recourse to the borrower's other assets.

Other agreements of leasing include sale and leaseback financing. Under the sale and leaseback agreement, the owner of the property sells it to a person or institution and then leases it back for an agreed period of time at an agreed rental amount. Companies that want to free up capital that is tied up in buildings often use leaseback. It offsets the need to raise potentially expensive capital in the marketplace to finance expansion.

According to Verschoor (2001) improved access to leasing helps SMEs circumvent two common barriers to obtaining outside financing, i.e. the prevailing prohibitive interest rates and prohibitive collateral requirements of conventional bank financing.

Lease financing is particularly relevant for SMEs, as shown in a study by Exco Grant & Thornton (2001) which estimates that about 39% of European SMEs use leasing as a means of financing as compared with 46% who use banks loans. Leasing was also identified as one of the most commonly used external sources of financing by European SMEs.

Bantug-Herrera and Sposeep (2006), state that since the late 1990s, the enabling environment for leasing in Russia has greatly improved and leasing markets specifically targeting SMEs have expanded rapidly. They argue that leasing can complement bank loans by providing SMEs with an alternative source of financing for major capital investments such as machinery and equipment. In Pakistan, SMEs have traditionally been core customers for leasing companies. During the 1980s and early 1990s leasing companies were the main sources of medium term finance for SMEs and many small enterprises benefited widely from lease financing (Murad, 2005⁷)

Leasing can be advantageous to SMEs, as it will enable these enterprises to maintain cash flow. It will also lower the risk of obsolescence due to technological changes because obsolete equipment can be returned to the lessor in order to acquire the newly introduced equipment in the market. Leasing will attract more favourable tax

⁷ Paper presented at the Conference on SME financing as organized by the State bank of Pakistan's initiative for SME financing, 10 – 11 May 2005.

implications. Asset-base leasing will allow the lessee to remove the asset and corresponding debt from the company's balance sheet for credit analytical purposes, thereby enhancing the company's borrowing ability to finance other pressing needs such as inventory, accounts receivable, growth etc, because the lender assumes the credit risk.

Conversely, the cost of borrowing will be higher since the lender will have no recourse to the borrower for repayment of the loan. The lessee will have difficulty making property improvements as the leased property belongs to the lessor. With sale and leaseback contract, the lessee acts much as the owner of the property rather than as a tenant paying for all repairs, maintenance, insurance and property taxes during the tenure of the lease. A sale and leaseback agreement requires that the lessee make improvements to the property and any increase in land value will accrue to the landlord at the expiration of the lease. In case of an asset-base contract the lender will act in his/her own best interests with respect to decisions affecting the asset, particularly in the face of an adverse market.

Leasing credit criteria and other features are quite similar to those used by commercial banks for equipment loans. For example, a lessee is required to put up a deposit, which normally ranges between 10% and 20% of the asset cost (Nair and Kloppinger-Todd, 2006).⁸ Besides that, there are other lease costs that include an all-risk policy to protect against general risk like fire, theft, flood etc, operating costs etc which range between 8% and 20% of gross lease value (Nair and Kloppinger-Todd, 2006). The primary considerations are the value of the equipment leased, the justification of the lease, and the lessee's projected cash flow over the lease term. Like a bank loan, leasing will require regular payments, which demand regular cash inflows through organic business activities. In view of the fact that cash flow generation by SMEs is not guaranteed or cannot be assertively forecast, leasing may not be a viable solution to Namibian SMEs for raising capital. Credit guarantee procedures and the demands of the leasing companies make it such that leasing is no longer obtainable unless enterprises can secure financial coverage. The market for leasing in Namibia is not well-developed and lack of funding on the supply side makes this source of finance unattractive. Like the other sources of finance discussed in the preceding sections of this chapter, the lessor

⁸ Agriculture and Rural Development Discussion Paper 28, The World Bank

cannot provide SMEs with the necessary skills, one of the identified constraints towards the success of the development of the SME sector. Therefore, leasing alone cannot be regarded as the best solution to the SMEs' predicament of lack of capital and skills transfer.

2.2.6 Conclusion

This section gave an insight into different types of funding for SMEs. There are clear-cut advantages to raising capital through a bank loan or overdraft, trade credit, factoring, invoice discounting and leasing. For example, the ability to acquire an asset through leasing, the immediate ease of liquidity crunch by factoring and invoice discounting and the possibility of acquiring stock without any down-payment through trade credit are some of the advantages accruing to SMEs should they opt to raise funds through these methods. However, the costs of acquiring funds by these means are high. The negative impact on the enterprises' cash flow especially with leasing, the issue of collateral required when acquiring a bank loan and the failure of the providers of these capital to provide the necessary skills eventually make these types of financing unattractive to SMEs.

Failure to address the twin problems currently hampering development of the SME sector by available providers of capital can have negative repercussions on the overall economy in the long run. Lack of two important intangible assets i.e. human and intellectual capital, can lead to high failure rates of small enterprises. Investment in skills development is essential for small enterprises to allow them to compete in the modern market place and keep pace with the global knowledge-driven economies. Therefore, a source of funding that takes into account the two most important needs of the SMEs, i.e. funding as well as business skills, is required. The next section discusses venture capital as a viable alternative source of funding that has attributes consistent with the needs of SMEs.

2.3 VENTURE CAPITAL INVESTMENT

2.3.1 Introduction

This section will focus on the characteristic of venture capital investment, first defining the concept. The third sub-section will look at the history and development of venture capital investment, while sub-section 2.3.4 will give an overview of different types of venture capitalists including angel investors and sub-section 2.3.5 will cover the different stages in venture capital investment. The sixth sub-section will cover the basic criteria to be considered when evaluating an investment deal and the pros and cons of venture capital investment towards SMEs funding, and the sub-section 2.3.7 will look at the benefits of venture capital for SMEs. The last sub-section of this section will explore possible ways of developing the venture capital industry.

2.3.2 Definition of venture capital investment

Venture capital investment is defined as being an investment in unquoted enterprise usually associated with high-risk, and in its original sense primarily directed towards young, often technology-based firms with a high growth potential (Christensen and Christensen 2002). In the United States, venture capital financing usually refers to equity investment in young, fast growing and often hi-tech companies. In Asia, including Hong Kong, the definition is loose, normally referring to equity investment in growing, unlisted companies, at all stages and in virtually most industries (Wong, 2005). Änkö (2001)⁹ defines venture capital as equity investment for the seed, start-up launch and expansion of a business, but it can also be provided for management buy-outs or buy-ins. Other definitions include that of Erikson (2005), who describes venture capital as risk capital that can be employed in the earlier, intermediate or later stages in the growth cycle of new enterprises. Kenney (2000) defines venture capital as an equity investment in the form of common stock or preferred stock, convertible debentures or other financial instruments convertible into common stock when the small enterprise is sold either through a merger or a public equity offering. At this liquidity event, a venture capital investor realises his profits in the form of capital gains. Venture capital as defined by Sack and McKenzie (1998) is finance provided to private companies in the

⁹ Presented at the OECD round table conference: SME competitiveness, May 2001

form of equity or quasi-equity investments over the medium term (3 to 5 years), with the purpose of realizing above average capital gain after the investment is sold to a trade buyer or public market.

Venture capital firms raise money from individuals and institutions to invest in businesses that have a potential for yielding high returns on high-risk investments (Salman, 1990). Venture capital funds usually have limited lifetimes that are determined when the fund is formed (typically ten years, which can be shortened or lengthened by one year increments for up to three years) (Salman 1990; Gompers and Lerner, 1999). Venture capitalists or fund managers are usually general partners who control day to day operations while investors are limited partners, who only monitor fund activities periodically, and do not participate in the fund's day to day activities (Salman 1990, Gompers and Lerner, 1999). Investors can include private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and venture capital firm managers. Professionally managed venture capital firms are usually private partnerships or closely held corporations (Salman 1990; Gompers and Lerner, 1999).

Venture capital investments are not secured with collateral; rather, venture capitalists take an ownership stake (equity investment) in the privately held businesses in which they invest (Salman, 1990). Traditional and also currently, the lion's share of investments by venture capital firms has been in companies flaunting early stage (new) technology-based products. Such businesses have the potential for a high failure rate but also for yielding dramatically large profits. Venture capitalists reduce risk by carefully evaluating the technical and business merits of proposed business plans. Ultimately, they only invest in a small number of the businesses that are candidates for investments. Holding a portfolio of young companies in a single fund reduces the risk in that portfolio (Small Business Notes, 2004).

The ownership stake that venture capital firms generally take in their portfolio companies typically runs in the 30-40% range. In return for their investment, venture capital firms have an influence over business management decisions. Typically, venture firms have a seat on the board of directors for the portfolio company and are intimately involved with the company in which they invest (Small Business Notes, 2004).

Research that was conducted by Christensen and Christensen (2002) established that 79% of the enterprises in their sample of venture-backed enterprises confirmed that venture capitalists take a seat on the board of these enterprises. In this regard, they provide company management with contacts and help in formulating enterprise strategies. Visiting and talking to company management helps to maintain close relationships between the fund managers and the enterprise. According to Salman (1990), venture capitalists visit each of their portfolio companies on average 19 times per year, resulting in 100 hours of direct contact, both by phone and in person. The manager will look to add value to the investment through active participation; however he/she will seek to exit the investment in the portfolio company within five to seven years of the initial investment. Typical exit strategies used by venture capital managers include initial public offering (IPO) which is the listing of the company on the stock market, merger or acquisition of the company by another company or buy back of the company by the initial owners and/or management of the company.

At the exit point the venture capital firm liquidates any interest that it holds in the portfolio company. Because of the risk that they face, venture capital firms expect a higher than average internal rate of return as compared to other types of investment. However, rates of return are dependent not only on the success of the company in which they invest, but also on the performance of capital markets in general and the market for initial public offering of company stock in particular. The expertise of the venture capital manager in enlarging and adding value to the business before successfully exiting its investment will dictate the success of the exit for their investors themselves and the owner of the company (National Venture Capital Association 2004).

Berlin (1998) notes two key features that distinguish venture capital investment from other types of funding. He states that (a) venture capitalists usually take an active role in the management of the projects or companies they fund, therefore contributing professional, seasoned management experience to the specialized knowledge and skills of the project's initiators or company owners; (b) Venture capitalists work in close collaboration with the stock market to take the company or project they fund public; therefore increasing the amount of capital available to these ventures, and creating opportunities for the public to share in the wealth of successful projects or companies.

The definitions of venture capital investment as outlined above are all the same in that they all refer to equity or near-equity investment with a high level of risk to the investor. The main characteristics of venture capital that can be derived from these definitions is that venture capitalists contribute risky capital, managerial competencies and mentoring to the enterprise they invest in, which should demonstrate the potential to develop into significant economic contributors. Their main target is those start-up entities and existing high-risk small businesses suffering from capital deficiencies and a lack of collateral, but having high profit potential as aspiring growth companies. In return for their investment, venture capitalists will take an equity position in the company, usually in proportion to the amount of their investment and the level of risk involved. The relationship between the investor or venture capitalist and the entrepreneur is a strong partnership in which neither party is trying to get the upper hand, but rather both are working together to make money. The future return on the investment is tied to the performance of the company. For a better understanding of the concept it is important to know how venture capital investment developed over the years, and how it became common amongst the SME sector. The sub-section 2.3.3 will give an overview of the background information on the origin of venture capital investment in the UK and the United States of America (USA). The section will also look at the development of the venture capital industry in Israel and India.

2.3.3 History and the development of venture capital investment

Venture capital has a lengthy history in the USA especially, going back at least to the financing of the railroads and textile mills in the 1800s. Modern venture capital industry began taking shape in the post-World War II years (Galante, 1995) prior to World War II, there were a few wealthy families investing in young ventures. Shortly after World War II, these families established offices in New York and hired professional managers to discover, evaluate and invest in small companies with superior growth prospects. These were the first family venture capital funds. The other significant private sector initiative was the establishment of American Research and Development (ARD) in Boston in 1946. The American Research and Development Corporation was formed to facilitate new business formation and development. ARD was important because of the companies it funded and because of General Georges Doriot, the Harvard Business School (HBS) member, who established it. Doriot influenced a number of HBS students

who later became venture capitalists. ARD's \$70,000 investment in the Digital Equipment Corporation in 1958 was worth \$350 million 1971, ample proof that significant returns were possible (Kenney and Hsu, 2004). The USA began to assert its predominance in venture capital investment as compared to other countries worldwide (Lee and Wong, 2004). According to the Global Entrepreneurship Monitor (GEM) 2003 Study, the USA accounted for 65% (USD 21.2 billion) of the total classic venture capital invested domestically in 2002, as compared to the rest of the 28 GEM nations surveyed (35%, USD 11.2 billion).¹⁰

The origin of the UK venture capital industry can be traced back to the early 1900s when venture capital enterprise Charterhouse and other banks provided the first pool of venture capital in UK. During the 1930's in both the USA and the U.K there were discussions on the lack of investment capital for small businesses. In the UK, the 1931 Macmillan Report (Harris, 1995) identified a shortage of private sector funds for supporting small business. There was little agreement about what types of business should receive funding and the proper vehicles for providing financing (Kenney, 2002). However, one of the world's largest venture capital institutions, 3i, which is based in the UK, started investing in the mid-1940s (Coopey and Clarke, 1995). By 2003, the British Venture Capital Association had about 165 registered venture capital fund members. Those enterprises have invested in over 11 000 companies, who between them employ nearly 3 million people, or an equivalent of about 18% of the country's private sector workforce. These venture capital funds invest in every sector of the economy across all regions of the country (Green, 2003).

Venture capital investment can also be traced in the Middle East. The first generation of venture capital funds in Israel began to operate in the late 1980s and this movement accelerated in 1990s. As of December 1997, Israeli technology and private equity funds had raised \$2.1 billion of which \$1.2 billion had been invested and \$900 million remained to be invested. By 1997 there were 85 venture capital enterprises active in Israel. Between 1991 and 1997, technology venture capital funds raised more than \$1.5 billion (Morgenstern, 1998).

¹⁰ The 29 countries which provided information on venture capital are UK, South Africa, Greece, Netherlands, Belgium, France, Spain, Hungary, Italy, Switzerland, US, Denmark, Sweden, Norway, Poland, Germany, Brazil, Australia, New Zealand, Singapore, Japan, Canada, China, Portugal, Ireland, Iceland, Finland, Slovenia, Israel

Although the Government of India began with the idea of setting up a venture capital fund back in 1973, according to most observers, real venture capital investment did not begin to happen until 1998 when it exceeded 100 million US dollars for the first time. However, a National Equity Fund (NEF) was established and administered by the Industrial Development Bank of India (IDBI) and later by the Small Industries Development Bank of India (SIDBI). Total disbursements from this fund amounted to USD 30 million, too small for India's size, where the small and informal enterprises account for at least a third of the GDP of USD 450 billion. Detailed regulations for the VC Industry were not introduced until 1995 and about twenty domestic VC enterprises were registered in the following five years. In 1999, VC investment in high-technology enterprises was in the region of USD320 million. Most of these investments are above USD500, 000 or more. They have served a purpose. They have unleashed the entrepreneurial zeal in the sectors where the urban educated were well positioned to take advantage of opportunities that arose from India's economic liberalization (Anantha-Nageswaran, 2003).

The sub-section 2.3.2 indicates that venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. This kind of capital is an important source of equity for early stage companies, and could be in the form of equity or debenture. Besides capital, these investors will also give strategic directions by serving on the board of the investee enterprise and assist in selecting personnel to occupy key positions in the organization. This is done to ensure the provision and transfer of skills to the enterprise they invest in. This type of model is then ideal for SMEs because, as Section 2.1 revealed, SMEs' financing needs start from the day when a business concept is born and continue until the time when it plans to expand its operation, whilst venture capital investment financing will be available at the initial stage of business establishment. The involvement of venture capital investors in the strategic decision making process and recruitment process will assist in alleviating the problem of lack of skills inherent in the SME sector as confirmed in the previous sections. The participation of venture capitalists in SME funding is therefore critical in addressing the main two problems currently inherent in the SME sector. The subsequent section will look at different types of venture capitalists and different stages of business development

2.3.4 Types of venture capitalists and stages of investment

The definition of venture capital investment in section 2.3.2 confirms that venture capital investment can come in the form of equity or convertible debentures (Kenney 2000). The equity investment can be in the form of either ordinary or convertible preferred shares in the company that are repaid when the company is sold or goes public. The convertible or subordinated debt refers to the typical, semi-secured investments in the company through a debenture ranking below the secured lenders that often require periodic repayment. Section 2.1 confirms that SMEs are characterised by lack of collateral to secure bank loans. With equity investment, an enterprise will not be required to provide any collateral for the capital supplied. Equally, an enterprise with reliable cash flow can choose a convertible or subordinated debt, depending on its capital structure and financial leverage. Subsequent sections also confirmed that venture capital's return is based on the capital appreciation of its investment over the time that the investment is held. The higher the growth and appreciation of the investment, the more profitable the investment would be. In cases where the partnership between the venture capital enterprise and the investee company are strong and mutually beneficial, the venture capitalist may continue to serve on the Board or be actively involved in the day-to-day management of the business.

Besides the formal venture capital investors, there are other informal forms of venture capital investment including business angels, otherwise commonly known as angel investors. This rest of this sub-section will look at angel investors as another source of funding for SMEs which is slightly different from those sources described in section 2.2. The characteristics of business angels are closely related to those of venture capital investors as described in the previous sub-sections of this section. Business angels are typically well-educated, high net-worth individuals who invest their personal funds at arm's length in businesses owned and operated by individuals unrelated to them. The angels are frequently entrepreneurs or former entrepreneurs. They have much to offer new firms, both in financing and in knowledge and experience in operating a business (Riding and Bélanger 2006). According to Thompson and Choi (2002), angel investors are a specific type of venture capitalist that mostly target small business enterprises. They are generally successful business individuals in communities, who invest in local businesses. They are less formal and less public in their approach to investing. In

addition to providing financing, business angels contribute their expertise, knowledge and contacts both formally and informally to the business they invest in. An angel investor usually acts as a bridge that supports the business after the self-funding stage and before the venture capitalists, who will come after a business has proven its worth (Stolze, 1999). Farrell (2002) defines angel investors as those individuals (not the enterprise principals) investing their own funds, often assuming unsecured, highly illiquid risks. According to Farrell, sometimes angel investors play an active role in the management or finances of the enterprise, and they generally gain an equity position in the enterprise in exchange for the investment. Angel investors are generally said to be long-term or “patient”, often having no predetermined end or exit.

For small businesses seeking more modest equity investment, these informal investors often fill the gap between money from friends and relatives and formal venture capital. According to Stanco and Akah’s (2005) survey, 94% of venture capitalists contacted confirmed that angel investors play a significant role in the venture capital industry and that their involvement in the industry is indeed beneficial to the formal venture capital industry.

A study made for the EU in 1998 estimated the potential for business angel investments to be approximately €10 billion a year (European Business Angels Network, 1998) as compared to the investments of the whole European venture capital industry which made €4.1 billion worth of seed and start-up investments (EVCA year book, 2001). In 2001, angel investors played a financing role in more than 20 000 SMEs, or about 15% of the 1.3 million SMEs in Canada. During 2004, 17% of angel-financed enterprises were majority-owned by women. Canadian SMEs that were angel-financed reported revenues that were 40% greater and total assets that were 25% greater than other enterprises (Riding and Bélanger, 2006). The USA angels have historically financed ten times more start-ups than formal venture capital funds, and there were an estimated 400 000 business angels investing USD30 to USD40 billion per year in 50 000 enterprises (Sohl and Sommer, 2002).

The main difference between an angel investor and a venture capitalist is in the size of investment. Unlike venture capitalists, angel investors invest in only one venture at a time, which will allow them to dedicate their resources and time to assisting the

company to grow. They often have contacts in the financial and business community, and will also have some experience within the company's industrial sector. They can offer advice and expertise in areas where the company is having difficulty with expansion. These investors want to provide more than money. Sometimes they invest in a field in which they have not specifically worked before; however, they have broad-based business experience that supplements the specialty or the niche of the company they invest in. This personal experience is a tremendous advantage for smaller enterprises.

The best way to find an "Angel" is by networking. Some of the best contacts may include local business colleagues, accountants and/or lawyers with wealthy clients, and customers or suppliers who periodically invest in small businesses. Business angels usually go through an extensive due diligence process and base their investment decisions on the expectation of high rates-of-return. Angels and venture capitalists both play key roles in the venture industry. Angels rarely fund a company to exit, and thus, they need institutional money to exit a deal. On the other hand, venture capitalists seldom provide the seed capital and time commitment to start-up entrepreneurs in order for those companies to get to a place where they are venture worthy (Stanco, and Akah, 2005).

While some start-up companies remain with business angels throughout their entire life cycle, others eventually turn to venture capital financing to meet the rising costs associated with later stages of development (Small and Medium – Sized Enterprise Financing in Canada, 2003). Studies show that in the USA, business angels' work in cooperation with the venture capital sector by seeking out and screening new projects, which encourages start-ups and increases deal flows for venture capital enterprises (National Venture Capital Association website). The presence of a well-regarded and connected business angel in a previous financing deal may assure venture capital investors of the quality of the enterprise and deal. In fact, studies have found that more than half of all venture capital-funded high technology projects in the USA had business angel participation, and that this proportion was even higher among smaller and newer enterprises. Hence they can be essential in establishing the venture capital market in any economy (Small and Medium – Sized Enterprise Financing in Canada, 2003).

As mentioned earlier, venture capital investment can be introduced into the business during different business cycles. Some literature views angel investors as part of the self-funding phase, but for the purpose of this review, angel investors will be viewed as part of venture capital investment. The following section will look at different business cycle stages at which a venture capital investor can provide funding.

2.3.5 Business cycle stages

The definition of venture capital indicates that funds can be provided to an enterprise as start-up capital, or it can also be provided to an enterprise at a later stage of its development. The decision on when to acquire the venture capital investment is influenced by the company's expansion requirements, and the business interests and skills of the venture capitalists. What is appropriate at one stage of development may not be suitable at another stage of development. For example, although SMEs commonly borrow from banking institutions, these types of financing is often not appropriate or accessible for fast-growth nor as start-up capital for knowledge-based and technology-driven entities, because their assets may be intangible and financial institutions are usually unable to realise any value in the event of a default. Also, because their products may take time to generate revenues and profits, these entities may be unable to service their debt during that period when profits are hard to generate.

Venture capital investment can be introduced to the enterprises at three different stages of business development. Firstly, some venture capitalists specialize in investing in the early stages, the seed and start-up phases. Secondly, the majority of venture capital firms seem to be investing in the expansion phase of the enterprises' development. Finally, still other venture capital firms are primarily interested in the later stages of the portfolio firms' life (Berggren *et al*, 2005). The following sections will give a brief overview of each stage of business development to assess the different types of financing suitable during each business phase.

The seed or start-up financing is provided when the business is just an idea. It is mainly supplied to promote a concept, develop the initial product or service and market the organization. This is mainly made available to young entities that may have been in operation for only a year and have not produced a product or service for commercial

vending. The appointment of key management personnel might be in progress or could have just taken place. During the seed and start-up stages, small and medium enterprises are often almost entirely dependent on risk capital from owners' personal resources and informal investors (family, friends, venture capital individuals or business angels) to finance their initial operations, such as research and product development. At the seed stage, equity financing is initially obtained either from the owner of the business or from family and friends. Subsequently, financing may be supplemented by seed capital investment from informal venture capital investors. Small business owners often experience problems in turning their ideas into living business concepts; hence the availability of seed capital will give life to their business ideas.

First stage financing is provided to companies that have exhausted all initial production and marketing budgets and need additional resources to bring their products or services to the market. At this point, the company's key personnel may be in place, but the business may still not be profitable. The second stage of financing is provided for expansion. Usually, marketing and sales are progressing well. However, the company may still not be profitable. Unlike banking institutions that are interested in an enterprise's profitability, venture capital investors focus more on future prospects, as their investment is of a medium- to long-term nature. The first and second stage of financing is in the form of equity, as per the definition of venture capital. This type of capital is merely for those enterprises in their early development phase.

Another definition of venture capital financing refers to it as financing in the form of subordinated debt that may require regular payments. As already mentioned in the section 2.1 under the characteristics of SMEs, small enterprises are faced with cash flow problems and may not be in a position to commit themselves to regular loan payments. However, medium to large enterprises with sustainable cash inflows, which are unwilling to dilute the owners' equity holding in a company but need funds for expansion, may be able to afford a near-debt type of financing. These are the institutions that will consider third stage financing. Mezzanine capital or third stage financing is a hybrid of debt and equity financing with risk and performance characteristics that are similar to that of equity. It is a source of capital that has characteristics of both debt and equity, and is considered to be unsecured as it is the last debt in line for any claim on assets. There are usually both debt (debenture) and

equity (shares or warrants) instruments involved (Frank, 2004)¹¹. It is basically debt capital that gives the lender the right to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. Because of its debt characteristics, mezzanine financing can be used to improve a company's debt/equity ratio, and allow it to remain within the banks' covenants.

Mezzanine capital can be a cheaper source of financing than equity, as the owner of the business is exposed to less dilution in his equity stake in the business. The cost of mezzanine capital, which for example in the USA generally ranges between 18% and 22%, is significantly lower than the returns targeted by equity investors that can be between 25% and 35% (Abbasi, 2004; Henry, 2005). To attract mezzanine financing, a company must usually demonstrate a track record in the industry, with an established reputation and product; a history of profitability; a viable expansion plan for the business ranging from future acquisitions and initial public offerings. This type of financing is typically used to finance the expansion of existing companies with growth in sales and positive or break-even cash flow levels. Funds are used for plant expansion, marketing, working capital, or new product development. Companies at a stage of development with insufficient assets to collateralize their borrowings may also choose to raise money with mezzanine capital, especially if they do not want to achieve further dilution by raising additional capital, but this type of financing is not suited to start-up financing (Abbasi, 2004). Before advancing or committing any funds to an enterprise, the venture capitalist will conduct a thorough due diligence on an enterprise to determine the viability of the potential venture. The next section will briefly review some of the criteria to be assessed during the due diligence process.

2.3.6 Criteria for the deal evaluation

The preceding sections of this section focused mainly on the type of financing a venture capitalist may provide, without touching on the requirements to be met to qualify for the type of funding needed. Like banking institutions, venture capitalists also have their own credit criteria to be met for an enterprise to be eligible for funding. As mentioned above, venture capitalists usually invest in new, young and rapidly growing companies that

¹¹ The paper was presented by R. Frank at the roundtable meeting of institutional investors at the 37th annual meeting of the Asian Development Bank held in May 2004 in Korea

have the potential to develop into significant players in their respective markets. Because of the high risk involved, venture capital investors may evaluate several investment opportunities each year, but will only invest in a few companies that have the potential for high rates of return within a predetermined payback period. These investors essentially look for opportunities that pose the least amount of market risk (Fiet, 1991). Fiet (1995) identified issues like technical obsolescence, many existing competitors, many potential and new competitors, weak customer demand and market attractiveness as indicators that serve as proxies for market risk. Therefore, the qualification for venture capital funds can be highly competitive, as the levels of existence of these factors differ in each enterprise. Besides the market risk, all venture capital investors have certain investment requirements, regardless of the focus of the company or the industry that it operates in.

In addition to the five indicators mentioned above, there are other factors considered to be key fundamentals in venture capital financing that can positively contribute to the success of a venture capital deal in order to generate expected returns. These include aspects relating to management, potential for capital gain, realistic financial requirements and projections and owners' financial stake in the business. The entire structure of a venture capital deal depends on the strength of the enterprise management and its expertise (Gladstone and Gladstone, 2004). Skilled management is critical for attracting outside investors and for ensuring the success of the fund. Key people in the company should have experience in the fundamentals of the business and the ability to deal with change and growth. A capable, committed and well-formed management team brings significant credibility to the company. Strong management teams with a combination of technical, financial and marketing skills, ideally with experience in raising and exiting risk capital investments, can entice a venture deal. Backing from venture capitalists not only depends on good technological advance or good product, but will equally assesses the quality of management available to ensure continuity in operating the business after the deal has been finalized.

One key element of venture capital investment is that it is risky capital mostly provided to those enterprises with high growth potential. This indicates that venture capitalists need an above-average rate of return. As a result they tend to be attracted more to high-growth oriented companies that involve rapid potential and actual growth in terms

of sales and market share, based on competitive advantage and dominant market position. These kinds of investments are expected to yield high rates of return on equity arising from rapid sales growth and wide profit margins. High rates of return serve as determining factors in whether the company is worth investing in or not. Hence companies with high potential to achieve these targets are usually aspirants of venture capital investments. Most enterprises would like to see an annual rate of return in the 30-40% range over a three-to-seven-year period or at least returns proportional to the perceived risk, depending on the business cycle. The earlier the company is in the business cycle, the higher the rate of return the venture capitalist will need to be compensated for, due to the increased risk of investing in a new company. While these rates may seem high, the venture capitalist is risking a lot by investing in an untested business. The company the venture capitalist invests in may do well, allowing it to go public and generating a high rate of return, or it may stagnate, forcing the venture capital enterprise to liquidate its position and take a loss.

The valuation of a venture capital deal is influenced by the enterprise's future cash flow, which will be driven by its ability to grow revenues in the future and the level of its operating assets. Future figures for the balance sheet and income statement items need to be presented in hypothetical realistic financial statement projections. In the search for funding, emphasis should be placed on total financial requirements for a specific stage of growth that needs to be funded. By demonstrating a realistic sense of financial state and financial requirements, management will be demonstrating its ability to plan properly and take the company forward.

One of the most important indicators of management's commitment to the venture is the financial resources the owners have committed to the company. This includes financing from friends, contacts, and families of the major partners. If a venture capitalist is going to commit resources to any company he/she must be sure that the owner(s) is/are committed as the two parties need to share the risk in the business. This financial commitment is a strong indicator of the owner's desire to see the business succeed.

The previous sections in this section looked at venture capital as a source of funding for SMEs, mainly emphasizing the benefits of venture capital for SME financing. It should be emphasised that compared with other sources of SME funding, venture capital

investment as a source of SME funding can have its shortcoming due to a number of factors. The next paragraph will summarise the key benefits and disadvantages of venture capital financing mainly targeting SMEs. The advantage of venture capital is that it can be committed as growth capital without fixed expense of debt. If provided to an enterprise, it will allow that entity to maintain its financial flexibility which will enhance borrowing capacity for other future opportunities, whilst the equity funding will strengthen the company's balance sheet and reduce gearing in the business. Depending on the amount of capital needed, venture capital equity is more accessible earlier in a company's life cycle as compared to a bank loan or bond issue, and these equity investors can be sources of synergistic opportunities as a result of their experience in similar industries. Through their previous business contacts the involvement of venture capital equity investors in a company can attract other lenders to the business should the company need more finance in the future. Rewards when realised during the liquidation period can be substantial, especially in start-up situations. However, the most vital advantage to the SMEs, given the sector's managerial skills needs, is the venture capitalists' participation on a Board of Directors, thereby providing additional resources.

The disadvantage of this type of financing is the fact that the required return on investment is generally higher than the cost of debt. This demand for high returns may introduce the danger of short-term thinking. The characteristics of SMEs indicate that these enterprises are unable to provide accurate and reliable information on their financial conditions and performance. Should an enterprise be financed through venture capital investment, it will be required to generate detailed reports on the company's performance and future prospects. If financing is provided in the form of equity, the owners of the enterprise will be required to give up a share of their business and share decision-making and profits. Therefore, this type of financing needs to be approached with caution as it comes with its own strings attached which may not all be favourable to SMEs. Despite the stated disadvantages of venture capital financing, there are benefits of this financing for the SME sector and the economy at large at a macro level, as laid down in the following section.

2.3.7 Benefits of venture capital investment for SMEs

In Sections 2.1 and 2.3 we examined the characteristics of SMEs and venture capital investments. These sections confirmed through literature reviews the contribution of both SMEs and venture capital to the country's economic growth through skills transfer, employment creation and poverty alleviation. This section will look at the benefits of venture capital financing to the SME sector, with the main emphasis on skills transfer and capital provision.

Literature on financing start-ups predicts that high-risk projects are associated with venture capital rather than with bank financing (Ueda, 2004). In these models the venture capitalist has superior expertise in screening, monitoring and providing managerial support for the founder, and this expertise seems to be of more value for high-risk projects. As venture capitalists normally draw up equity or equity-like contracts, these findings imply a close tie between highly risk entrepreneurs and equity financing. Venture capitalists themselves consider it to be the core of their own business model that they select high-risk, high-return ventures and contribute towards improving their prospects during the period of investment (Manigart *et al* 2002), which makes them an ideal source of funding for SMEs that are regarded as being highly risk.

The definition of venture capital investment confirms that it is a long-term investment with a minimum holding period of 3 years and generally takes businesses through more than one business cycle, making it an ideal source of funding for a newly established small business with volatile revenue growth. Unlike more common debt instruments such as bank loans, the equity investment in the company usually does not require regular payments. Instead, a venture investor will look for a capital gain and an increase in the value of his shares. This means that the company will have cash available for growth. This infusion of equity can create tremendous benefits for the company such as allowing for expenditure on capital equipment, providing working capital, or assisting with growth strategies. The future sale of the company, its going public, other forms of appreciation in stock value, or other exit strategies will give the venture capitalist the needed return on his investment. This return depends on the success of the company in which they invest. Thus, the company's future and the venture capitalists future are

integrally linked. In many ways a venture financier is a partner, not a lender. The company's success is his main objective.

The common characteristic of venture capital investment is that as an investor-partner, the venture capitalist will take part in the management of the company, whether through participation on its Board of Directors or through providing management input on a regular basis, which can be negotiated by the two parties. The venture capitalist will likely take an active role in helping the company to grow, providing the most favourable environment for success and minimizing risks to his/her investment. As mentioned above, lack of skills is quite common in the SME sector; hence the venture capitalist will ease the burden by supplying capital and imparting skills to the owner.

A substantial amount of factual evidence on the economic impact of venture capital investment has been published. For example in the USA, business angels invest about twice as much in monetary terms and twenty times more in terms of the number of ventures financed than the formal venture capital industry. According to the Capital Connection there are six business angel networks that operate in Silicon Valley. They all provide capital investments to start-up and/or early stage companies (Jungman and Seppä, 2004)

Besides providing finance and skills to small and medium enterprises, venture capital investment has a positive impact on economic factors such as employment creation, sales and profitability. A study conducted by venture capital researchers Paul Gompers and Josh Lerner (1999) found that venture capital can have a significant positive impact on labour market performance. A vibrant venture capital market can result in the growth of other sectors. For example in the USA, during the last 50 years a number of the fastest growing enterprises, particularly in the technology area, received venture capital. These include Amazon.com, America Online, Amgen, Apple Computer, Cisco Systems, Compaq, DEC, Federal Express, Genentech, Intel, Lotus, Netscape, Oracle, Seagate, Sun Microsystems, 3Com, Yahoo! and countless others. These and other venture capital-supported enterprises were responsible for the establishment of entirely new industries such as biotechnology, semiconductors, database software, the Internet, hard disk drives, minicomputers, workstations, and data communications. In this way venture

capital became an important part of the U.S. national system of innovation (Kenney, 2000).

Various research studies established that venture capital activities are significantly associated with higher patenting rates and industrial innovations. There has been empirical evidence that venture capital financing is related to product market strategies and outcomes of start-up (Hellman and Puri, 2000). The results from Hellman and Puri's study indicate that an engagement of venture capital in small innovative companies leads to a subsequent increase in the likelihood that a company will bring its product to market. About 59% of entrepreneurs who participated in the survey considered obtaining venture capital as a more significant event in their businesses than obtaining finance from other sources.

In addition to jobs and revenues, venture capital backed companies together with academic institutions usually perform a greater share of research and development (R&D). According to the data from the US National Science Foundation, the dollar value of small company R&D rose from \$4.4 billion in 1984 to an estimated \$40.1 billion in 2003. These small companies not only stimulate innovation but they also supply larger R&D enterprises with a stable stream of idea invention. Of the top 50 enterprises in US R&D, 41 were either originally venture-backed or were acquirers of venture capital created companies (Venture Impact, 2004).

If added to a portfolio, venture capital investment can also enhance returns on investments. Because of its high risk, venture capital investment offers high return. The Isenberg School of Management at the University of Massachusetts concluded in their June 2005 report on "Benefits of Venture capital Equity (CISDM, 2005) to a well-diversified portfolio, venture capital equity can increase the returns more than can other asset classes. However, because of its volatility they warned that investors have to be aware of the amount of risk they are prepared to take in order to earn high returns.

Another important factor is that venture capital investments have been instrumental in developing financial markets in many economies. Most developing countries' capital markets are underdeveloped. Most companies listed in major stock exchanges around the globe raised their seed capital through venture capital equity investors. In countries

like the United States (US), venture capital investment has been around for many years. Venture capital investment has been an important source of financing for a small number of technology-based start-up enterprises. In Canada for example, in 2002, the majority of venture capital investments (84%) were concentrated in two technology-intensive sectors — information and communications technologies (65%) and life sciences (19%) — while traditional sectors attracted 11% of venture capital investments. However, low technology companies in traditional sectors with a unique idea or product and high market potential have also attracted risk capital investment (Small and medium-sized enterprise financing in Canada, 2003).

The impact of venture capital on sustainable development cannot be verified in general, but a study conducted by Splinter and Vergeer (2005)¹² concluded that the impact for all the stakeholders at all levels is strong and positive. For example Aureos Capital East Africa and Business Partners from South Africa have measured the number of new jobs that were created as a result of the investments made by venture funds. Aureos East Africa created 2,815 jobs from 1997 to 2003 with a total investment of €12 million. Business Partners created 700,000 jobs between 1981 and 2004 with a total investment of €754 million (Splinter and Vergeer, October 2005)¹³. Although the venture capital investment concept is fairly new in South Africa, other official data available shows significant growth since 2000. As of December 2003 South Africa's venture capital equity industry had about R41, 5 billion funds under management as compared to a figure of R34, 7 billion reported in 2000 (KPMG & SAVCA, 2003).

According to a study carried out by Global Insight and published by the National Venture Capital Association in July 2004, jobs and revenues in US companies backed by venture capitalists grew during the 2000 – 2003 economic downturns. Even in those sectors that suffered net job losses such as computer hardware and semiconductors, venture-backed companies were less affected. Not only did ventured-financed companies grow faster than their national industry counterparts, but also those sectors with higher concentrations of venture capital financing experienced higher employment growth differentials. The study revealed that companies that received venture financing

¹² This survey was carried out by Jeroen Splinter and Jan-Roland Vergeer from FACET BV, with assistance from Gerrit Ribbink in Ghana and Hedwig Siewertsen and Wieteke Gondrie in Zimbabwe. However, the study was conducted by the Adapppt with the support of the Netherlands Committee for International Cooperation and Sustainable Development (NCDO).

between 1970 and 2003 accounted for 10.1 million jobs and US\$1.8 trillion in revenue in 2003, representing approximately 9.4% of total US jobs and revenues. These same companies registered about 6.5% and 11.6% gains in jobs and revenues respectively during the same period, whilst the country's national employment fell 2.3%, and the US company revenues rose by 6.5%. The study also found a correlation between venture capital funding and productivity. This study established that the higher the level of venture capital funding per worker in a given state, the more likely that state was to experience growth in output per worker. The same study also linked venture capital investment to higher wages by establishing that states in which companies received the highest levels of venture funding in turn had the highest wages.

The literature confirms that a variety of small businesses in different economies and sectors benefit from venture capital investments, ranging from high to low technology and in different development stages, from start-up to large established companies. The phenomenon of venture capital investment has been common in many developed countries, and as an asset class has become an important component of many institutional portfolios. It has also become popular in developing countries and has been successful in transforming the industrial world.

The history and development of venture capital industry in many countries illustrates that venture capital investment was introduced to fill the void left by banking institutions especially in the small business sector. Since companies can finance their growth by going public, it is extremely difficult for small businesses without many years of operations to attract investors through a public offering. Literature on the role of SMEs in economic development in Section 2 proves that small and medium businesses have been crucial to economic growth in many countries, but their ability to reach their full potential has been limited due to lack of capital and skills available to the sector; hence governments in different economies in the past introduced departments or sourced funds from international organizations to assist in providing finance to the small businesses with the intention of enabling them to mature so as to be attractive for public listings. Most of these agencies operate more or less in the form of venture capital equity investment, although on a smaller scale and probably less different from modern venture capital investment funds. The next section will look at how venture capital funds were established in different economies with more emphasis on the responsibilities of

different stakeholders that can contribute towards the successful implementation of the venture capital industry.

2.3.8 Establishment of venture capital funds

Section 4.3 gave a brief overview of the history of venture capital investment, without necessarily giving a synopsis of how to develop the industry in any economy. This section will briefly look at how the venture capital industry can be developed in order to benefit the SME sector in a country. The focus of this section will be on funding, i.e. how to raise capital to establish a venture capital fund, and on legislation and other government support which is vital to the establishment and success of venture capital funds.

The establishment of venture capital funds can originate with both the private and public sectors. At times funding can also be sourced from international agencies. For example, the World Bank was one of the major forces that induced the Government of India to start venture funding by providing funds. However, the second phase of the Indian venture capital industry attracted many foreign institutional investors joined by private domestic venture capitalists (Bowonder and Mani, 2002). The Malaysian government funded its venture capital industry with about M\$115 million in 1991 and it continued to provide funds to a number of domestic venture capital firms. These funds were allocated to technology-related venture capital financing. In addition the government also established a company specifically to provide venture financing to potential Bumiputra or ethnic Malay entrepreneurs. The government sponsors the majority of the domestic venture capital funds in Indonesia, whilst the Thailand venture capital industry is funded by regional funds in Hong Kong and Singapore (Sack and McKenzie, 1998). By 2004, most equity investment in Mexico was provided by foreigners although the government introduced a regulation that requires insurance companies to invest up to 1% of their reserves in venture capital funds (Kappaz and McNeece III, 2004).

Private independent venture funds in countries like the USA are primarily funded by pension funds, insurance companies and sometimes by corporate investors. These funds are typically managed by a team of professional venture capital managers who go out and raise a predetermined amount of capital (Macdonald and Associates Ltd, 1998).

Literature on the success of venture capital investments in emerging markets, especially in China, emphasises the combination of a few key elements needed for venture opportunities. In his article entitled "So You're Thinking of Investing in China", Dr Martin Haemming identifies issues such as large mass manufacturing base, engineering and entrepreneurial talent, large domestic markets, and capital and innovation as some of the key fundamentals needed for venture capital prospects. The success of manufacturing capability, especially in China, has been complimented by a profound pool of engineering talent that has been employed at a fraction of the cost of foreign equivalents. However, besides these fundamentals, the industry needs to be supported through legislature to encourage participation by all the stakeholders.

The government's support in this venture seems to be critical as reflected in the following paragraphs of this section. Government support can stimulate the venture capital market in the economy and ease the financing needs of SMEs. The most direct means that any government can apply to encourage venture capital investments is by providing financial incentives for investment in venture capital funds or small and medium businesses through a fair and effective tax system. It has been widely confirmed in the literature that venture capital investments in the USA for example have been positively influenced by the clarification of the "prudent man" rule in the Employee Retirement Income Security Act (RESA) of 1979, which was initially misinterpreted as prohibiting pension fund investments in venture capital.¹⁴ As a result, pension funds started to invest substantial amounts of money in venture capital funds. Statistics have shown that in 1978 US pension funds accounted for 15% of venture capital funds, and by the middle of the 1980's this figure had risen to more than 50% (Romain and. van Pottelsberghe De La Potterie, 2004).

Taxation, primarily in the form of capital gains taxes, can have a major impact on the availability of funding for venture capital investment. To support the venture capital market, a government could introduce capital gains tax rates lower than general income tax rates. A decline in the capital gains tax rate would increase the raising of venture capital funds through the demand side as a low capital gains tax rate often encourages entrepreneurship and the desire of people to create their own companies and to engage

¹⁴ Report by OECD titled Financing Innovative SMEs in a Global Economy, June 2004

in R&D activities (Gompers and Lerner, 1998). Under these circumstances, investors were being rewarded for investing in high-risk investments, as they would receive favourable tax treatment on high-risk capital gains as compared to risk free income. Another impact of low capital gains tax rates is the incentive to realise capital gains earned on successful venture capital investments and the freeing up of not only the capital gains, but also the original investment. This means that there could be more reinvestment of funds from successful investments into new venture investments than would otherwise be the case if capital gains rates were substantially higher. If there is an incentive to exit successful investments, in many cases the original investment and a portion of the gains are likely to be re-deployed into new venture investments, thereby increasing the overall supply of funding to the venture capital market.

Another form of government financial incentive is the provision of leveraged equity participation to venture capital funds. Through this programme, the government can provide a certain percentage of the capital of a venture fund, higher than what private investors would put in, while taking only a risk free rate plus a minimal percentage of the fund's profits. This will leave any excess profits to other equity investors who are likely to provide a smaller portion of the fund's capital, and will at the same time leverage or enhance the potential profits to private investors. This practice has been offered as an option by the US Small Business Investment Company and the Australian Innovation Investment Programme, and has been proved a success (Stillman, 2002).

Government can also relax the foreign exchange controls over all venture capital transactions in order to ease conversion of proceeds from sales of shares to foreign currencies. For example in India, foreign venture capital registered with the Securities Exchange Board of India (SEBI) can freely invest and disinvest without any approval from the Reserve Bank of India (Bowonder and Mani, 2002).

Governments can also extend loans or loan guarantees directly or through their agencies. This kind of assistance can be directed to funds specializing in specific sectors of particular importance to the government. For example in the United States of America, the Small Business Investment Company programme and the programme of its Overseas Private Investment Corporation use this kind of support, offering loans or loan guarantees in an amount of twice the private capital of the fund. Because the

interest rate on government debt is well below the profit expectations of a venture fund, the excess returns that will flow to the private investor will increase the potential rate of return. Some governments have also provided guarantees against losses to be derived from venture capital investments, to encourage investments in venture funds. For example the US State of Oklahoma guarantees investments in state-sponsored seed and early stage investments. In Austria, the government offers similar guarantee to investors in SMEs (Stillman, 2002).

Evidence of the effectiveness of government support comes from the experience of the US Small Business Investment Company (SBIC) programme, which started in 1959 when there were only 15 venture capital funds with a total of not more than \$500 million to invest in the United States. In 2000, over \$5 billion was invested by SBICs in 3000 separate investments and represented over half of the number of all individual investments by organised venture capital funds. Through this programme most young fund managers managed to raise their first venture funds, and most of the outstanding private US venture funds have their roots in the programme. The programme also contributed to the skills development in venture fund management that can allow for the establishment of more organised venture capital funds by those individual fund managers (Stillman, 2002).

Governments also need to create a fiscal environment suitable for encouraging entrepreneurs. Research conducted by the Solvay Business School in Belgium demonstrated that venture capital intensity is pro-cyclical since it reacts positively and significantly to GDP growth. Short-term and long-term interest rates have a positive impact on venture capital intensity, which means that these rates affect more the demand side of venture capital than the supply side (Romain and van Pottelsberghe de la Potterie, 2004). An economic environment of low inflation and low interest rates normally promotes and supports entrepreneur ambiance. On the other hand, increasing public spending and increasing the level of public borrowing could lead to rapidly rising rates and possibly high taxation. This in turn could lead to damage in general confidence and consumer spending, and specifically to damage in confidence in the stock market. Unfavourable stock market conditions can increase difficulties for venture capital investors in raising funds due to its impact on these investors' quoted portfolios. Furthermore, unfavourable stock market conditions can make it difficult for venture

capital investors to achieve public listings of their investments. Flotation is a critical exit route for the venture capital industry and an active market in new listings encourages investment in venture capital funds. Bad market conditions can discourage quoted companies from raising funds to finance acquisitions, making it harder for venture capital investors to sell investments to trade buyers.

Availability of intellectual skills in the economy can have a positive effect on the development of venture capital industry. The development of the Chinese venture capital industry especially on high technologies-focused funds improved because since 1999 there has been a substantial influx of venture capital into the country's information technologies industry, particularly in the areas of network and Internet infrastructure and this can be attributable amongst other things to the availability of technical skills in the country (Xiao, 2002). According to the National Science Foundation, China has graduated more engineers per year than the United States, Japan and Germany combined since 1997. In 2000 alone, China graduated 195 000 bachelor level engineers compared to 61 000 for the United States. The availability of this low cost engineering expertise makes China an attractive site for technology development projects that would be extremely expensive if located in the West. The Chinese Government has declared a policy of encouraging innovation and has implemented a programme to develop Chinese technology standards in a number of strategic industries. All these developments have also contributed to the country's consumer purchasing power as the country's GDP surged at about 9% per annum, a middle class emerged and China has become the second largest economy after the United States when measured by purchasing power (Haemming, 2004).

2.3.9 Conclusion

The focus of this section was mainly on venture capital investment and its contribution towards economic development in general, and the small and medium enterprise sector in particular. Literature reviewed focused on capital investment in risky enterprises with potential to grow if supplied with technical and managerial skills. These two features are the main common characteristics of venture capital investment which would also be beneficial to SMEs as they address the most constraining factors limiting the progress of most small and medium enterprises. This section also substantiated that venture

capital funds are available at any stage of development of an enterprise, and may be provided for a minimum period of time, normally three years, with a general holding period of up to ten years. For an entity to secure this type of finance there should be a level of commitment from the owners, which is assessed through the amount of money and time invested in the business. Whilst the venture capitalist can provide managerial skills, the acid test of any deal is the honesty and integrity of existing management.

Other issues that a venture capitalist looks at are the potential for capital gain at liquidation and a realistic financial forecast. Although venture capital financing is regarded as expensive, its advantages outweigh its costs by far. Besides the transfer of skills, other advantages of venture capital include the ability of venture investors to broaden the customer network through their existing contacts and create access to new markets. What is more critical to the venture capital industry is the establishment of venture capital funds, which need to be supported by both the public by providing conducive legislation to encourage participation and private sector by providing financing needed to kick-start these funds. Nonetheless, while venture capital has the potential to address the two important issues of lack of capital and skills within the SME sector, empirical research is required to investigate exactly how this is achieved. The next chapter discusses the methodology that was adopted in answering the research question that was stated in Chapter 1.

CHAPTER 3

RESEARCH METHODOLOGY

3.1 Introduction

A survey method was used to gather data that was analysed so as to generate insights, which could be used to address the research question and realise the objectives stated in Chapter 1. Surveys can be conducted in many different ways including by telephone, by mail or in person. All surveys have one most common characteristic, that of gathering information from a fraction of the population being studied. This fraction is what is referred to as a sample. The sample size depends on the purpose of the study, the statistical quality needed, the utilisation of the results and professional and financial resources available (Scheuren, 2004).

The following sections explain the survey methods used to obtain information from different stakeholders, provide some characteristics of the research instruments, detail how the participants were selected and approached, describe how the data was collected and processed, and describe how the data collected was analysed.

3.2 Survey method

The survey method was applied to collect information to generate insights in order to answer the research question (Kervin, 1999 and Patton, 1990) that looks at ways in which venture capital can contribute to the development of SMEs in Namibia. Due to a large number of SMEs and institutions dealing with SMEs at different levels, the survey method was useful in identifying a small sample of those enterprises that can attract venture capitalists, and institutions directly involved in the SME sector. The main focus was on a broader understanding of current problems hindering the development of SMEs, concentrating on funding and skills development. The survey method enabled the researcher to collect data that could be useful in identifying the importance of the availability of capital and skills in the development of the SME sector. Collective views from different stakeholders also assisted in explicating the role that venture capitalists can play in providing both needed capital and skills to the SME sector.

Owners and managers of SMEs were interviewed in order to gather information on their operations. Questionnaires were distributed to other stakeholders in the SME sector like banking institutions, and government ministries and agencies. Therefore a non-probability sampling using the purposive or judgmental sampling technique (Saunders *et al.*, 2000) was used.

3.2.1 Sampling

The strategy used was one of critical case sampling that selected SMEs on the basis of whether they can attract venture capital funding based on the feasibility of their business model, meaning that the enterprise should have the potential to grow. Other factors such as staff complement, turnover, asset base and product exportability were considered due to their importance in attracting venture capital financing.

With critical case sampling, the sample is a set of cases or individuals identified by the researcher as being particularly significant to the research topic. The same sampling technique was used with venture capital managers and other institutions involved with SMEs. The critical case sampling was also used with other stakeholders like banking institutions, mainly focusing on those with well-established SME divisions and those with small-scale SME sections.

The focus of data collection was to identify those SMEs that were candidates for venture capital financing based on the criteria stated above. With these critical cases, the researcher assumed that whatever was happening in these enterprises with regard to financing and skills problems was likely to be happening in other SMEs as well. The literature review in Chapter 2 demonstrated that SME problems are largely homogeneous; hence if the enterprises in the sample are having difficulties with the supply of skills and access to equity capital, then it is likely that a large number of SMEs are having the same problems or will experience the same problems in the future if these dual problems haven't been addressed. It was also established through the literature review that there is a shortage of skills and lack of capital within the SME sector.

The researcher experienced problems with acquiring a reliable database on SMEs in Namibia. The researcher approached banking institutions, SBCGT, the Ministry of Trade and Industry, the Namibian Chamber of Commerce and Industry, USAID and SME Compete, but none of these institutions could provide the database for SMEs. The researcher was instead referred to the JCC, an entity that promotes and renders support services to those organizations that promotes SME and private sector initiatives in order to enhance equitable economic growth in Namibia. A list of 1626 SMEs was received from JCC. This list includes SMEs involved in different businesses, i.e. manufacturing, hair and beauty saloons, dressmaking and tailoring, Internet cafes, catering services, entertainment businesses, distributors of different products, printing, pharmaceuticals, information technology and other consultancies etc. However, SMEs involved in hair and beauty saloons, dressmaking and tailoring, Internet cafes, grocery retailers, entertainment businesses such as bars, cash loans, catering companies and consultancies were excluded from the population where the sample was drawn from. These businesses, which accounted for 83% of the total population, are of subsistence type and are intended only to provide a living for the owners with no intention of growing to attract venture capital investors. Therefore only 325 SMEs were available for sampling purposes. The electronic mailing (email) addresses of about 245 of these SMEs' were included in the list, whilst only the prepaid cell phone numbers of the rest were listed.

The researcher initially applied random sampling to select a sample of 200 SMEs, and send electronic messages to those with email addresses. 80% of the messages were returned undelivered. The researcher followed up with telephone calls, but most numbers were no longer valid. After several attempts, the researcher managed to contact 33 SMEs in the sample in order to establish whether they met the criteria outlined above. However, after the first interview session with banking institutions the researcher realised the importance of product exportability to the sustainability of SMEs and their ability to attract venture capital funding. Therefore each of the 33 SMEs that the researcher contacted was asked whether its annual turnover was greater than N\$1 million, and whether its total asset base was N\$5 million or more. The researcher also asked if they currently exported their products or if they intended to enter the export market in the future. The Namibian population is relatively small, and empirical studies indicate that about 50% of the population depends on subsistence farming, and does

not have any buying power to purchase goods and services for consumption. Therefore for a business to succeed there is a need to manufacture or provide goods with exportable potential, in case they cannot be absorbed in the local market. Out of the 33 SMEs, only 15 met the criteria as stated above, whilst the remaining 15 did not meet some or all of the criteria set. Hence, a critical case sampling was applied during this research to select SMEs to provide insight into the operations of SMEs in Namibia.

Amongst the fifteen SMEs who were identified based on the criteria stated above, two were not interested in sharing their views with the author, whilst three were too busy to grant an interview or complete the questionnaire despite numerous attempts by the researcher to get them to do so. Interview dates were set, but these entrepreneurs were not available when the researcher went to their offices. The ten who were interviewed were more receptive and keen to know more about venture capital financing.

Banking institutions were also included in the sample because the literature singled them out as traditional sources of funding for SMEs in most countries, even in Namibia. The main criteria for including banking institutions in the survey was the bank's commitment towards SME through the establishment of an SME division and the size of the SME loan portfolio as a percentage of its loan portfolio. After explaining the purpose of the survey and the research questions to be addressed to the four commercial banks, the researcher realised that there are only two banks that were actively involved with SMEs. Only these banking institutions were interviewed to obtain data to answer the research question and meet the research objectives.

Venture capitalists were also contacted to establish their requirements in deal selection and willingness to invest in the SME sector. Three questionnaires were sent to Namibian investors who operated a venture capital fund. One firm responded that they did not regard themselves as a venture capital fund, as they concentrated only on debt financing. Another company was not willing to participate, and one private equity fund manager completed the questionnaire. Therefore, the responses from venture capitalist should be interpreted cautiously as the author did not have a large sample for addressing the research question. However, those who participated addressed the fundamental issues involved and could assist in formulating views to achieve the research objectives. The Government, through its agencies, was approached so as to

assess its support for both equity investment and the SME sector in general, because neither venture capital investors nor SMEs can thrive without government support.

Individuals selected for the interviews or for completing questionnaires were all in decision-making positions in their institutions and could influence decisions at the strategic level. For example, the owners/ managing partners provided information within the SMEs, heads of SME units within banking institutions completed the questionnaires sent to banks, the Deputy Directors within the government ministries attended to the government questionnaires, and managing partners/fund managers responded to the venture capital fund questions.

3.2.2. Data Collection

Different qualitative typologies were used in collecting the data, which were mainly collected through semi-structured questionnaires with open-ended questions. Open-ended questions were used so as to allow respondents to give answers in their own way, speak their minds (Saunders, 2000), and provide extensive and developmental answers. Different questionnaires were designed and used for each specific group of stakeholders. The researcher chose this type of data collection because there are a large number of questions to be answered for each category of the sample. Information collected is regarded to be highly reliable, because it was recorded as given during the interview. The interviewer strived to be neutral at all times in order to avoid influencing the information given.

3.2.3 Questionnaire

A research questionnaire was developed in order to guide the interview sessions and obtain reliable information from the participants in a semi-structured way. The types of questions selected were influenced by the literature review and the research objectives, so as to identify the factors that influence the supply of finance and transfer of skills to the SME sector. The SME questionnaire had 24 questions, banking institutions had 13 questions, venture capital had 16 questions and government agencies had 7 questions.

Government ministries and agencies (**Annexure A**) were contacted for information on the government's policies in addressing the lack of skills and finance within the SME sector. Questions also focused on the government's policies on venture capital financing since the government's support for both SMEs and venture capital investment, especially in policies and regulatory issues, is essential to the success of the marriage between SMEs and venture capitalists.

The researcher wanted to gauge the status and extent of venture capital financing in Namibia, and to assess their relevance within the SME financing context; hence venture capital funds were selected to be included in the research population. Questions to venture capital managers (**Annexure B**) were significant because the researcher wanted to establish the willingness of these investors to fund the SME sector and to determine whether Namibian SMEs are big enough to attract venture capitalists by establishing the deal size these investors are likely to finance. The researcher also wanted to find out about the preferred exit strategy of these investors and compare it to what is currently available.

Questions to banking institutions (**Annexure C**) gathered information on support to the SME sector through financing and skills transfer, and the views of SMEs on venture capital financing as a source of finance. Questions to banking institutions are relevant because the researcher wanted to assess financial discipline within the SME sector, as well as the demand for funds by SMEs, in order to assess whether SMEs are borrowing funds from banks, or perhaps are generating profits internally to sustain their businesses.

Questions to SMEs (**Annexure D**) focused more on business activities so as to assess their potential for growth and their attractiveness to venture capital investment. Other questions assessed the financial discipline and willingness of SMEs to fund their operations with equity capital. These questions are relevant because the answers provided will be important to a venture capitalist during the searching and decision-making process when purchasing a business.

3.2.4 Administration of questionnaires

The questionnaire survey was administered in three regions of Namibia, i.e. the Erongo, Khomas and Ohangwena regions. The three regions were selected mainly in order to widen the sample rather than restricting it to the Khomas region which has the advantage of having access to all resources available to the SME sector. All the respondents who received an electronic copy of the questionnaire were telephonically informed about the survey before the submission of the questionnaire in order to establish their willingness to participate in the survey. The researcher explained the purpose of the survey which was also clarified in the questionnaire. Questionnaires were distributed electronically through email to those who had access to computers, because it was the quickest and most practical means of delivery.

Before conducting the face-to-face interviews the researcher explained the purpose of the survey to the sample respondents. Five face-to-face interview surveys were conducted with those small entrepreneurs who did not have access to an electronic mailing system. Two of the interviews took about an hour to conclude, whilst three of them took longer as they were conducted at a Trade Fair where these enterprises showcased their products. Telephonic interviews were conducted as follow-ups in order to clarify the meaning of some data submitted electronically. The order of questions varied as the researcher was mainly guided by the flow of each conversation. During the face-to-face and telephonic interviews the researcher took notes on key points raised. The in-person interview survey allowed the respondents to get immediate clarification on questions that were not clear to them.

3.2.5 Problems with survey methods and on-line questionnaires

The potential weakness of a survey method is the fact that it does not allow one to obtain an in-depth understanding of the problem, but rather provides a broader understanding. However, this was not a problem during this research as the main objective was to understand the broader needs of SMEs in Namibia. Other weaknesses as cited by Chivaka (2003) include issues such as collection of masses of data that provide nothing of theoretical value, level of measurement errors which lead to

extremely low validity and lack of adequate establishment of connections between variables.

The main problem with an emailed interview survey is the fact that it can lead to a low response rate due to a number of reasons (Coomber, 1997). Firstly, the sample respondents may not receive the questionnaire during the first attempt at sending due to technical problems from either side. Secondly, the sample respondents may not feel urgency in completing the questionnaires despite numerous electronic and telephonic reminders, therefore delaying the completion process of the research due to late submissions. Thirdly, the sample respondents may not be motivated to answer all questions, especially open-ended questions, as they view them as being time-consuming because they require a certain amount of writing. This will lead to the poor quality of information provided, as respondents are required to explicitly share their elaborated views in order to address the research question.

3.2.6 Mitigatory approaches

In order to address the above potential weaknesses of the survey method used in this research, certain steps were taken to ensure that data collected was useful to the research. To address these concerns the researcher focused on a small sample. The questionnaires were clear on what information was needed and where the respondents could not understand, either they called the researcher to seek clarity on the question for electronically submitted questionnaire, or clarity was given during the interview sessions for face-to-face interviews. To address the validity problem, respondents were required to elaborate on responses to a number of questions, most of which served as follow-up to the preceding questions. This made the responses clearer and easier to interpret. The research was not focusing on relationships between variables; hence the issue of causal connections was not much of a problem.

On-line questionnaire problems were addressed by persistently resending questionnaires and hand-delivering some questionnaire when technical problems with electronic mailing systems occurred. The researcher conducted telephonic follow-up to remind the respondents about deadlines, until all the questionnaires had been collected.

3.3 Validity problems

Validity refers to “the best available approximation to the truth or falsity of a proposition (Cook and Campbell, 1979). There is no single definition of the ingredients of the validity concept (Black, 1993). However, when qualitative researchers talk about research validity they are usually referring to qualitative research that is plausible, credible, trustworthy and defensible (Johnson, 1997). The “truth value” of the findings of this research can be assessed through the internal and external validity.

3.3.1 Internal validity of the survey method

The most important type of research validity is internal validity which refers to the extent to which the error variance is controlled (Parker, 1990) or to which an observed relationship between variables is causal (Cook and Campbell, 1979). Internal validity is relevant when qualitative researchers explore cause and effect relationships (Johnson, 1997). This research did not assess any cause and effect relationship, but was more focused on establishing a broader understanding of the two constraining factors hampering the development of the SME sector in Namibia. Therefore, internal validity problems were not a serious weakness in the research.

3.3.2 External validity of the survey method

External validity deals with the reliability of a proposition. It examines whether an observed fundamental relationship should be generalised to and across different people, places, settings and times (El-Diraby and Zhang, 2006). The survey method used in this research achieved external validity because many SMEs operating in Namibia are still micro-enterprises, operating on a very small scale that will not fit the model of venture capital investors. Therefore, those SMEs included in the sample are a good representation of the population of those SMEs ready for expansion and with exportable products, and the information supplied by these enterprises can be used to establish the level of lack of skills and capital within the SME sector.

External validity problems were not a drawback with the data collected from financial institutions, government agencies and venture capitalists. The Ministry of Trade and

Industry is the key government agency regarding the government's trade policy formulation and SME development; hence there is no other agency that can represent the Government regarding information needed for this research. The two banks that participated in the survey are the only banking institutions which have well-established SME departments; hence their responses are a true reflection of what is currently happening within the banking sector's lending activities to SMEs. The objective of the questionnaires to venture capitalists was to provide understanding of fundamentals regarding their investment requirements; hence the information supplied by the respondent venture capitalists is valid, although the specific data may vary from one fund to another.

3.4 Data Analysis

Because the interviews were based on open-ended questions, the results were transcribed, tabulated and codified in order to develop the data analysis. Qualitative data analysis was used to interpret the information provided and answer the research question. The information was classified into answer categories and expressed as percentage frequencies. For easier interpretation of data collected, graphical tools in the form of histograms/bar charts were used to present responses from different stakeholders.

It is important to state that the results presented are based on the number of answers per participants. Some participants gave more than one answer to one question and elaborated on both. Therefore, the sum of the number of responses per question given for some questions exceeded the total number of participants interviewed, i.e. Chart 11 in Chapter 4. This occurred mainly with regard to general questions rather than those specific questions asking about a specific enterprise, and should not be viewed as distorting the information given. The results of the survey are presented in Chapter 4, subdivided as per respondent categories.

CHAPTER 4

DISCUSSIONS OF FINDINGS

4.1 Introduction

This section presents and discusses the answers provided by the interviewed participants from the SME sector, banking institutions, venture capital funds and government ministries. The research results are structured and discussed according to the different variables that were covered in the interviews. These variables were selected based on the problems addressed in the research and the literature review.

4.2 Responses from the Ministry of Trade and Industry

Literature on the establishment of venture capital funds clearly confirms that the venture capital industry cannot survive without government support. This support can be in the form of funding for venture capital investment and formulation of laws and regulations to govern the administration and operations thereof. Besides supporting the venture capital industry, it is equally essential that government assist the SME sector by developing policies that support the operations of SMEs and enhance their sustainability. This can be done through government tender policies, improving market access and networking through quality control and product standardisation. Government facilitation of these processes will make the SME sector attractive to external capital providers, knowing that the government is willing and committed to the development of SMEs.

Although it was stated that venture capitalists would assist SMEs in accessing a wider network due to their existing business contacts, one striking conclusion drawn from the SME survey conducted by the researcher is that the transformation of the SME sector would not be possible without any government support. While venture capitalists may provide funds to finance projects as well as the required skills and guidance to execute tasks, they cannot influence decisions or determine criteria for government tenders. It is also important to note that once an SME enters into a partnership with a venture capitalist, that enterprise will still remain an SME until such time as it matures into a

fully-fledged, sustainable business entity. Its success depends largely on market conditions and any other initiatives favourable to the SME sector. For example, if government tender policies are not favourable to SMEs, it may not be possible for that enterprise to secure tenders and utilise the funds acquired from a venture capital investor, or to generate income and grow the business.

Since government support to SMEs is vital to the success of a joint venture between an SME and a venture capitalist, this research looked at the Government's support for the establishment of venture capital funds in Namibia. The Ministry of Trade and Industry stated that there were no venture capital schemes in Namibia, but that a study had been done to create such a developmental vehicle to support the SME sector. It was also stated that currently, there are no policies to regulate the venture capital industry in Namibia.

The researcher also established what current government support was provided to make SMEs attractive to capital providers other than banking institutions, especially equity investors. The focal point was the Government's procurement policies in creating opportunities for small businesses to improve prospects for SMEs to succeed in Government tenders, to level the playing field and to ensure fair competition between SMEs and well-established entities. The government representative's response in this regard was that preferential percentages are given during tender awards. An SME's tender is allowed to be 15% above tenders from well-established entities and still be regarded as competitive. Furthermore, the Ministry of Trade and Industry also issues SMEs with certificates for recognition in tender purposes.

The research also focused on the Government's support in assisting SMEs in participating in local and international trade to improve the sector's market access, networking, quality control, product standardization and direct foreign investment which can directly contribute to the profitability of specific enterprises and improve their future prospects by increasing their reserves and strengthening their capital base. It was established that the Government, through the Ministry of Trade and Industry, facilitates the participation of SMEs in local and international trade fairs, exhibitions and trade missions. The Government is also co-signatory to various trade protocols and agreements to enable Namibian products to enter those markets duty and quota free.

The researcher wanted to establish whether there is any other government assistance for SMEs in raising capital. Assistance in raising capital is currently provided through the SBCGT, which provides collateral of up to 80% of the borrowed amount to those entrepreneurs with viable business ideas but find it difficult to obtain loans from financial institutions. The amount to be guaranteed should be not less than N\$50 000, but not greater than N\$250 000. Besides the SBCGT, the Government has established the Development Bank of Namibia with the objective of funding bigger projects with capital requirements of up to N\$20 million.

Furthermore, the Government, through its Ministry of Trade and Industry, has set funds aside to assist emerging entrepreneurs in carrying out feasibility studies, developing business plans, product development, sourcing of production input and franchising. The Ministry also engages private consultants who are paid by the Ministry on behalf of SMEs to provide mentorship and after-care services, and to assist in developing entrepreneurial skills.

4.3 Responses from venture capitalists

As mentioned in section 2.3 venture capitalists were interviewed to determine the status and extent of venture capital financing in Namibia, and to assess its relevance within the SME financing context. The literature reviewed confirmed that the main challenge in the establishment of the venture capital industry is finance. Because the venture capital market is still in its infancy stage, this research attempts to identify a common funding mechanism for venture capital funds. Therefore, the researcher wanted to know from the respondent venture capitalists how they raised the initial capital. Findings indicated that the bulk of the initial capital came from institutional investors, i.e. insurance companies and pension funds. This venture capital fund issued listed preference shares on the Namibian Stock Exchange and managed to raise 99% of the initial capital, whilst individuals provided the remaining 1%. According to the fund manager interviewed, the fund did not receive any government financing or support.

The investor expressed concern that venture capital, as an asset class is currently not recognized, as there are no regulations in place to govern the industry's operations. The fact that venture capital is not recognized as an asset class has VAT and tax

implications to the fund. The respondent investor suggested that amendments needed to be made to the Financial Institutions Act, 1984 (Act No.38 of 1984) and Stock Exchanges Control Act, 1985 (Act No.1 of 1985) in order to clarify the rules around venture capital as an investment vehicle.

It was mentioned in the literature that some venture capitalists only fund SMEs which are involved in specific business activities. The researcher thought it important for the venture capitalist to identify the sectors most attractive to invest in, especially the ones the fund mainly specializes in. The respondent venture capital investor indicated that her company did not have any specific area of expertise, but they do finance established, cash generative enterprises in any sector. These criteria were applied in order to reduce the risk appetite, as this fund primarily deals with pension fund money.

Other criteria outlined by the respondent were that SMEs should be well established, and profitable, with good track records in order for them to be eligible for funding. The enterprises should be managed by competent individuals with market knowledge to enable them to add value to the business after the investment has been done. These enterprises were expected to have growth potential as well as a clearly defined industry focus. Above all, the venture should be acquired at a realistic purchase price, and the market should have reliable exit strategies to allow the venture capitalist to exit the deal after the desired holding period.

Because venture capital financing is a specialized source of funding which may not benefit all SMEs especially the micro and small enterprises, it is therefore vital to establish whether size really matters to venture capitalists. In order to manage the credit risk within a portfolio, the fund managers have set exposure limits for single enterprises. When asked about the size of the deal that the fund may consider investing in, the fund manager indicated that deals are normally defined by the mandate of the fund, which does not allow investments of more than N\$30 million in any single company. Nonetheless, any investment of less than N\$5 million would not be considered, because one of the fund's objectives is not to spread too thinly through small investments.

The minimum amount to be invested is well within the funding requirement of SMEs, as these venture capital investors are prepared to finance both small and large deals, without any collateral being required. For example, the highest maximum amount which may be borrowed by an SME from a local commercial bank is currently N\$5 million, but there are those SMEs with funding requirements in the region of N\$100 million who cannot be accommodated by banking institutions. It is these enterprises which can benefit from investment by venture capitalists.

SMEs, bankers and venture capital investors identified liquidity crunch as a major factor contributing to the failure of many SMEs. This mainly comes as a result of the inability of SMEs to generate cash to repay their debt. This problem may still exist if venture capital investors decide to exit a deal within a short period of time, whilst the business is still trying to build its cash reserves. The researcher wished to find out from the fund manager the holding period for an investment before liquidation, as well as the expected rate of return from the same investment. The current holding period for an investment is ten years, with an after-tax hurdle rate of return equivalent to the yield of a ten-year government bond, multiplied by 1.3.

The success of the venture capital market depends on the exit strategy available in the country. Typically, venture capitalists gain their returns when the business undergoes its initial public offering (IPO) or when it is sold to another firm. The researcher wanted to find out the most common exit strategy and compare it to what is currently available in Namibia. With regard to the fund manager interviewed she stated that his company does not have any exit preference, as long as the exit strategy does not inhibit the company's ability to sell for value, but that it would logically prefer a listing in the public exchange.

It was established through the literature review that the NSX has been under pressure due to the decline in trading volumes and company valuations. Institutional investors are reluctant to invest in local stocks since management of these stocks has failed to create value due to a lack of skills capacity. Investors are still waiting for good investments that directly contribute to economic growth and employment creation. Literature review in chapter 1 confirmed that most Namibian savings through pension funds, life insurance and short-term investments are currently invested in South Africa

due to poor investment opportunities in Namibia. This actually shows that investors are in need of Namibian companies with potential growth to invest in. The existence of venture capital funds in the market will create opportunities for Namibian institutional investors who are currently looking for publicly traded companies to add value to their portfolios. Therefore, the market is ready to accommodate the venture capitalists' preferred exit options to allow institutional investors and venture capitalists to realize returns from their investments. This should be an incentive to venture capital investors to invest in the Namibian SME sector since there is a need for good investment opportunities.

Venture capitalists were also asked whether they saw any prospects for venture capital investment in Namibia. The respondents agreed that there were indeed good prospects for venture capital industry in the economy. This would be driven mainly by the current underlying economic growth, with sectors like manufacturing currently looking attractive. Therefore, SMEs invested in high growth sectors are likely to benefit from venture capital investment once the venture capital industry becomes well established in Namibia.

Another factor that makes the market attractive to venture capital investors is the fact that there is currently a financing gap within the SME sector as banks are not keen to finance these enterprises due to a perceived high risk within the industry, coupled with the fact that in many banks, credit decisions are not made locally. The waiting period for loan approval has become highly frustrating and is increasingly discouraging SMEs from borrowing. SMEs confirmed their need for further funding to finance future expansions. Banking institutions cannot address the dilemma of shortage of skills within the SME sector, so there is a need for these enterprises to enter into partnership with investors who can provide both capital and transfer skills to the owners for the sustainability and long-term growth of these enterprises.

Venture capitalists interviewed feels that the government is encouraging businesses in the private sector to form partnerships with previously disadvantaged citizens to ensure that the majority of these people benefit from the country's economic resources. These venture capitalists saw this as an opportunity for the venture capital industry to grow because to finance these deals, there will be demand for huge amounts of funding

which banking institutions may not be prepared to provide due to the level of risk. Although the risk involved in BEE is not comparable with that involved in venture capital, deals the venture capitalists views are that because venture capital is normally risky capital which can be utilised to acquire an equity stake in an enterprise, the demand for this capital will be high, but there may be a shortage of supply since there is currently only one venture capital fund which is actively funding the BEE initiatives. Therefore, the establishment of more venture capital funds will create opportunities for previously disadvantaged individuals, and will enable them to generate wealth for the country in general and their families in particular.

Namibian venture capital investors are facing challenges that hinder the success of venture capital funds in Namibia. There are currently many misconceptions about venture capital as an asset class in Namibia. There is also a lack of skills within the industry itself because it is still at an early developmental stage and it takes a while to build up these skills. Other general problems identified by these investors include issues such as the inability to find the right companies to back and inability to make returns commensurate with the risks and efforts involved in investing in SMEs.

Venture capitalist in the survey identified lack of market knowledge as another challenge facing SMEs in Namibia, since it hinders them from penetrating the marketplace, and obstructs them from growing and become attractive to other investors. The fund manager emphasised honesty and good corporate governance as two fundamentals that cannot be compromised in a deal. When asked whether any government support was needed, participants urged the government to create an enabling environment for SMEs and provide tax incentives for investing in SMEs, and said that it should seriously consider venture capital as an asset class in its regulations because venture capital infuses the economy with fresh capital as opposed to the perpetual shifting of old capital.

4.4 Responses from banking institutions

As discussed in section 2.2, banking institutions are the main providers of capital to SMEs through bank loans and bank overdrafts. The main objective for gathering this information was to assess the financial discipline within SMEs and their funding

requirements based on the amount of money these enterprises borrow from banks. The researcher sought to understand the current problems which, from a financier's point of view, may contribute to the problem of shortage of funding for SMEs. This information is necessary for recommendation purposes in addressing the problems that may arise from the demand and supply side of both capital and skills. This same information also needs to be reviewed together with the characteristics of and requirements for venture capital financing, to assess whether this may have any effect on the establishment and development of the venture capital industry in Namibia. In addition, information from banks is useful in identifying the financing and skills development gap that currently exists within the SME sector.

The literature review reveals that most SMEs rely mainly on banking institutions as their main source of funding. The researcher wished to establish whether the size of the SME loan portfolio with banking institutions is significant, given the role that SMEs play in the economic development of the country. The size of the SME loan portfolio with banking institutions can be utilised to assess whether there is demand for capital, or whether SMEs are simply reluctant to approach banking institutions. The total loan portfolio of SMEs currently with respondent banking institutions is more than N\$3 billion, and all the banking institutions which participated in the survey each indicated that their SME exposure is not more than 5% or N\$150 million of the total loan portfolio. The total loan portfolio of the banking industry in Namibia overall stood at N\$23.9 billion as of 30 June 2006. Therefore the SME sector accounted for only 0.6%¹⁵ of the overall banking loan portfolio.

One important factor regarding financing, which also forms part of good corporate governance, is the level of financial discipline within an enterprise. This is critical as the recipients of capital, in this case the SMEs, are required to account for all the expenses incurred in a business. The mismanagement of funds may lead to the enterprise's inability to honour its financial obligations. Literature review in section 2.3 cites that venture capital financing can be in the form of equity or debt that requires regular repayments of these funds; hence the researcher thought it important to measure the financial commitment and discipline within those SMEs that were funded by banks by

¹⁵ This figure is indicative, as it only reflects information from two banking institutions. The author is of the view that the rest of the banks who did not participate in the survey may have a relatively small portion of SMEs loans in their loan portfolios.

looking at the default rate of the SME loan portfolio. The current default rate is within the range of 0% to 5% (Chart 2). The non-performing loan (NPL) ratio for the whole banking industry in Namibia was 2.9% as of June 2006.¹⁶ Although the NPL ratio for SMEs is above the industry's ratio, a ratio within the single digit rate is still manageable, given the level of risk and business operations of SMEs.

Chart 1 – Size of SME Loan Portfolio

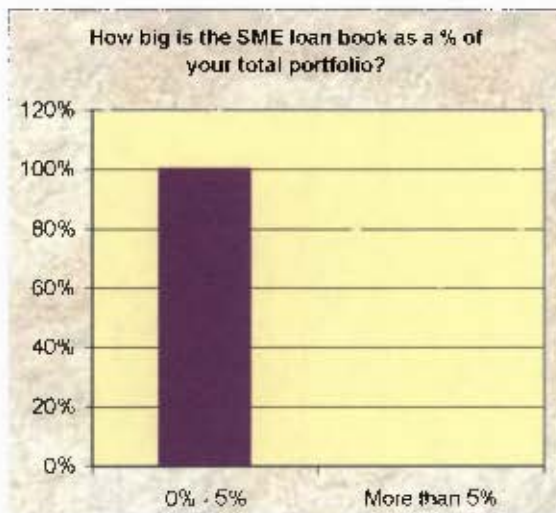
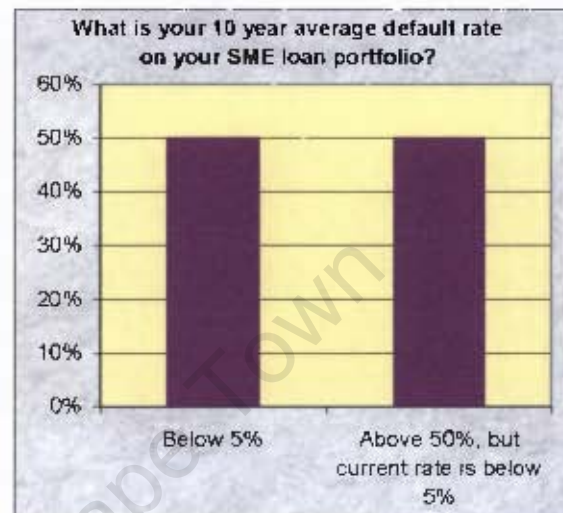


Chart 2 – SME Default Rate



Interviewed venture capitalists expressed their concerns about financing deals of smaller magnitude. Although financing and skills development problems do exist within the SME sector, the researcher is of the opinion that these enterprises should be able to absorb the amount of funds available through venture capital financing. Of those SME managers/owners interviewed, a few indicated that their capital requirements could be in the region of N\$100 million, whilst others could not specify any amount. The researcher needed to assess the level of risk that banking institutions are willing to take based on the maximum amounts that banks are prepared to lend to SMEs.

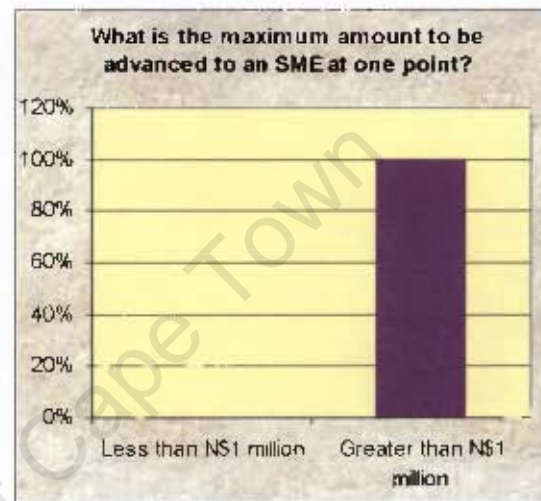
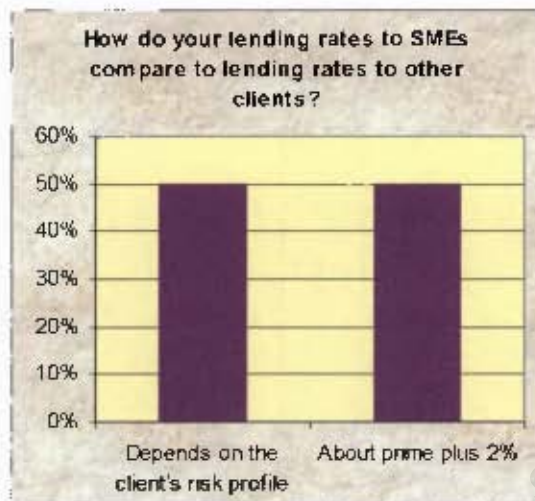
The maximum amount that a bank can currently grant to an SME exceeds N\$1 million, with the highest amount totalling N\$5 million. However, an enterprise with a funding requirement of N\$100 million may not find it easy to raise the needed funds through the sources currently available, and may therefore need a venture capitalist to fill that void. If one compares the N\$5 million, which is the highest amount yet loaned to an

¹⁶ www.bon.com.na

enterprise, with the N\$250 000 collateral currently provided by SBCGT, it can be deduced that current government support through SBCGT cannot be effectively utilised by SMEs as it is below the required collateral for their funding requirements. The security requirement for SME loans can vary from 0-100% of the borrowed amount, depending on the risk attached to each application. The higher the risk attached to the application the more security/collateral is required from the applicant. If the applicant has a strong balance sheet for instance, it can be used to offset the need for collateral.

Chart 3 – Maximum Lending Amount

Chart 4 – SME Lending Rates



It was established through the literature review that venture capital financing could be extremely expensive. One of the reasons why SMEs are reluctant to borrow from banking institutions is because of the high cost charged on bank loans and overdrafts. It was also established that venture capital financing is risky capital, which attracts higher-required rate of return. Chart 4 shows information required for comparison of prevailing lending rates with the expected rate of return on a venture capital investment as per the literature review and data collected from the participating venture capitalists.

Lending rates charged by banking institutions to SMEs differ, with 50% of the sample charging varied rates based on the risk profile of each client, whilst another 50% charged rates equivalent to 2 % above prime. These rates are currently comparable to an after-tax 10-year government bond yield which is an expected rate of return on an investment by respondent venture capitalist. However, based on information from the literature review, one could probably use a 25% required rate of return as a benchmark

to compare with lending rates that banking institutions are charging on borrowings to SMEs. Although bank lending rates appear more competitive, the benefits accruing to SMEs from banks are not comparable to those provided by venture capitalists. As stated in section 2.3, venture capital investors provide both capital and skills; hence the cost of funding paid on venture capital financing includes all the benefits accruing to SMEs. Therefore, it is not justifiable to compare the expected rate of return on equity or near-equity investment with lending rates charged by banks, as the risk and return in terms of benefits including commitment by the two capital providers differ. The decisive factor should rather be the target capital structure of the specific enterprise, and the overall weighted cost of capital that can be used to maximise the shareholders value

The research objective for this study is to identify a tool that can address the dual problems of SMEs, i.e. lack of capital and shortage of skills. The research question assesses how venture capital can be utilised to tackle these two key problems and contribute to the development of SMEs in Namibia. At the same time, one needs to be vigilant in ensuring that there is a market for the proposed concept so as to avoid the crowding-out effect of introducing an idea that is already in existence. Therefore, it is vital to ensure that venture capital fills an existing gap in the market, one which nobody has been prepared to fill in the 16 years since independence. Therefore, the author thought it necessary to establish whether banking institutions are addressing the SME problems in a manner that ensures the SME sector's sustainability.

Chart 5 – Other Services to SMEs

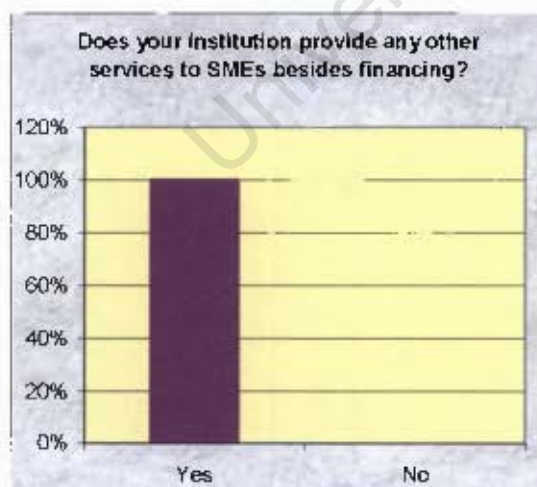
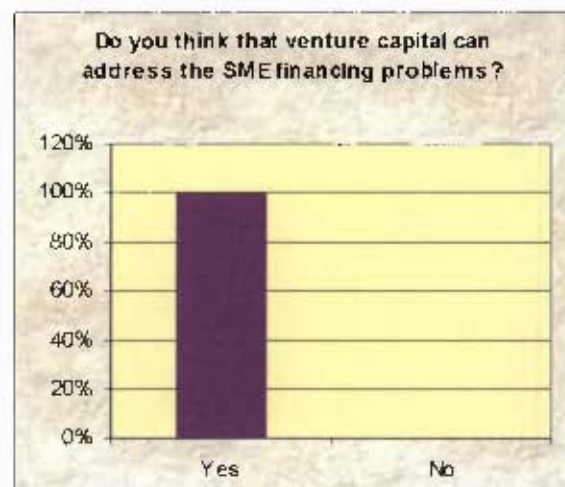


Chart 6 – SMEs and VC Financing



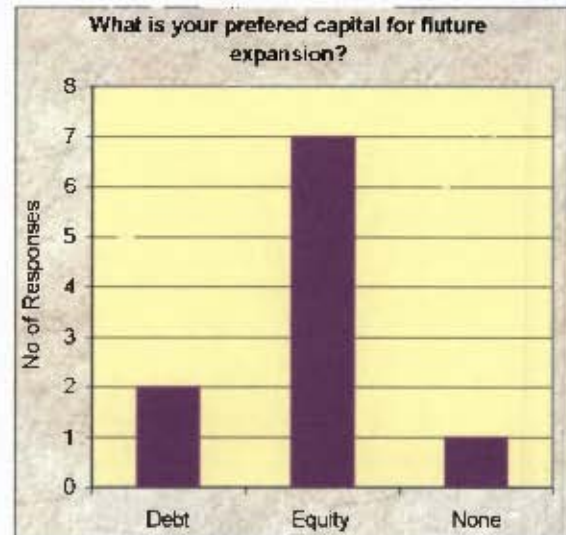
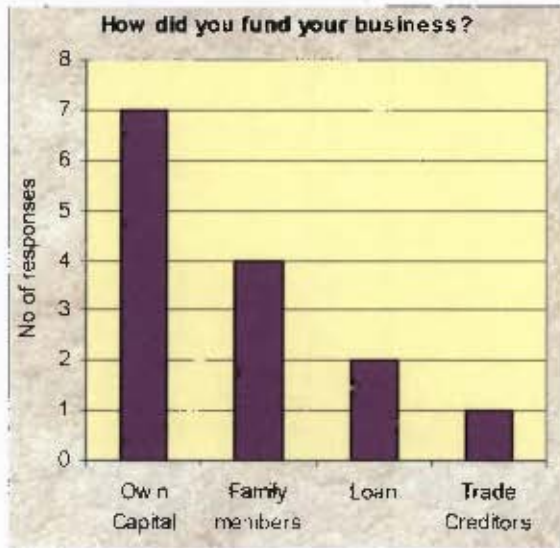
The two banking institutions interviewed indicated that they provide other services to SMEs, mainly in the form of mentorship programmes. The benefits of these programmes will be established through the survey of SMEs in section 4.5. Should banking institutions be providing training to SMEs, there may not be a need to introduce venture capital financing as banks may have taken care of the two main problems, especially when looking at the two characteristics of venture capital financing, i.e. provision of both capital and skills development towards SMEs. Venture capital investment is a relatively new concept in the Namibian market. However, sections 4.2, 4.4 and 4.7 of this research highlighted the characteristics and benefits of venture capital funding to SMEs, and described how it addresses the dual problems of lack of skills and capital, which are viewed as obstacles to the sustainable growth of the SME sector in Namibia. It is vital that all the stakeholders see the need for developing the venture capital industry in order to uplift the SME sector in Namibia. The researcher attempted to solicit views from all the participants regarding venture capital financing as a source of funding for SMEs. Those banking institutions interviewed were of the opinion that venture capital financing can definitely address the financing problems of SMEs because it will give them access to equity partnership that is at times more appropriate for specific projects.

4.5 Responses from SMEs

As mentioned in the preceding chapter, the researcher interviewed different stakeholders in the SME sector including SME owners/managers themselves. The researcher wished to establish how SMEs funded their businesses. This information was significant in measuring the capital contribution that the owners of these enterprises had put in as a commitment towards their businesses. Through the literature review it was established that one of the most important indicators of the owner's commitment to a venture is the financial resources the entrepreneur has committed to the company. This includes financing from friends, contacts, and families of the major partners. If a venture capitalist is going to commit resources to any company he/she must be sure that the owner(s) is/are committed as the two parties need to share the risk in the business. This financial commitment is a strong indicator of the owner's desire to see the business succeed.

Chart 7 –Sources of Funding for SMEs

Chart 8 – Preferred Capital



Of those interviewed, three participants responded that they funded their businesses purely with their own capital. Two of the ten interviewed used both their own capital and a loan, whilst one bought his initial stock on credit from a supplier that he knew whilst employed by another company, and he complemented that with own capital which he used to buy equipment. Four entrepreneurs sourced funds from family members, and contributed towards the business with small funds which they had saved. Overall, all those entrepreneurs interviewed funded their businesses partly or wholly at the initial stage.

Chart 7 above reflects the commitment of owners/managers of SMEs towards their businesses, since all the participants used their own capital to set up their businesses, although this was supplemented by funds from family members, banking institutions and trade creditors. Those who acquired bank loans indicated that it was a requirement of the banks that they should also contribute financially towards their businesses, and that banks would not grant them loans if they did not have any funds of their own. SMEs responses in Chart 7 above are a clear indication that bank lending is not always available at an early stage of an enterprise's establishment. This also confirms the risk aversion of banking institutions towards providing start-up capital for SMEs

SMEs were asked if they preferred equity or debt capital for future expansion. This question was useful in assessing the ideal capital structure of these enterprises. The

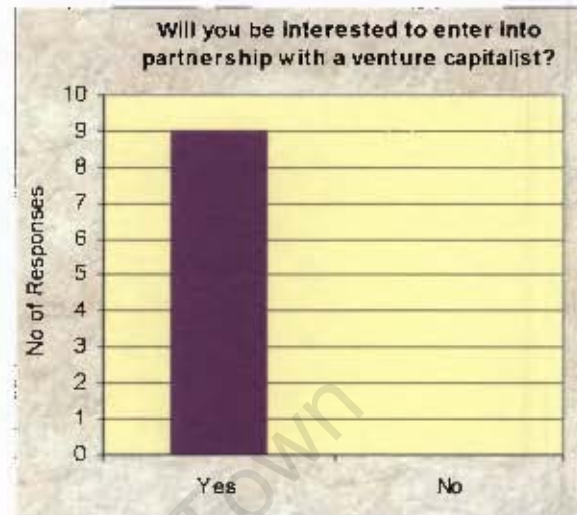
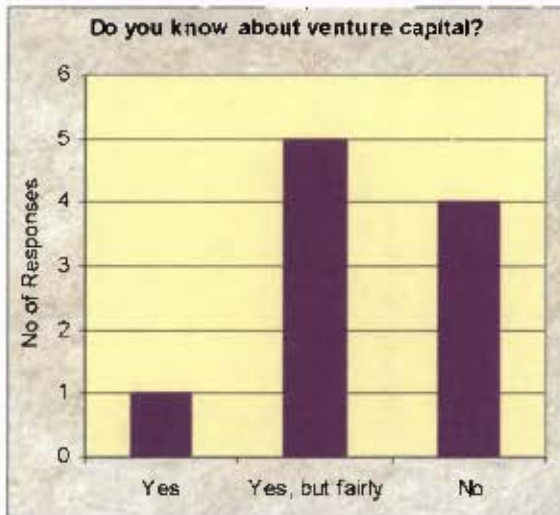
question was also important in assessing whether SMEs were keen to finance their businesses with near-equity capital, or if they preferred other sources of funding which venture capital may not be able to provide, i.e. those mentioned in section 2.2. Seven respondents indicated that they would prefer equity capital, whilst two preferred to fund their businesses through a bank loan.

Although the participants could not give the percentage target of their capital structure, these entrepreneurs expressed the need for refinancing their businesses with equity or near equity capital. This would not put pressure on their cash flow requirements since there would not be any mandatory regular repayments. Through the literature review it was established that venture capital financing could be equity investment in the form of common stock or preferred stock, convertible debentures or other financial instruments convertible into common stock when the small enterprise is sold. About 70% of the participating SMEs preferred equity capital as a source of funding rather than bank loans or any form of debt, as reflected in Chart 8 above. This information clearly shows that SMEs regard equity financing as a preferred source of funding for their businesses, Unfortunately equity financing cannot be sourced from the current financial institutions, especially banks which has been dominant in financing the SME sector. Therefore there is a need to introduce another funding mechanism that can meet the funding requirements of SMEs and enable them to expand their businesses.

It was essential to know whether SMEs fully grasped the concept of venture capital to measure their understanding of the benefits and disadvantages of venture capital financing, and determine whether it was something these enterprises might consider. 10% of those interviewed knew quite well what venture capital is all about, 50% had a fair idea of the concept, but did not understand other benefits that a venture capitalist may bring to the business, whilst 40% had no understanding of the concept. Although close to 90% of subjects interviewed did not know much about venture capital financing (Chart 9), they all understood the concept after the researcher had explained it to them. This could have introduced some bias in the study. SMEs in the survey expressed reluctance of some small business owners to give up an equity stake in their businesses due to the fear of losing control and allowing other parties to influence decisions. Venture capitalists will not be able to address the financing and shortage of skills problems within the SME sector if these entrepreneurs are not willing to enter into

partnership with them. Hence the researcher considered it necessary to assess whether SMEs are prepared to sell an equity stake in their businesses to venture capitalists.

Chart 9 – Knowledge of Venture Capital **Chart 10 – Interests in Venture Capital**



Of those SMEs interviewed, 90% expressed their willingness to have a venture capitalist as a partner in their business (Chart 10). This is supported by the SME responses in Chart 8 which shows that these SMEs require equity capital and not loans or bank overdrafts. What they liked most about venture capitalists was the fact that these investors would be able to address the dual problems of lack of capital and skills scarcity within the sector.

Chart 11 – VC and SME Financing

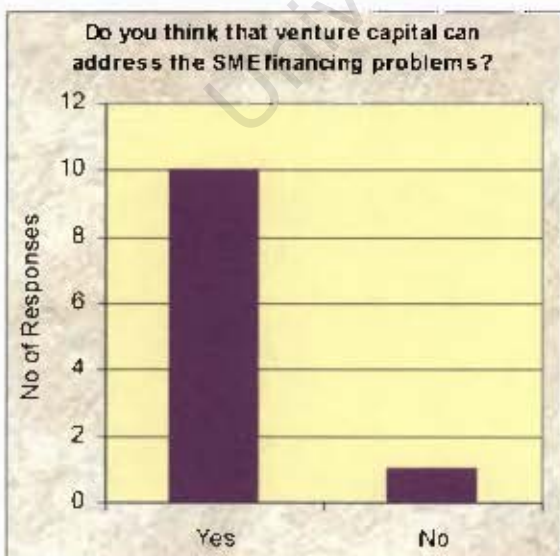
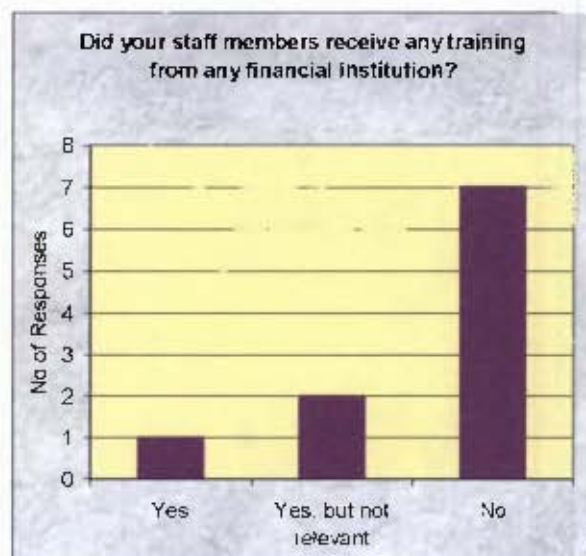


Chart 12 – SME Training



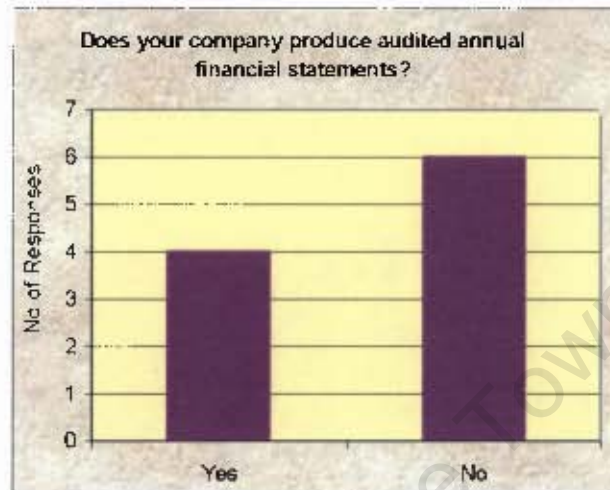
The researcher wanted to know whether the participating SMEs thought that venture capital financing could benefit the overall SME sector by addressing the funding problem within the sector. All the SMEs interviewed were of the view that other SMEs besides themselves would also benefit since the venture capitalists could finance a business at any stage of development, unlike other providers of capital such as banking institutions which seem not to be attracted to small enterprises.

The literature review reveals that there is a shortage of skills in the SME sector. However, other institutions like banks, government and the JCC provide training through their SME mentorship programmes. The researcher wanted to assess the impact of training and mentorship programmes currently offered to SMEs, in order to assess whether they can reliably address the shortage of skills in the future. As shown in Chart 12 above, 70% of the participating SME had not received any training from any institution, 10% benefited from these training and mentorship programmes and found them useful, whilst 20% indicated that their staff members had attended these training and mentorship sessions, but that the training was not relevant to their businesses. The current training programmes offered by banking institutions, JCC, SME Compete, and Women Action for Development (WAD) etc only fill a small gap in the shortage of skills within the SME sector. These mentorship programmes are geared more towards basic business management, and cover topics like bookkeeping, client services, marketing etc, which are equally critical to the success of small businesses.

Whilst business management courses may address one aspect of the shortage of skills, SMEs need training in technical skills related to their business activities. For example, an SME that manufactures beauty products will need a Chemical Engineer or someone with skills in quality control. These are the types of skills needed. However, although current mentorship programmes as mentioned above do not cover technical-related courses, they are still beneficial to small and micro enterprises operating on a small scale. There is still a gap that needs to be filled especially amongst medium to large enterprises with complex business activities of a technical nature, and venture capital can then address this specific problem because venture capitalists are professionals with experience in different sectors including finance, engineering, medicine etc.

One of the most important factors in venture capital investment, which is also in line with corporate governance, is the availability of audited annual financial statements. Of the respondents, 60% indicated that their enterprises did not compile financial statements, whilst 40% produce audited annual financial statements (Chart 13).

Chart 13 – Audited Financial Statements



Those enterprises that did not compile annual financial statements understood the need and importance of producing annual financial statements, but did not have the human and financial resources to do that. These institutions could not afford salaries for bookkeepers, accountants and external auditors who could assist in drafting and auditing the financial statements, again due to lack of finance. The partners and owners of these enterprises did not have the skills to do that; hence it was difficult for these enterprises even to determine the size of their own enterprises based on their asset base. They did, however, understand the need to produce audited financial statements, and viewed these as another tool for financial management discipline.

There were other problems identified by SMEs during the discussions, which, although they were not part of the structured questionnaires, the author felt needed to be addressed in order for venture capital as a financing tool to succeed. The following section will include an analysis of information collected from all the stakeholders in order to assess why the current institutions and policies geared towards addressing SMEs' financing and capital intellectual shortages failed.

Whilst the Government cannot be expected to protect SMEs as this may kill competition in the market, one would expect Government policies to be geared towards advancing SMEs by allowing for fair competition, without compromising on the quality of output delivered. So far, the Government's role has been largely limited to supplementing, and to some extent facilitating the provision of private sector financing, especially through banking institutions. It has also come to light that there are Government programmes currently supporting the growth of SMEs, either through revenue growth, by the awarding of tenders or through assistance in providing collateral to augment chances of securing funding.

Government is also assisting small entrepreneurs by facilitating their participation in local and international trade fairs, exhibition and trade missions in order to allow these entities to access the market and improve their networking. The problem, however, is that most SMEs are not aware of all Government programmes available, and benefits accruing to the sector have been rather insignificant. Other benefits currently offered to SMEs by the Government through its Ministry of Trade and Industry equally did not benefit the sector as most Government policies have not been fully implemented or have not been aggressively marketed in order to reach out to many SMEs. Most SMEs feel that they are excluded from most Government programmes, especially those in regions other than Khomas.

The Government has in some respects failed to monitor the progress of most of its programmes with the aim of assessing their impact on many SMEs. The imbalance in information dissemination and lack of advocacy of Government's policies was also confirmed by the researcher as most SMEs from other regions knew little about the type of assistance available through different Government agencies. This is related mostly to issues of market access and networking, development of business plans, conducting of feasibility studies and engagement of private consultants who are directly paid by the Government. Access to market and lack of proper distribution channels has a direct negative effect on the ability of SMEs to raise capital, but was rated as the third highest constraint on the successful operation of SMEs. The inability of SMEs to produce bankable business plans was emphasised by banking institutions as a critical contributing factor to SMEs' failure to secure financing. SMEs complained about the high cost involved in the drafting of a business plan as a deterring factor, whilst on the

other hand the Ministry of Trade and Industry claims to provide these services to SMEs. This clearly shows that there is a mismatch between the supply of these services and the demand for the same services with the result that they may not be utilised to the fullest.

The problem relating to government initiatives through its tender process contributes to the need for more capital or money due to lack of clear specification in most Government tenders. Some Government tenders do not specify the quantity of products needed, which can make pricing very difficult. At times the Government may decide to award a small portion of a tender to a Namibian company, while a larger portion of a profitable project is granted to a foreign company. The split of Government tenders has become costly to SMEs, as they normally calculate costs based on the overall tender, which allows for cross subsidization of different items or services in the tender.

Government has introduced preferential percentages to be given to SMEs during tender awards. Currently SMEs have the advantage that their tendered amount can be higher than a foreign tender by 15% and still be regarded as competitive. Although these entrepreneurs appreciate the gesture, they feel that this percentage needs to be increased, as it does not necessarily make much difference due to a number of reasons. A Namibian company will still need to import raw materials and components from South Africa or overseas, on which they will be required to pay duties and transport costs. The overall cost of all this is likely to exceed the 15% advantage as provided by the Namibian Government, leaving the Namibian SMEs with little option, other than allowing the foreign company to take over the full tender. SMEs feel that the current percentage of 15% is not significant and needs to be revised for the Government to meet its intended objective.

SMEs spend their valuable time and money in establishing correct specifications for products needed by the Government, especially for mechanically related goods or services. They feel that government officials are too relaxed, ignorant or unskilled, and that these officials indirectly transfer all the costs and responsibilities of finalizing the tender requirements to the SMEs, thus putting pressure on their limited financial resources. SMEs also realise that the tender periods at times are quite short, and do

not allow SMEs enough time to acquire prices for raw materials which have to be imported. It can therefore happen that the tender will close whilst the SME is waiting for prices of raw material to complete the tender document. Problems evolving around government tenders can be viewed as highly deterring factors in attracting venture capital as most small businesses may first require government support through tender awards in order for them to survive whilst exploring the foreign markets.

Small business entrepreneurs also feel that Government takes too long to pay for goods and services provided by SMEs, thus forcing these entities to pre-finance the projects for Government tenders and incur enormous financing costs while they are waiting for the Government to pay for goods and services provided. Again, this has a negative effect on the relationship between the SMEs and capital providers, especially banks, and will tarnish the credit record of the small enterprises, which will then make it difficult for them to secure financing in the future.

Agencies like the SBCGT, one of the government's initiatives established to provide collateral was also regarded as being ineffective in its operations. Most entrepreneurs interviewed failed to get any assistance from SBCGT. Another limitation on the effective economic contribution of the Trust is the maximum limit which can be collateralised by the Trust. The amount is currently fixed at N\$250 000, which is regarded as being very little in comparison to what these businesses actually require to meet financing requirements for their operations. Whilst this amount can be increased, caution should be exercised to avoid huge debt obligations which SMEs, especially small entities, may not be able to meet. Medium enterprises should however be encouraged to seek equity capital to finance long-term capital projects.

The issue of Black Economic Empowerment (BEE) requirements, currently used as a criterion to secure tenders especially in the public sector, has been mentioned as disadvantaging white small business entrepreneurs. Whilst they support the concept of BEE in income distribution, some white entrepreneurs feel that the value addition by BEE partners to their businesses is very minimal. These entrepreneurs require a partner who can supply the necessary capital and skills to their business. It is now evident that capital is a scarce commodity for many Namibian citizens and is not always available; hence the expected contribution of a black partner is likely to be of a technical

nature, but technical skills are another scarce resource in the Namibian labour market. Because of this, some white SMEs find it very difficult to secure Government tenders, since it is hard for them to find a partner who will truly add value to the business.

Small business entrepreneurs also feel that there is no proper consultation between them and the Government. SMEs have tried to channel their suggestions on how to develop the sector through the Ministry of Trade and Industry, but their requests have never been attended to, despite numerous follow-ups with the relevant individuals. Most of these suggestions were on how to produce raw materials, which serve as the key input in the manufacturing sector. A good example given was the processing of sealskins for leather shoes, which have potential for export markets. The Namibian seals are culled and skinned in Henties Bay, exported to a tannery in South Africa, and then sold back to the Seal Shoes Manufacturing Company in Henties Bay to be processed into shoes. The cost of acquiring the processed leather is very high as the Namibian Seal Shoes producers have to pay import duties and transport costs to bring the processed leather back to Namibia. SMEs are claiming that their pleas to the Government to be instrumental in opening a second tannery in Namibia have been ignored. Related to this is the issue of lack of a supply chain for raw materials or input for most enterprises. Most SMEs interviewed import their raw materials from South Africa, which affects the costing of their products and makes them uncompetitive compared with the same products imported elsewhere.

Further direct costs that contribute to SMEs financial woes are labour costs. Labour costs in Namibia are regarded as being high, and do not correlate positively with the available skills and the quality of output produced. This is mainly evident in the manufacturing sector, mostly in crafts-related trades. SMEs would like to see the channelling of more funds towards training through the well-established developmental NGOs that sometimes facilitate or directly fund these training programmes.

Small business entrepreneurs realise that the organizational performance culture amongst most employees in the sector also contributes to the sector's low productivity. There have been cases where some SMEs received tenders to supply products for both local and export markets, but failed to deliver within an agreed period of time because of lax performance culture in Namibia. The international market is a cut-throat one, and

inability to deliver the right quantity and the right quality of goods at the right time does not promote relationship building that can ensure sustainable supply, business growth and the ability to secure funding in the future. Inability to produce the right quantity has contributed to high production costs and increased prices on locally manufactured products, and has made these products highly unattractive to consumers. Many SMEs are either family-owned businesses or branches of South African businesses, which makes the decision to admit equity partners a long and circular one.

The introduction of venture capital financing should not be seen as a complete solution to SMEs' dilemma of supply of capital and transfer of skills. As indicated in the section covering the views from venture capitalists, this type of financing may not be available at the lower end of the sector, but these micro enterprises will still be critical to the long-term sustainability of the venture capital industry. The literature reviewed in Chapter 2, Section 2.3 of this paper revealed that micro enterprises can serve as a supply chain to venture capital funds, since their funding requirements will eventually exceed what banks and other debt providers provide. On exiting a deal, a venture capitalist may consider reinvesting the proceeds in another enterprise, which may be operating as a micro enterprise today. These enterprises will only be able to attract venture capital funding in the future if they are provided with government support and required skills needed at their business stage today.

This research established that there is a demand for equity capital in the SME sector, but the supply of this capital is very limited in the Namibian market. Of those sources of funding available, venture capital financing is the only one that can address the SMEs problems of lack of capital and skills due to venture capital's main characteristics, as these investors will take an active role in the management of those enterprises they fund, therefore contributing professional and seasoned management experience to the specialised knowledge and skills of an enterprise's owners. It was also found that venture capital is a type of capital preferred by SMEs themselves, because the majority interviewed indicated that their preferred capital for expansion is equity capital. All the stakeholders interviewed suggested venture capital investors as the ideal type of partners who could address the two major problems of shortage of skills and capital within the SME sector. It was nevertheless confirmed that there is limited knowledge of venture capital financing especially in the SME sector, and there are still many

misconceptions about it as an investment vehicle. The issue of lack of skills is evident in the demand and supply side as it takes a while to build up skills and there are still not have many venture capital funds with experienced staff to manage these funds.

The need for venture capital financing in Namibia is more pronounced in the more well-established medium to large enterprises category. These are the enterprises that have operated successfully for several years. Their business models demonstrate a sense of sustainability and they want to make a leap forward. This could be in the form of opening new branches, or acquiring modern plants and equipment for expanding production and capacity.

However, the current status quo in the market does not in any way support or guarantees the viable operation and success of the venture capital industry in Namibia. Besides the lack of skills and capital needed for the feasible operation of SMEs, other initiatives need to be introduced to make the sector attractive to venture capital investors. Government policies do not support the promotion of SMEs, there is lack of governance within the SME sector itself, institutional investors through pension funds do not allow for investment in unlisted entities and there are no regulations that govern the venture capital industry. Venture capitalist interviewed expressed their concerns with regard to the lack of investment opportunities in the market. This is a clear indication that there is a need to create an environment which will allow companies to qualify for venture capital funding. Sections 5.2 to 5.4 in the next chapter will look at recommendations which, once implemented, would assist in developing the SME sector and creating an environment that promotes venture capital investment in the market.

The following chapter will give recommendations based on the analysis of the collected data and the literature reviewed.

CHAPTER 5

POLICY RECOMMENDATIONS AND CONCLUSION

5.1 Introduction

In order to address the shortage of skills and lack of finance within the SME sector through venture capital financing, there is a need to develop the venture capital industry, as there is only one fund that currently operates as a venture capital fund. The development of the venture capital industry relies mainly on the availability of resources, both capital and human, supported by sound policies and regulations. The efficient operation of the venture capital market, on the other hand, depends on several interdependent components including governments, individuals and institutional investors. It also depends on the number of venture capital enterprises, the proficiency of venture capital fund managers and a critical mass of quality business opportunities that will attract venture capital investments. Operational and structural efficiency in all of these components can attract venture capital investors and hopefully contribute to the country's economic prosperity through financing of high growth-potential SMEs.

A study of the establishment of venture capital funds in different countries indicates that the success of venture capital funds depends mainly on the combined efforts of both the government and the private sector. The support most needed is through regulation, funding, taxation, education and awareness creation. The role of the private sector is mainly to provide support through funding, by establishing privately funded venture capital funds. The private sector, more especially the pension funds, insurance companies and other investors with surplus funds, should assist the government by establishing a private venture capital fund through the supply of needed capital.

The private sector can provide the skills necessary for the management of these funds, and can even establish privately funded educational institutions that focus on entrepreneurial skills to ensure continuity in skills provision. The few individuals who are currently academically empowered should organise themselves and identify experts in different sectors in order to establish venture capital funds. These professionals will be able to manage a venture capital fund once they put their academic and technical skills together, with an external expert being brought in to assist in the process. This team of

experts can then raise funds that they can manage from both private and public entities. Venture capital funds can also be established to cater for specific economic sectors like manufacturing, engineering etc, based on the skills of the fund managers managing that fund. They can also specialize in targeting enterprises at a certain level of business development, i.e. early stage or mezzanine.

There is a need to establish a committee that can spearhead the process of establishing venture capital funds in the country. This committee can liaise with the government to give input on regulatory matters and possible funding mechanisms after consultation with venture capital associations in different countries where the concept has been proven to be a solution in developing the SME sectors. The Namibian Asset Managers Association can equally consult with the government and other institutional investors to identify methods of establishing a venture capital fund. These investors can contribute a certain percentage of the funds under their management as the initial capital and appoint the key personnel, based on their experience and expertise, to manage the fund.

As there has not been much evidence on other private sector initiatives or support besides funding, most recommendations will focus mainly on government support, as the industry's success in other countries seems to be more sensitive to government programmes. Issues relating to regulations and taxation are the government's main responsibilities towards the establishment of the venture capital industry.

5.2 Policy recommendations

As mentioned in the previous chapter, the main challenges with regard to the establishment of the venture capital industry in Namibia will be the lack of skills and capital, coupled with non-existence of laws and regulations to guide the operations of venture capital funds and ensure efficient administration of the industry. The government's commitment towards the establishment and development of the venture capital industry was proved to be of essence. This commitment will take the form of funding and policy formulation.

With regard to capital, the government should support the industry by focusing more on how to attract non-governmental sources of financing in order to promote the supply of funding to SMEs. This support will be viewed in line with the government's commitment to the market, and can be done by introducing rules and regulations that will allow the formation and operation of entities that make direct investments. Through this the government will be able to encourage banks, venture capitalists and capital markets to create uniquely tailored programmes; for example, directing venture capital to seed companies in growth sectors and supporting the participation pension funds in venture capital investment. The laws should make it easy for companies to be established, and these investors should see a way to ultimately sell their investments. Furthermore, the laws should protect the rights and property of the investors, and ensure that there are transparent and predictable rules that apply to all. Administration and regulations should be fair and practical, and should not delay business activities. The burden of regulation should not be disproportionate to any perceived benefits.

Regulations should also cater for small venture capital enterprises, as it is those enterprises which normally operate at the smaller end of the investment market and play an important part in the life cycle of the venture capital industry. These investor's regulations and guidelines will guide venture capital funds and can be used as benchmarks to assess whether these funds are meeting the intended objectives of economic growth through the development of the SME sector. There are currently funds being managed by some institutions that operate as de facto venture capital. The formulation of laws governing these funds will help these businesses better decide whether to explore more fully their options to invest in other companies within the context of those laws and regulations, and hopefully benefit from any incentives to be introduced.

5.3 Supportive mechanisms

The government can affect the supply of financing to the venture capital funds through the extension of loans or loan guarantees, directly or through their agencies, especially the Namibian Development Bank, to registered venture funds that will invest within government guidelines. However, the ideal programme of government support is one that encourages investment by non-governmental sources, and results in an investment

programme that can be self-sustaining without continued investment by government. It is worth noting that the main two objectives of investing in SMEs are profit and economic development. Private investors are looking for the highest rate of profit on their investment, which should be in line with the risk they are taking. The government, on the other hand, is investing with the objective of accelerating economic development. Therefore, the government should offer incentives that increase the potential profit for private investors in return for investment in economic sectors regarded as being particularly important to economic development.

The main challenge with regard to the financing of venture capital funds targeting SMEs will be to strike a balance between economic development and profit generation from these investments, especially where the government enters into partnership with private investors in establishing a venture capital fund. Investments should be made with a long-term view to allowing these funds to be self-sustaining over a longer period of time. Government financed venture capital funds with short-term benefits may not be able to sustain their operations, and the government may be forced to keep pumping new money into old investments. Therefore, to prevent this from happening, the government should encourage investors that are motivated by the need for profitability and turnover investments, not only by economic development.

Another direct means by which the government can encourage venture capital investments is by providing financial incentives for investing in venture capital funds or small and medium enterprises, through a fair and effective tax system. As of now, the Namibian Government does not charge any capital gains tax upon liquidation of investments, which can be an added incentive for foreign investors to invest in Namibia. However, should the Namibia Government consider enhancing its revenue by introducing legislation on capital gains tax, consideration should be given to introducing a capital gains tax that can encourage equity capital investment in SMEs through favourable tax regime.

The success of any investment programme is based on the ability and experience of the person managing the process. A venture capitalist should ideally know how to evaluate and structure investments, and how to assist the management of companies in the development of their businesses. It was confirmed that there is currently a lack of skills

even within the venture capital industry itself. Thus, one critical success factor in the venture capital market which may also need the government's support is education. Whilst the government is not expected to educate investors directly on venture capital investments, its support through spearheading the process can have significant multiple impacts. The government can develop and adopt policies that are focused on promoting entrepreneurship. Improving the skills base, raising the quality of education at secondary and tertiary levels, and increasing the awareness and understanding of business and enterprise should become fundamental priorities of government policy. The most effective policy is the one that encourages tertiary institutions to develop courses and training materials on venture capital investments. Students need to have a better understanding of both business and entrepreneurship so they can be the investors, innovators and pioneers of the future. Besides this, a market needs to develop businesspersons who can serve as role models to inspire and motivate students to seek an entrepreneurial career in business. There are a few businessmen such as Messrs H. Pupkewitz, A. Mushimba, Q. Van Rooyen, S. Martin and Dr F. Indongo to mention but a few, who can be promoted as ambassadors of goodwill to upcoming young entrepreneurs.

An additional success factor in venture capital investment is the enhancement of the country's workforce. Skills formation is a necessary precondition for venture capital investment to succeed. A country's GDP is closely linked to the level of its economically active population. No amount of money or varied methods of financing can generate the ideas and opportunities necessary to make an investment worthwhile without a skilled labour force. For venture capital investment to succeed there is a need to increase the level of productivity within the SME sector in particular and the economy in general.

Other issues such as a large mass-manufacturing base, engineering and entrepreneurial talent, large domestic markets, capital and innovation are some of the key fundamentals needed for venture capital prospects. Whilst all these elements may not necessarily be available in Namibia, the public and private sectors can consider these sectors as having the potential to play a pivotal role in the development of the venture capital investment industry in the Namibian economy. Specifically, the manufacturing sector has already shown growth potential, and can be strongly regarded as one sector that can attract venture capitalists to the Namibian market. This sector

creates jobs in other economic sectors such as services and can increase the country's exports, increase government taxes and promote research and development.

The challenge to the market that comes along with the promotion of the manufacturing sector is the development of engineering skills within the Namibian labour force, which if supplied in abundance can be available at comparatively low costs. The low cost of labour can be passed on to the consumers and would make Namibian products relatively affordable compared with the same products from other countries where the cost of labour is high. Competitive prices stimulate demand and contribute to the economic growth of the country. The literature review reveals that manufacturing capability especially in China has been complemented by a profound pool of engineering talent that has been employed at a fraction of the cost of foreign equivalents. Because of the strong political and economic ties between Namibia and China, Namibia can learn from China and hopefully, in its small strides, emulate some of the Chinese examples for its own economic accomplishments.

Another driver of investment activities that can attract venture capital investors is the government's consideration of the privatisation of some of its state-owned enterprises, especially the profitable ones. Privatisation of profitable state-owned enterprises could create attractive public market exit opportunities after the introduction of the right corporate governance practices and commercial structure, along with enhanced management teams.

5.4 Challenges within the SME sector

During the interviews, the researcher identified a few problems which might make it difficult for Namibian SMEs to attract venture capital investors. Issues of financial information disclosure and business plans are crucial to all the financiers including venture capitalists. It was established through the literature review that banks are increasingly taking the view that lending decisions should be based primarily on an analysis of the borrower's cash flow and business plan, with the availability of security being regarded as an important, though secondary, consideration. 60% of the participating SMEs indicated that they do not compile financial statements due to high fees of qualified bookkeepers and accountants, and high auditing fees. Every capital

provider needs to be well informed about the financial position of the company s/he is investing in, in order to determine the value of the entity and the appropriate price s/he should pay to acquire an equity stake in the business. An entity without proper financial records is difficult to assess and may not be attractive to invest in. Hence SMEs are advised to be willing to spend money in compiling annual financial statements to be audited by reputable audit professionals. Auditing firms should also consider pricing their services to SMEs affordably. Inadequate disclosure of an entity's financial accounts can be viewed by the providers of capital as evidence of weak management and lack of financial discipline and can minimise the company's chances of attracting capital. Adequate disclosure of financial information means the presentation, in a fair and transparent manner, of the company's credit footprint as well as its track record on governance.

The availability of information about a company's finance is a prerequisite for the preparation of a business plan, which can be used to introduce a company to other business partners with an interest in it. SMEs are experiencing difficulties in writing convincing business plans and some are highly disappointed by the fact that current financial institutions consider a bankable business plan as part of the minimum criteria to be met for a company to qualify for a bank loan. Unfortunately, should a company consider entering into partnership with a venture capitalist, the first introduction would be through a concise business plan to introduce the business to these potential investors. A well-conceived business plan can serve as a blueprint and roadmap for entrepreneurs in the operation of their business activities and allocation of resources in an effective and efficient manner. What is more important to the business plan is the disclosure of information about the company's finance and governance, so as to provide a sound basis for an informed assessment by the venture investors of the feasibility of the proposed business project. As previously stated, SME financing problems cannot be resolved by capital providers alone, but should be resolved through collective efforts by different stakeholders including SMEs themselves. SMEs should approach the Ministry of Trade and Industry for assistance in developing their business plans, whilst the Ministry should aggressively strive to disseminate information on available assistance to all SMEs in the 13 regions.

Other problems mentioned during the interviews with SMEs included issues such as lack of financial discipline amongst SMEs because some fail to reinvest profits in their businesses, but use them for personal expenditures not related to their businesses. Lack of financial discipline amongst most small entrepreneurs can also be regarded as a huge challenge with regard to attracting venture capital to the SME sector. Small entrepreneurs have to demonstrate financial management ability in order to attract venture capital financing. Financial accounting and control systems are crucial for SMEs because these can be used for purposes of diagnosing possible problems as well revealing hidden advantages such as the level of financial leverage in the company. Equally, venture capitalists that perform due diligence on an entity look at the information disclosed. Venture capital investors, like any other providers of capital, will require SMEs to observe other corporate governance issues, as they too are under constant pressures to comply with the principles and practices of good governance.

Unwillingness of entrepreneurs to enter into partnership with technically skilled investors for fear of losing business control or sharing it with other partners came out as being common amongst the SMEs. This will hamper the process of value addition to these enterprises, and will discourage other investors such as venture capitalists from investing in the sector. In order to attract venture capitalists, SMEs should demonstrate their willingness to share decision-making powers and profits with venture capital investors. The logic with venture capital investment is the fact that SMEs will be able to own a reduced percentage of a bigger enterprise as compared to the current situation where they own 100% of a small enterprise. Therefore, SMEs should realise that they can achieve greater economies of scale by involving venture capital investors in their businesses.

Strengthening SMEs must be a priority in order to prepare them for facing challenges and enticing venture capitalists to enter the Namibian market. Venture capital investors may only target medium to large enterprises, leaving the small and micro enterprises out. However, the success of the venture capital industry requires vibrant small and micro enterprises that can grow into medium and large enterprises and create opportunities for venture capitalists. Hence banking institutions should be prepared to fill the gap which venture capitalists may not fill, to provide a smooth supply chain for the venture capital market and create demand for the industry. Therefore, the clients'

limitation and the banks' interest must be formulated such that the loan delivery mechanisms can provide access for SMEs without eliminating commercial principles and prudential banking. In order to provide financial assistance for SMEs, banks should develop lending programmes appropriate for SMEs and simplify administrative procedures. Together with other specialised SME consultancies, banks should provide technical assistance through well-structured mentorship programmes. The government should consider increasing the amount of collateral currently provided by the Small Business Credit Guarantee Trust.

Small businesses are dynamic innovators that will shape the economy of the future. A strong entrepreneurial culture is essential for the future competitiveness of any economy and for generating economic growth. SMEs can create many jobs within a short period of time, increase the tax base, add to the growth of national income, and provide substitutes for imported goods. In fact, our economic future is becoming increasingly dependent on the growth of small business enterprises to diversify economic activity and to compete effectively in the global marketplace. Accessing suitable financial support to provide the opportunity for such growth is critical to the expansion of small businesses. Without adequate financing, the growth of these businesses will be stunted and our future prosperity threatened. Therefore, promoting SME access to finance will require a combined effort to improve the business climate, strengthen the capacity of SMEs to help them cope with formal banking requirements, promote financial sector development, including the scaling up of micro finance institutions, and diversify the sources of financing, notably by favouring intra-private sector linkages. Therefore, developing an enabling environment for SME development by providing affordable sources of finance is crucial for both the SME sector and for the economy as a whole.

5.5 Conclusion

The purpose of this research was to provide an analytical insight into ways in which venture capital financing can contribute to the development of small and medium enterprises (SME) in Namibia. To answer this question, the research gave an overview of the current financial set-up in Namibia with views on how capital and skills are supplied to the SME sector. It looked at the definition and characteristics of SMEs in

Namibia and globally. The research further assessed other sources of funding that may be available to SMEs, with a brief synopsis on their advantages and disadvantages. It then moved on to introduce venture capital financing as an instrument for SME financing and transfer of skills to the SME sector. Whilst access to capital and lack of skills are not the only constraints to the growth of SMEs, these factors are considered important for success in developing SMEs. The literature review shows that venture capital financing can be exploited to address the dual problem of lack of skills and capital currently hindering the development of the SMEs. This research established the willingness of SMEs to engage with venture capital investors, as banking institutions, venture capitalists and SMEs interviewed emphasised equity financing as a fundamental need for Namibian SMEs. Their growth path, their stage of development and their characteristics would influence the ease with which small businesses obtain financing, especially through venture capital.

Some SMEs may find it difficult to access financing through venture capital as these providers of capital base their investment decision on sector, enterprise size, experience (both on the demand and supply side), business type, region or other criteria over which the SMEs have no control. Therefore, in order to maximize their ability to access financing, SMEs should improve their management abilities, especially in areas such as business planning, finance and accounting, and the preparation of cash flow projections. SMEs should make it a habit to communicate effectively with investors and any other providers of capital and keep them fully informed about their operations at all times.

Whilst the literature review proved that banking institutions are not keen on lending to SMEs, it is still important that banking institutions continue to expand their involvement with SMEs through their SME lending and mentorship programmes, especially to the small and micro enterprises, so as to create a market for venture capital investment. This can be achieved if banks develop more cost-effective ways of evaluating SME loan applications and become more involved with SMEs by conducting site visits and providing advanced financial management advice. Banks should also revise existing risk-taking procedures and emphasise subjective criteria such as character lending especially to those SMEs which have viable and sound business models, but do not have a long performance track record. Banks can contribute to the development of the

venture capital market by expanding current small-scale initiatives to find innovative ways of increasing their financing of SMEs and by accepting a higher degree of risk. Improvement in every aspect of SME customer service and the provision of more relevant training and information to make lending officers more sensitive to the unique needs of small businesses can positively contribute to resolving the financing dilemma of SMEs in Namibia.

All stakeholders in the SME sector will need to work together with the government to agree on an effective Code of Conduct establishing service standards for small businesses, which in turn can positively contribute to the smooth establishment of the venture capital market in Namibia. Venture capital is more successful when there are proper regulations in place. Therefore the government's role should be in the formation of policies and laws, so as to involve more private investors in the further development of the venture capital investment industry, whilst SMEs must have the will to transform and succeed.

The study did not provide much detail on the implications and difficulties with regard to the establishment of venture capital funds, the main focus being on the barriers in the management of these funds. Further research is required on issues pertaining to legal structures to assess the conduciveness and attractiveness thereof to venture capitalists. There is also a need to assess the adequacy of deal flows with the objective of establishing whether the Namibian market is large enough to generate deal flows sufficient to attracting quality management to the fund. It is also important to determine an optimal fund size that is large enough to permit diversification of the portfolio, without forcing management to look for deals outside its area of expertise to avoid the situation of over-supply of funds with little demand for the product. Future research also needs to be conducted to assess the impact of venture capital on the success of portfolio companies for those Namibian companies that have so far benefited from funds such as the Stimulus Private Equity Fund. As the market grows, it will be interesting to see the relationship between the growth in venture capital funds raised, the growth in total costs of borrowing or lending rates from other financial institutions, and the growth in SME loan portfolios with banking institutions.

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ANNEXURE A: GOVERNMENT AGENCIES

**SURVEY ON POTENTIAL OF VENTURE CAPITAL FINANCING IN PROMOTING
SME SECTOR IN NAMIBIA**

DUE DATE : On or before 15th October 2006

Please return the completed form to gaomas@ssc.org.na

PLEASE READ THIS FIRST

Reason for collection: The author is writing a dissertation that looks at "The contributions of venture capital investments to the development of small and medium enterprises in Namibia" as part of a Masters Degree in Corporate Financial Management with the University of Cape Town. It is therefore critical that the form is completed and sent back to the author on or before the due date to enable her to complete the project in time.

Data is confidential: Information asked for in this questionnaire will be used for **statistical purposes and be published at the aggregate level only**. Data and information relating to individual organisations will not be made available to anybody other than the author.

Queries: If you have any queries or difficulties completing the form, please contact Maria Nakale at +264 - 81129 1751 (cell) or +264 – 61- 280 7087

Please note that you do not have to answer all questions if you do not wish to. You are not compelled to answer those questions that are not relevant to your organization.

Thank you for your co-operation.

Maria Nakale
Author of the Survey Design

Person in your organisation who should be contacted if any queries arise regarding this form:

NAME:.....TELEPHONE No.: ().....
POSITION:
E-MAIL
ADDRESS:.....

- I. What are the government policies on public and corporate procurement programmes in creating opportunities for SMEs?
- II. What does the government do to assist SMEs in raising capital?
- III. What opportunities or government support is available to SMEs in participating in local and international trade to improve market access and networking (i.e. quality control and product standardisation) as well as securing international funding?
- IV. How does the government communicate its support programmes to SMEs? Are they well marketed?
- V. What does the government regard as success factors contributing to the attainability of funding by SMEs?
- VI. Does the government support venture capital investment? If yes, how?
- VII. Does the government have comprehensive policies for venture capital investments?

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ANNEXURE B: VENTURE CAPITAL INVESTORS

SURVEY ON POTENTIAL OF VENTURE CAPITAL FINANCING IN PROMOTING SME SECTOR IN NAMIBIA

DUE DATE : On or before 15th October 2006
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Person in your organisation who should be contacted if any queries arise regarding this form:

NAME:.....TELEPHONE No.: ().....
POSITION:
E-MAIL
ADDRESS:.....

- I. How did the fund raise its initial capital? Was it privately or public funded?
- II. As a venture capitalist, what would be the size of the deal that you would be interested in and why?
- III. Does your company specialize in financing companies involved in any business activity or at any stage of a business cycle? Why?
- IV. What are the basic requirements to be met by an entity to qualify for funding from your company?
- V. What is the minimum rate of return you expect from the venture investment and what is your holding period for this investment?
- VI. What exit strategy would you prefer for this kind of investment?
- VII. Do you see any prospects for venture capital investment in the Namibian market?
- VIII. What problems did your institution experience in the past with regard to providing funding to SMEs?
- IX. What can be done to address the problem?
- X. Did you receive support from the government regarding the establishment of the fund? If yes, what kind of government support is available?
- XI. In general, what other government support or programmes that you are aware of are available to promote venture capital investment and its support to SMEs?
- XII. What can be done at the policy-making level to entice venture capital investment in Namibia?
- XIII. What would you say are the constraints, challenges and opportunities that hamper or contribute to the success of venture capital funds in Namibia?
- XIV. What would you regard as the main drivers of venture capital investment in the economy?
- XV. What are the lessons Namibia can learn from other countries regarding venture capital investment for the SME sector?
- XVI. What are the challenges that venture capital investors face in funding the SME sector?

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ANNEXURE C: BANKS AND OTHER FINANCIAL INSTITUTIONS

SURVEY ON POTENTIAL OF VENTURE CAPITAL FINANCING IN PROMOTING SME SECTOR IN NAMIBIA

DUE DATE : On or before 15th October 2006
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Person in your organisation who should be contacted if any queries arise regarding this form:

NAME:.....TELEPHONE No.: ().....
POSITION:
E-MAIL
ADDRESS:.....

- I. Does your institution have a financing support programme specifically earmarked for small and medium enterprises? Please elaborate.
- II. If your answer to I is yes, how big is your loan book relating to SME financing activities as a percentage of your overall loan portfolio?
- III. How do your lending rates to SMEs compare with lending rates to other entities or customers?
- IV. What was the default rate for your loan portfolio to SMEs over the past 10 years?
- V. What is the maximum amount to be advanced to an SME at any one point?
- VI. Does your institution provide any other services to SMEs besides financing i.e mentorship programmes etc?
- VII. Which SME activities (sectors) have potential for growth in terms of production in Namibia?
- VIII. Why do you think that the SME activities in VII, have potential for growth?
- IX. What interventions/ policies are needed to enhance the productivity of the SME Financing sector/ specific SME Financing activities?
- X. Are there any other existing problems, opportunities and policy options for the Namibian SME Financing sector?
- XI. Do you think that venture capital investment will ease the problem of lack of financing in the SME sector?
- XII. What are the lessons Namibia can learn from other countries regarding venture capital investment in the SME sector?

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ANNEXURE D: SMALL AND MEDIUM ENTERPRISES

SURVEY ON POTENTIAL OF VENTURE CAPITAL FINANCING IN PROMOTING SME SECTOR IN NAMIBIA

DUE DATE : On or before 15th October 2006
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NAME:.....TELEPHONE No.: ().....
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INTRODUCTION - WHAT IS VENTURE CAPITAL (VC) INVESTMENT?

Venture Capitalists are companies or individuals who provide investment capital, management expertise and experience to potentially high growth unlisted companies. These investors provide funds for start-up situations and for existing high-risk small businesses suffering from capital deficiencies and a lack of collateral, but having high profit potential as aspiring growth companies. In return for their investment, venture capitalists will take an equity position in the company, usually in proportion to the amount of their investment and the level of risk involved. The relationship between the investor or venture capitalist and the entrepreneur is a strong partnership, in which neither party is trying to get the upper hand, hence both parties work together to make money. The future return on their investment is tied to the performance of the company.

Venture capital investment is typically categorized as a long-term investment with a minimum holding period of 3 years and generally takes businesses through more than one business cycle. Unlike more common debt instruments such as bank loans, the equity investment in the company usually does not require regular payments. Instead, venture capitalists look for a capital gain and an increase in the value of their shares. This means that the company will have cash flow available for growth. This infusion of equity can create tremendous benefits for the company such as allowing for expenditure on capital equipment, providing working capital, or assisting with growth strategies. The future sale of the company, its going public, other forms of appreciation in stock value, or other exit strategies will give the venture capitalist the required return on his investment. This return depends on the success of the company in which s/he invests. Thus, the company's future and the venture capitalists future are integrally linked. In many ways a venture financier is a partner, not a lender. The company's success is his/her main objective.

As an investor-partner, the venture capitalist will take part in the management of the company, whether through participation on its Board of Directors or providing management input on a regular basis, which can be negotiated by the two parties. The venture capitalist will most likely take an active role in helping the company to grow, providing the most favourable environment for success and minimizing risks to his/her investment.

Venture capital investors provide the company with personal experience and a stable financial base on which management can make strategic decisions. Once introduced into the business, this gives managers the time to focus on strategic issues and the finance to enable them to revitalize the firm and take it onto the next phase of growth.

- I. How did you fund your business operations, i.e. own capital, family members, loan from any financial institution or government agency?
- II. Does your company experience problems in raising capital to finance its operations?
- III. In your own view, what factors hinder the securing of finance for the SME sector in Namibia?
- IV. Would you prefer a loan or equity capital for future expansion?
- V. Does your company produce annual audited financial statements? If not, why not?
- VI. What are your views on the current organisational set-up for those institutions that deal with financing issues relating to the SME sector?
- VII. Did these institutions deliver on their mandates, and did they succeed in transforming the SME sector by providing or enhancing opportunities for securing financing? Please elaborate
- VIII. If your answer to VII is No, what do you think needs to be done to rectify the problem?
- IX. Did your staff members receive any training through mentorship programmes currently run by those institutions responsible for the development of the SME sector?
- X. Name those challenges facing new and existing small businesses as they attempt to develop and expand their export markets.
- XI. What are the opportunities available to SMEs for participating in local and international trade to improve market access and networking?
- XII. Why do you think financial institutions in Namibia are not that keen to finance SMEs to their full capacity?
- XIII. Do you see any government support for SME financing? Please elaborate on your answer.

- XIV. Are you aware of any government policies on public and corporate procurement programmes in creating opportunities for SMEs?
- XV. How much do you know about venture capital investment?
- XVI. Do you think that venture capital investment could be a solution to the SME financing problem? Why?
- XVII. If your answer to XVI is yes, which sectors do you think would be more attractive to venture capitalists and why?
- XVIII. Would your company be interested in venturing into partnership with a venture capitalist?
- XIX. What are the lessons Namibia can learn from other countries regarding venture capital investment for the SME sector?
- XX. What do you think the government can do to alleviate the SME financing problem?
- XXI. What kind of regulatory constraints does the SME sector face with regard to start-up costs, i.e licensing and registration requirements?
- XXII. What is your company's annual sales? Please circle the relevant range.
- (i) N\$0 – N\$500 000
 - (ii) N\$501 000 – N\$1, 000 000
 - (iii) Above N\$ 1 mil
- XXIII. How many people are employed by your company?
- XXIV. How would you rate the following factors as constraints in running your business, a rating of 1 being the least constraint and 5 being the main constraint?
- a. Availability of raw materials
 - b. Access to finance
 - c. Lack of skilled employees
 - d. Lack of demand for your products
 - e. Access to market and proper distribution channels
 - f. Access to public contracts and subcontracts
 - g. Lack of information on tenders
 - h. Tediousness of bidding procedures

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