

Reaping the rewards of risk

South Africa needs more venture capitalists who brave risks by supporting new entrepreneurs with early-stage finance. In such uncharted territory failure is a possibility, but so are excellent returns.

by Julia Long

Venture capital is a type of equity investment in promising start-up ventures. Investors look for smart business ideas with significant growth potential. In return for the initial uncertainty, they count on being rewarded with very attractive profits later.

Lessons from the United States

High risk characterises the venture-capital industry. The United States model has shown that failure must be accepted as part of the exercise. Only one out of ten investments gives super returns, but these are the deals that lure investors. Patience is required as it may take five to ten years before investments are ready to provide returns. For the investors, returns materialise only at exit, and are once-off.

The US venture-capital industry has had its ups and downs, with the NASDAQ crash and the technology slump still fresh in the memory. By 2003 many venture capitalists had to write off their investments and the industry shrank to half its 2001 capacity. A 2007 US report shows most investments are made in businesses in the expansion or late-development stages, while

substantially fewer are made in early-stage ventures.

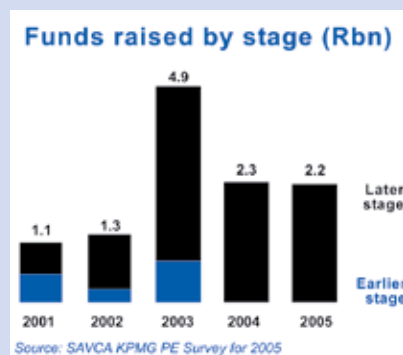
Venture capital in South Africa

There are several reasons for scarcity of venture capitalists in South Africa. Venture capitalists charge management fees based on the size of the fund. Since the fund size required for such early-stage investing is so small, the management fees received cannot cover venture capitalists' expenses. Moreover, the typical South African investment committee dislikes unpredictable investments because the representatives are mostly from institutions that focus on later-stage, bigger deals. Investors' price-earnings expectations are also too high. In addition, there is a big demand at present for later-stage funding, which is generally a less risky and more attractive choice for investors.

The South African Venture Capitalist Association (SAVCA) was formed in 1999. According to a 2005 survey by SAVCA and

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KPMG, South Africa has an almost exclusive preference for later-stage investment, as can be seen from the box below.



More angel investors needed

The importance of the SMME sector in South Africa is generally acknowledged. Despite this, new entrepreneurs struggle to raise early-stage finance to bring their ideas to fruition. Furthermore, these sorely needed entrepreneurs often lack financial management expertise, and require skills support right from start-up. But they find South African investors to be risk averse and uncomfortable with the prospect of failure.

There is a huge gap as far as investment in early-stage businesses is concerned. The country has excellent scientific and technological skills, but start-up ideas generally do not draw the necessary support. Failing to fill this gap will lead to a scenario in which opportunities for later-stage investments will not be generated.

HBD Venture Capital has launched itself into this tough market. However, evidence of what can be achieved is its recent exit from Red Five Labs in which HBD made more than 100% cash profit (and an IRR of 84%). Hopefully, success stories like these will help change the mindset in South Africa.

The hardest challenge is to place a value on the ideas of young entrepreneurs. There are no sales trends, customer bases, nor quoted share prices that may serve as guidance. As the South African venture-capital industry is in its infancy, there are not many successes to take courage from. Therefore, more angel investors that are prepared to take risks – and even fail – are needed.

For their part, entrepreneurs should be confident enough not to accept the first no, but to keep on pursuing investors!



Julia Long (julia@hbd.com), CEO of HBD Venture Capital, spoke at a Leader's Angle talk event at the University of Stellenbosch Business School. HBD takes

its name and its cue from the term 'Here be dragons', used in ancient times to mark uncharted territories on maps. For more details about the USB's monthly talk series and Long's talk, visit www.usb.ac.za/leadersangle.