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The Quest for Unicorns

A major investment climate change is needed to get South Africa out of the starting blocks... but that change looks like it's about to happen

Much has been written and vaunted about the 'massive' R2 Billion sitting in various 'Venture Capital' funds in South Africa, as well as the 168 deals concluded over the four-year period (2011 – 2015). But, with South Africa's fluctuating GDP forecast, the continued uncertainty surrounding a ratings downgrade and other instabilities causing market jitters, these numbers seem way too small and not nearly enough, to get South Africa to the place it needs to be in terms of fuelling its future economic pipeline and growing its tax baseline.

With a fair number of the top-listed companies on the JSE also reporting lower employee numbers, due in the main to an increase in automation, the country needs an urgent and rapid investment climate change to get it out of the starting blocks and to the winning line, where we can have more ideas turning into actual businesses, that become sustainable employers and economic contributors. This is vital considering that 60% of future employment & income opportunities have not yet been conceived and the 'big' corporations will slowly die off, given the fact they do not have the necessary nimbleness to disrupt or take advantage of new markets quickly enough.

While the idea of helping start-ups get going seems to be high on the agenda of government, investors and individuals alike, in practice, available money is still being invested in post revenue businesses, leaving a gap in the early stage start-up funding cycle, and where we actually need it most.

To understand why this might be and why a group of forward-thinking businessmen are spotting huge potential and happy to dive into the largely untapped waters of the early VC pool, let's start with understanding what Venture Capital (VC) is, and is not.

The South African Venture Capital and Private Equity Association (SAVCA) in its 2015 report defines VC as "a subset of the private equity asset class, which deals with pre- dominantly equity funding of high-tech, high-growth-potential businesses, whose growth is achieved typically through radical global scaling.

The need for VC stems from the specific requirements of such businesses in the start-up and early growth phases, and from the part that experienced VC fund managers can play in structuring and nurturing investments into these businesses."

Importantly, this survey also noted that what it qualified as VC deals were reported as investments into post-revenue-type businesses, and precisely why FUTURENEERS™, challenges the understanding of the term venture capital and is billing itself as a 'real' VC organisation.

> "Despite presenting the highest rate of return for forward thinking investors, start-ups are often perceived as high-risk." - Booysen

"It's an unavoidable fact. Despite presenting the highest rate of return for forward thinking investors, start-ups are often perceived as high-risk. And so ideal investment partners who lack the time or knowledge to screen, manage or grow these businesses often elect to invest in mature, well-established enterprises - Private Equity territory" says Jo Booysen, founder of FUTURENEERS™.

The harsher economic climate during the SAVCA reporting period (2011 – 2015) saw a reduction in the number of deals done and the

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amount invested. This though, is where Booysen and his colleagues at FUTURENEERS™ view things differently, as it is in precisely these times that innovation drives investment opportunities, and especially when these start-ups require support the most. It's also when and where non-VC mind-sets ignore potential and retreat into arch-conservatism.

To effectively re-engineer the early-stage investment funding model in South Africa, FUTURENEERS™ is not only prepared to venture into this largely ignored gap between angel/seed funding and more mature Private Equity (PE), but it has assembled a team of individuals with remarkable track records in local and international business success and venture capital experience, and united them with a diverse range of professional services and service providers, designed to assist their selected early stage start-ups get to the next level and keep growing.

"There is a perception that there are not proper returns in the early stage sector," says Booysen. "This is wrong. Currently, most of South Africa's investment monies sit in Private Equity structures, but the world has changed. Start-ups are leaner and we have adopted the stance of getting in early with a number of properly screened opportunities, helping them grow, and thereby increasing our own rate of return, rather than waiting for one opportunity at a higher cost.

With pre-revenue start-ups, "we will look to invest anything between R5–R15 million without taking the ownership away from the founder" –Booysen

"We've also created an international ecosystem that we will be exposing our selected start-ups to, by creating a 'bridge' that will link SA start-ups to the outside world, and vice versa."

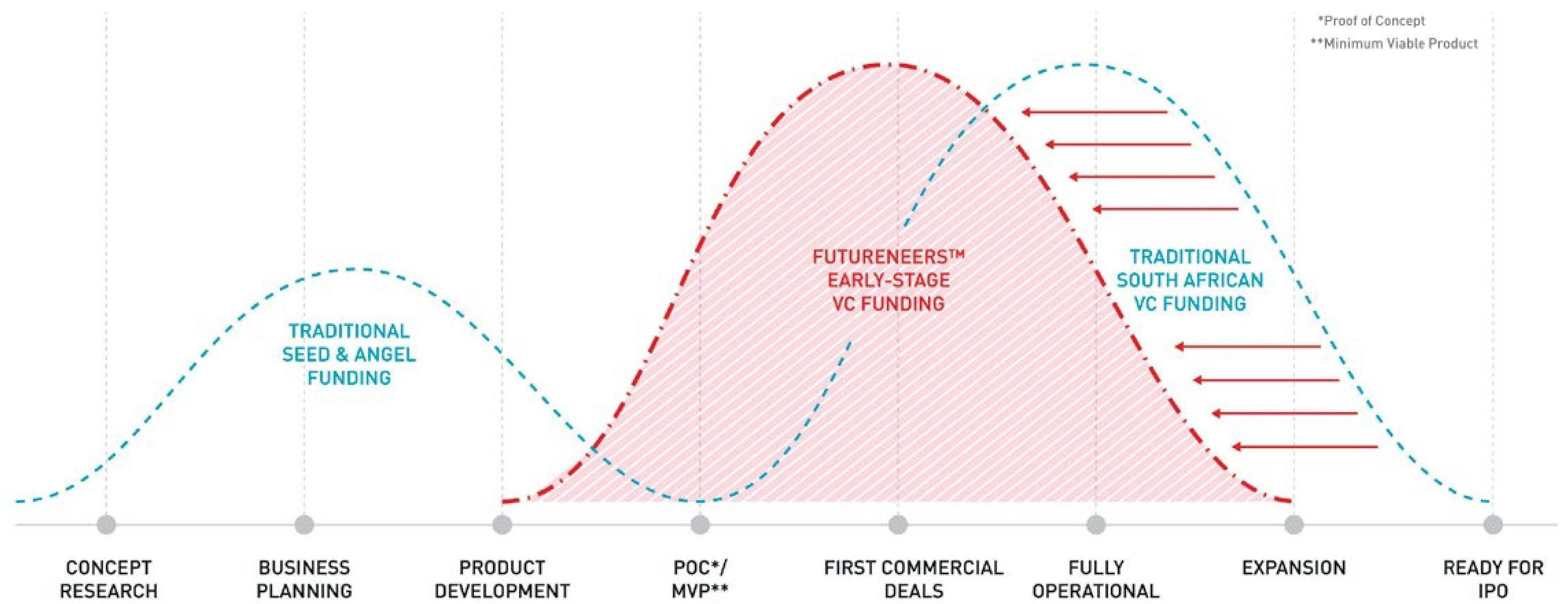
The FUTURENEERS™ thinking is both unique and logical. By offering truly world-class expertise at rates that start-ups can afford, FUTURENEERS™ will nurture them from seed... through growth... to their appearance on the world stage as global brands - through a full-service, innovation-driven super-highway built for entrepreneurs and investors alike.

Those entrepreneurs who know they have a valuable commodity in hand are usually wise enough to plan - almost from inception - how they will make their company appealing, so as to attract the level of funding necessary to realise the true potential of their businesses.

Although some may plan an offshore strategy from the beginning and this may be perceived as merely a fickle desire to depart for greener pastures, this weighty decision is more likely motivated by the need to ensure that thriving companies, in which founders are heavily invested, will continue to grow and be sustainable. Thus, without a radical re-evaluation of local entrepreneurs, it is inevitable that South Africa's best and brightest will look further afield, while foreign Venture Capital will exhibit little appetite to enter an environment from which this quality of talent is departing. As radical as it may sound, a lasting solution will require nothing less than the formulation of an entirely new methodology for the sector - one that will have a measurable impact on entrepreneurs, investors, the South African Government and our greater financial ecosystem.

"IP and Exchange Controls are directly connected in their ability to promote systemic change for our long-term economic future and growth as a global technology authority. The current blindness to this reality highlights the 'disconnect' between the Regulators, investors and business," stated Booysen.

Although it would be almost impossible to find a serious Investor willing to pursue a project without a clear exit strategy...this is precisely the predicament foreign venture capitalists find themselves in with the South African tech sector.



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Futureneers Founders (left to right): Deon Lewis, Johannes Booysen and Jaco Gerber

Rather than possessing the indispensable freedom, up front, to calculate and manage their risk as they deem necessary, most foreign investors are dependent on a South African investor for their exit. "It's a limitation, which, on its own, would be considered unthinkable in most First World investment environments" says Booysen, "yet this prevailing reality directly affects our ability to freely tap into a global funding ecosystem where 'in-and-out' deals along with unencumbered exposure to VC funding are considered fundamental to a secure, timely exit."

Even pursuing a fairly traditional 'early-in, late-out' strategy, with a planned exit at Venture Capital stage, there are surprisingly few serious players in the field. "This dearth of available funding is particularly evident in the gaping chasm that exists, in South Africa, between VC and Private Equity - precisely where most Start-Ups require an additional injection of capital to safeguard their survival," notes Deon Lewis, co-Founder and FUTURENEERS™' CEO.

Whether the culprit is a general sentiment that there is easier money to be made elsewhere, or simple reluctance to venture into relatively fresh investment terrain, there appears to be a surprising degree of 'chronological confusion' over a fairly standard investment timeline. So access to funding at the profitable post revenue stage, where continued growth is essential to long-term success, is somehow still viewed as the domain of Venture Capital.

The 'chicken or the egg' phenomenon - as competitors in a global economy where being first-to-market can provide an almost unassailable advantage, start-ups often face an intimidating Catch-22. Because securing meaningful patent protection in the digital realm is not a simple task, and IP protection laws are notoriously difficult to defend, many start-ups need to have sufficient presence to ensure that they emerge as the market leader almost from Day One - the infamous "to-market-first" syndrome. While this coveted position can indeed be achieved, it frequently comes with a price tag that is beyond the budget of an ordinary start-up (who despite their enviable new perception as market leader may not even be generating sufficient revenue to cover their overheads - much less offer their investors any return).

This is compounded considerably by the fact that most businesses in the technology space for example, can be replicated with relative ease, given the right team and development window. So without protection of one's IP, Start-Ups have little choice but to hit the market with a bang. In such instances, these businesses are traditionally subjected to analysis of their subscriber base or adoption stats. Yet building a subscriber base that is large or 'niche' enough to attract further investment, ironically often requires the need to look beyond SA borders to ensure a sustainable enterprise. In plain English...deep pockets and Venture Capital.

The lack of 'mandated' venture capital - despite the perception that there is a ready supply of Venture Capital for South African

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entrepreneurs, closer inspection of the actual numbers reveals that deal-flow transactions and money invested per year are, in fact, relatively insignificant. A key contributor to this, of course, is the complete absence of 'mandated' Venture Capital in the system.

"Whether you do a deal that purchases 10% of a one million rand company or, 10% of a R100 million company, it still takes time and effort," says Booysen. "Start-ups are also costly to run and are therefore not necessarily an attractive investment opportunity. Except if you are a Futureneer of course," he smiles

With few international venture capital companies actually investing in South African start-ups because of the lack of mandate, and clear exit strategy or ecosystem to allow them to exit, it seems to be that no matter how exciting a South African prospect appears on paper, the current realities of closing the deal are just not worth the effort. "Vetting these deals and providing clean deal flow to our international partners is therefore an important aspect of securing foreign investment and one of the barriers FUTURENEERS™ aim to solve," commented Booysen. In the process, it will be delivering peace of mind to investors as it will also be responsible for the necessary due diligence required.

The work environment is crucial in order to construct a hub for innovation in South Africa that is on a par with the best in the world, as it would be useful to compare our 'tech heartland' with that of a desirable equivalent, where the differences are as startling as the similarities.

While Stellenbosch is experiencing an unprecedented rush of technological innovation, it is places like Tel Aviv that are attracting the money and brains - many of which are South African. In other words, the home ground advantage we should logically possess is being needlessly squandered. Many of these innovation hubs are surrounded by political uncertainty, terrorism threats and challenging geographical environments, yet they are undeniably entrepreneurial hotbeds that are attracting droves of investors and start-ups alike - dynamic, future-shaping companies that are carefully nurtured and mentored before the fruits of their labour are displayed to great acclaim in the arena of world technology. It is hard not to attribute some of this success to the efforts made by these governments to eliminate unnecessary red tape - so innovation and ideas can flow freely with their contemporaries abroad. South African companies in the same space face disheartening restrictions that not only severely hinder profitability, but that lack the incentive to create revolutionary tech IP.

South Africa seems to have so much to offer when you consider our magnificent, natural environment that should be a drawcard for technologically inclined creative, yet we clearly lack the allure needed to override concerns about the stifling effect that our economic environment is having on these industries.

While dealing meaningfully with the above challenges may appear to be a massive endeavour...transforming our current landscape into one that genuinely fosters and encourages long-term investment is by no means an insurmountable task. By identifying and meticulously analysing these shortfalls, Booysen, Lewis, and

Start-ups face an intimidating Catch-22 securing meaningful patent protection in the digital realm

Jaco Gerber (the third founder, and the company's CFO), as well as their international board of advisors (incidentally, all of whom are patriotic South Africans) are uniquely poised to effect that change. These Entrepreneurs and Investors are not only wholly committed to the initiative, they too believe that a platform, which connects SA Start-Ups with global Venture Capital, and global Start-Ups with South Africa, will move the country closer to its rightful place as a haven for business development and best practice. The key...is in the detail.

Talking of detail, the launch of the SARS equity finance mechanism - Section 12J - into the Income Tax Act, to assist in the development of a venture capital industry in South Africa has been welcomed by the SMME and investor sectors alike, but navigating the complex corridors of red tape and requirements (including the new BEE Codes), has proven to be more of a headache than a real boon. Introduced in 2009, and amended in 2014 to enhance support for entrepreneurial development, it is unclear as to how many of these funds are operational or, in fact, yielding actual results. Nonetheless, Gerber believes the 12J does present exceptional opportunities for the private investor market given the tax breaks that can be achieved.

This type of tax incentive model has been so successful in the United Kingdom, there is now a limit to the amount of money individuals can invest into venture capital funds. This has stimulated unprecedented growth in the UK with VC funding increasing from £288m in 2014 to £515m as at the end of 2015. It is something the guys from FUTURENEERS™ all want to see happen in South Africa too. And it will need to deliver on the prediction that 90% of employment will come from the SME sector by 2030. "South Africa needs to become a start-up nation and it needs to be an attractive destination for global businesses to want to trade here too," says Gerber.

Doing itself no favours though, there has also been a lot of negativity around VC in South Africa, from a start-ups perspective. Historically, investors calling themselves venture capitalists have looked to take significant stakes in the fledgling business, often ignoring the value of the idea, the passion and commitment of the ideators and founders and their own risk in starting something. Sadly, founders are frequently the losers in this equation.

Let's not kid ourselves here. Venture capitalists are looking for Unicorns to help them make money - it's business after all. In days gone past, shareholdings of the founders have been diluted to a point where they hold very little stake in their own idea. This may be as a function of requiring the right shareholder credentials to do business in South Africa, or simply a case of greedy investors who have a short-term view to making a quick buck.

A number of start-ups we spoke to believe that the current VC model (pre-FUTURENEERS™) is also fatally flawed. Primarily, there have been first world investment models imposed on emerging markets, whereas a more flexible and adaptable VC model can stimulate growth. Think the Grameen bank model, which gave micro-loans to women and has since seen a sharp rise in the number of successful entrepreneurs as a result and re-defined the community development space. There has also been a steep increase in the number of crowd-funded kick-starters. Mostly aimed at the seed and angel

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investment stage, these large crowd-funding platforms are also starting to spread their wings and flex their muscle in the VC stage.

Having recognised this, FUTURENEERS™ has adapted its VC model to take this situation into account: "Our key differentiator is in our interest in pre-revenue start-ups where we will look to invest anything between R5 million to R15 million without taking the ownership away from the founder," confirmed Booysen. Booysen is also keen to point out that if a 'gem' crosses their path and requires lesser funding, they will also consider investing, as it is as much about the idea itself as it is about where the company is in its lifecycle.

Booysen, Lewis and Gerber are firmly convinced that emerging markets present the best chances of discovering multiple business unicorns. Emerging market innovators have all the hallmarks and characteristics required to turn myth into reality – faced as they are with no other option. This is the space that FUTURENEERS™ and other future-thinking companies have predicted will accelerate a new investment climate change. After all, South Africa has a proven pedigree in this regard, with a number of world-changing life-enhancing inventions under its belt. Think the world's first heart transplant, the Kreepy Krauly pool cleaner, CAT scans, Pratley Putty, Dolosse, Speed Gun (not of the vehicle trapping kind, but the machine measuring the speed of the bowler), and Computicket, the world's first computerised ticketing system.

Other business luminaries with South African links include the likes of Paul Maritz, often credited with being the third-highest ranking executive at Microsoft behind Bill Gates and Steve Ballmer, and who was mainly responsible for Microsoft's desktop and server software development; Roelof Botha, CEO of possibly the world's largest venture capital company, Sequoia Capital, Kevin Bermeister a founding investor in Skype and, of course, Elon Musk, who is the founder of Space-X and Tesla.

Born out of necessity, South Africa and other emerging markets have what it takes to lead the innovation race and deserve the attention and support that ethical venture capitalists can supply. A look into the future is all it takes for us to claim back our status as a breeding ground for Unicorns. ▲

Kaz Henderson