

# Case Studies on the Regulatory impact on the growth of South African Startups

South Africa Startup Act Movement  
February 2023





### SA Startup Act Case Study Research

The SA Startup Act Movement with the support of FSD Africa commissioned a case study research project, which can be used to make the business case for startup policy reforms, as stipulated in the SA Startup Act Position Paper 2021. The case studies aim to demonstrate the negative impact of hindrances targeted through the SA Startup Act Position Paper relaxations, as well as case studies outlining the positive impact addressing such relaxations may have on the national economy.

The project entailed desktop research and limited fieldwork in so far as sourcing, collating, formulating, and documenting a set number of case studies based on the different relaxations outlined in the SA Startup Act Position Paper.

The research is intended to:

- i. Showcase real life case studies of the experiences of startups with domestic investments and the challenges experienced when raising foreign investments. This will help make the case for policy reform in the financial sector.
- ii. Make the case for special tax dispensation for qualifying startups to increase availability of financial capital.
- iii. Make the case for employment flexibility and special skills visas to help startups attract and retain high-skilled talent and enable them to be globally competitive.
- iv. Make the case to address Exchange Control Limitations, which will help alleviate limitations on offshore movement of South African Intellectual Property, and limitations placed on the amounts of money moved offshore.
- v. Outline the value proposition of the recommended startup policy reforms to various stakeholders.



### About the SA Startup Act Movement

The South Africa Startup Act is a proposed Economic Bill that may be introduced as a stand-alone Act, or a set of proposed amendments to an existing Act (such as the National Small Enterprise Act) that outlines a set of provisions with which to support the ecosystem that supports the creation of high-growth enterprises, where such enterprises are in the formation, or early growth-phases, thus being considered startups, and with the overarching purpose of accelerating socio-economic growth, development, competitiveness and the transformation of the South African economy through the increased involvement and impact of successful startups.

The purpose of the Act is therefore to outline ways in which to accelerate the success and contribution of startups and high-growth firms to the national economy, by removing and/or reducing those burdens that are keeping such firms from playing a larger role and having a greater impact in the national economy.

### Relaxations contained in the 2021 SA Startup Act Position Paper

The case studies aim to inform the need for policy relaxations contained in the SA Startup Act Position Paper 2021. The relaxations served as the main delineation of both case study candidate selection, as well as balancing efforts to have an equal distribution of case studies amongst the different relaxations.

The following four relaxations are proposed in the Position Paper:

- Relaxation 1: Provide tax breaks and incentives to encourage investment in Qualifying Startups.
- Relaxation 2: Remove barriers that inhibit access to skilled talent.
- Relaxation 3: Remove inhibiting regulatory barriers that hampers globalisation and investment into qualifying startups.
- Relaxation 4: A qualifying startup to be exempted from preferential procurement limitations.

### Financial Sector Deepening (FSD) Africa

Established in 2012 and supported by UK Aid, FSD Africa is a specialist development agency working to build and strengthen financial markets across sub-Saharan Africa. FSD Africa work to reduce poverty through a 'market systems development approach, which aims to address the structural, underlying causes of poverty by improving how financial market systems function.

### Contacts

info@fsdafrica.org | www.fsdafrica.org

### Research partner for the project

VS Nova Pty Ltd is a South African based management consultancy that conducts strategy and research work on behalf of members of the SA Startup Act Movement, including the annual reporting on early-stage VC activity for the Southern African Venture Capital Association.

### Research Lead:

Stephan J Lamprecht  
www.vsnova.co.za

# FOREWORD FROM THE CHAIRPERSON

---

When the South Africa Startup Act Movement was created in 2020, our mission was very clear - to create an enabling environment for high impact, high growth South Africa startups that will grow and scale their businesses globally. This would be done by aggregating a growing ecosystem of investors, capacity builders, academia, incubators, accelerators and startup networks, that will collectively lobby and advocate for policy reform. South Africa has a unique opportunity to grow its economy and contribute towards job creation, by strengthening its technology startup sector. Tunisia, an African pioneer in establishing a Startup Act for its country, is a great example of how a vision to position itself as an innovative business hub for startups at the crossroads of the Mediterranean region, Europe and Africa, can reap such rewards.

Our 2021 Startup Act Position Paper was a good starting point, as it established a clear foundation which outlined our recommendations to the government, on how to nurture and enable South African technology startups. It is important to note that, over the years we have been a startup ecosystem that has been speaking amongst itself and not effectively engaging key policy makers. But in the past 18 months (since October 2021), there has been great awareness and activism which has attracted the attention of the President of South Africa and his office, and various other ministers who are now aware of this great startup community that exists and aims to be part of the solution and not the problem in creating jobs and growing the South African economy.

The aim of this report is to highlight real life examples of men and women that wake up every morning in the hope of building a prosperous South Africa, through growing proudly South African technology startups. It further cements the need for startup policy reform, because in the absence of that, we will lose technology talent, lose investments, lose jobs and one of the few avenues that can revive our ailing economy. For government, this report can be used to understand qualitatively, the challenges created by the current South African policy framework. The recommendations outlined in the 2021 Position Paper provide guidance on how we can collectively find solutions to such challenges. For investors, entrepreneurs and everyone else in the startup ecosystem, this report can assist you in understanding the 'power of the collective' and encourage you to join the SA Startup Act Movement.

**Matsi Modise**  
Chairperson  
SA Startup Act Movement



# EXECUTIVE SUMMARY

## South Africa Startup Act

*Startups are significant and growing employers in South Africa. Tech startups in South Africa, as of May 2022 employed over 11, 000 people. Fintech is the largest employer, counting 4, 387 employment positions, or 40% of all startup jobs. It also attracted the greatest number of deals according to the 2022 SAVCA VC survey.*

South Africa is losing its status as the premier breeding ground for high-growth startups on the African continent, with many high-growth businesses leaving South Africa resulting in a loss of economic competitiveness and growth opportunities. Operating amidst a restrictive policy environment compared to competitor countries, the most significant regulatory challenge facing high-growth firms is the difficulty of securing international investments while domiciled in South Africa.

The South Africa Startup Act Movement (SUA) calls on the President of South Africa to unleash the growth and innovation embedded in our entrepreneurs and youth. This can be achieved by exempting newly established qualifying enterprises with a turnover of less than R100 million from the limitations of exchange controls, preferential procurement, a lack of tax incentives, access to highly skilled staff, and laborious red-tape that constrain their growth and ability to contribute to job creation, and in doing so accelerate the social and economic spill over of such startups to the rest of South Africa.



*"There is growing awareness that there is a subset of firms in the economy - high-growth firms (HGFs) - that contribute disproportionately to net employment growth. These firms also contribute disproportionately to innovation and productivity growth."<sup>2</sup>*

The key policy challenges facing South African high-growth firms include:

- (a) onerous, timeous, and costly **restrictions on transferring South African IP** to a foreign company, a core requirement for startups to expand their businesses;
- (b) cumbersome and expensive **exchange control restrictions** that require prior approval to raise offshore capital ;
- (c) **Capital Gains Tax** triggered too early; and
- (d) no **incentives** for risk capital investments in high-growth startups (amplified with the ending of Section12J).

The proposed policy reforms outlined here are expected to stimulate high-growth firms to create jobs, contribute to the national GDP, and enable South African founders to access capital from foreign investors.

The following case studies contextualise the South Africa Startup Act and show that the **South African Exchange Control regime is the principal obstacle in the growth journey of high-growth startups wanting to take on international markets**. Other forms of red-tape and regulatory constraints targeted through the Startup Act inhibit and frustrate founders, but South African Law, through Exchange Controls deny founders the option to set up international companies AND remain South African. In other words, South African Law fundamentally prevent our entrepreneurs and youth to contribute meaningfully to the development, transformation, and growth of the South African economy.

The intention with the Startup Act is to reduce and relax existing policies and regulatory barriers impacting on high-growth startups, where such startups must pre-qualify. The Startup Act is about creating fewer, not more regulations, simplifying the growth trajectory of South African startups, and accelerating social and economic impact.

The following document recounts the experiences of startup founders, investors, and advisors with South Africa's policies in their shared efforts to create successful growth journeys. Each case study touches on one or more of the regulatory barriers targeted

through the relaxations included in the SA Startup Act Position Paper. The case studies, denoted below in bold italics, involve actual founders, investors and advisors who participated on the condition of anonymity. Their voices can be heard throughout the document, through quotes taken from interviews and displayed anonymously in highlighted text.

### South Africa has functioning and well-resourced capital markets

South Africa, with a larger GDP than Finland, the world's leading innovation economy, is blessed with enviable capital markets.



Young firms account for about **20% of employment** but create almost half of new jobs on average across OECD countries<sup>3</sup>.

objective for most startups is to penetrate the global market for new and innovative products and services. International growth offers opportunities for inward Foreign Direct Investment, as well as expanding the tax base by creating a larger revenue base. South Africa desperately needs both FDI and an increase in taxpayers.

### To truly scale into global markets require accessing global capital

A pivotal consideration when setting up global operations, is to position the business for international investment. Creating offshore businesses to access global markets, is **done on the insistence of international investors**.

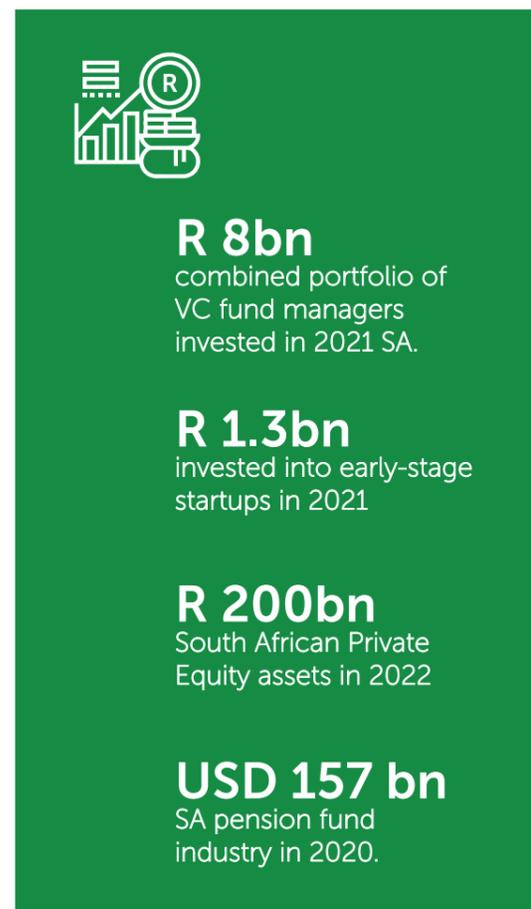
Establishing a foreign domiciled company by a South African startup is essentially about housing the startup's IP rights, both existing and future IP, in the foreign territory. This enables both the founders and the investor to have ownership in the entity that will have title to future IP created through the deployment of the investor's capital. If not, the investor cannot and will not invest.

Achieving this objective is essentially constrained in South African Law as it involves overcoming the restrictions of South African Exchange Control regulations.

The first case study in the report - **Going global requires global investors** - outlines the context in which South African founders and their investors navigate the intricacies and challenges of obtaining exchange control approval. It features the work of a law firm, supplemented with the results of a poll amongst founders that moved their businesses offshore.



80.8% of startups polled through this research had **set up a foreign based company** to attract foreign capital. More than 67.3% were instructed by their investors to do so as a **prerequisite to investment**.



### Small firms matter more when they grow: the need to enable growth

The economic foundational belief in the role and value of small firms' rests in the ability of such enterprises to grow, because, when growth happens, businesses innovate for change and create social and economic impact in the form of paying wages and creating new jobs.

Growth correlates with the size of the market, and no market is bigger than the global market. The

<sup>2</sup> Economic transformation, inclusive growth, and competitiveness: Towards an Economic Strategy for South Africa. Prepared by Economic Policy, National Treasury.

<sup>3</sup> "No Country for Young Firms?", Policy Note, Directorate for Science, Technology and Innovation Policy Note, June.

### Going global brings high-growth startups into conflict with SARB Exchange Controls

Exchange Controls restrict South African tech startups directly and indirectly in various ways, most notably an outright prohibition on structuring the startup as being held by an offshore holding company; the need to obtain Exchange Control approval when taking South African IP offshore; and the financial and administrative impact on day-to-day business when receiving payments from foreign customers.



Out of a small sample of 52 startups, **122** of those individuals and their families formally emigrated.

### Managing Exchange Controls and other regulations beyond the skills of most founders

Engaging with and obtaining Exchange Control approval is a complex undertaking and the skills to do so fall outside those of normal founders. *Journey without a destination* explores the trial-and-error approach of South African founders in trying to establish a dual footprint by having an operating base in South Africa and an investment base in the EU or US.

After months of pitching to more than 100 potential suitors, the founders featured in this case study got used to the standard feedback received: none of the investors were interested in putting capital into a South African domiciled company.

The startup incurred more than R2 million in legal fees. The 2021 average VC investment round in South Africa for comparison's sake was R7.93 million.



*Investors know that SA has very restrictive laws that makes doing business difficult which in turn makes fund raising difficult. Our investors did not want to invest in a South African based company and forced us to create an American offshore company before they invested."*

### Unicorn in a cage: coping with Exchange Controls can be difficult, costly, and self-defeating

*When chickens come home to roost* profiles the ongoing tussles facing a leading and globally successful South African startup, bidding to become a South African Unicorn. This would-be Unicorn is severely constrained by the exchange control restrictions enforced on it through its original approval obtained from the SARB.



Unicorn: a term used in the VC industry to refer to a private startup with a valuation of over US\$ 1 billion.



*Many startups which would otherwise be registered in South Africa may instead be registering their innovation-based businesses outside, to take advantage of jurisdictions that enable freer transfer of IP between parties where there are international investment interests.*

– Tech entrepreneurship Ecosystem in South Africa (Google and OC&C)

Even when able to secure Exchange Control approval, the consequences on structure and operating limitations can hold a business back through complexity, restrictions, and costs.

### Isn't it easier to simply relinquish ties with South Africa and operate offshore?

Others, well-aware of the above challenges opted to conduct business as non-South African firms. Doing so, as recounted by those interviewed, reduced the burdens of red tape, compliance, and costs.

A local startup accelerator is featured in case study four - *Golden goose shoved offshore* - recounting the way in which it gradually changed its own policies to straightaway encourage potential Fintech candidates to set up offshore holding companies into which to house IP and possibly in the future accommodate international investment.

This is not ideal either, as it is costly for South African founders to set up a truly foreign domiciled company. Founders must balance the regulatory realities of operating a business in South Africa where for example Fintech startups can be disqualified from serving the very customers that paid their school fees, due to the need for such startups to meet the financial sector's requirements that can include Level 1 BBBEE status.

A major concern voiced by the accelerator was the difficulty of attracting and retaining foreign skills. This had been compounded in recent times due to losing local talent to international markets because of the incredible demand for Fintech skills and experience across the globe.



Broadbased Black Economic Empowerment (BBBEE) is a policy of the South African

government which aims to facilitate broader participation in the economy by black people. A form of affirmative action, it is intended specially to **redress the inequalities created by apartheid.**

### Red tape keeps foreign founders and their investors at bay



*I am a foreigner in South Africa; you fight tooth and nail for everything. The political and economic environment doesn't really support positive contributions from foreign nationals*

Interviews included the experiences of foreign founders and their South African based startup, which they ended up operating as a foreign branch, rather than a South African entity.

The registration processes and requirements were experienced to be vastly more complex and time-consuming than expected, with the founders eventually opting to simply operate in South Africa as foreign nationals. This begs the question if **South Africa is really open for business?** since the resulting tax base was not South Africa, and the net impact on the South African economy accordingly vastly less than would have been the case if the company was set up as a South African entity.



Waiting two years to obtain a South African Trademark Registration, and three years for a simple response from PSIRA (a statutory instrument of the South African government) were **unacceptable delays** in the race to bring products to market in the shortest possible time.

Rather than investing capital, the company loaned the money from the foreign office to the South African company, amounting to an investment loss of approximately two million Euros. The overall assessed GDP loss including both investment and taxes expatriated in the above way, was estimated by the company to be between three and four million Euros.

### No country for small firms



*The top 10% of South African companies earn 86% of all income whilst the bottom 50% earn only 1.6% of income"*

Startups are critical to the competitiveness and sustainability of an economy but can do so only if there is due recognition for the **Need for level playing grounds**, the subject of case study six.

South African supply chains are monopolised by large firms and multinationals, making it very challenging for small firms to bring innovative and new products to market. This is aggravated through BBBEE where many startups, most Level 4 BBBEE firms, face enormous and sometimes impossible obstacles when trying to attain Level 1 BBBEE; the latter a requirement for firms offering products and services in competition with large and multinational firms and multinational firms, or doing work with the SA Government.

### BBBEE ownership impedes investment

The biggest impediment in attaining Level 1 BBBEE is the ownership requirement of the BBBEE codes, in principle dictating 100% shareholding from black individuals. This impedes investment as most VC investors, especially foreign VCs, don't meet this requirement.

Taking on a non-black investor, even if the founders are black individuals will weaken or even obliterate the BBBEE position of the startup.



Case study six relays the experiences of an engineering firm, 100% female owned, and operational in the domain of Science, Technology, Engineering, and Mathematics. Despite being a global triumph for Women in STEM, this company was effectively barred from Level 1 procurement because the founders were unable to find a suitable black individual shareholder.

A black entrepreneur who participated in this research project detailed how his business, set up in the US but operating from South Africa, opted to establish an international footprint to allow for international investment. The business has been hailed in local and international press as being a new breed of African success.

Except, none of this success effectively reverts to South Africa as the founder, recognising the regulatory obstacles in operating as a South African startup, and realising that he would not get any preferential treatment from international investors, chose to operate as an international domiciled company, and in doing so, managed to secure a substantial sum from a foreign VC.

### Red tape keeps foreign founders and their investors at bay



*It was the combination of inefficient tax; Exchange Controls; trapping of IP; and rigid visa regime. Each of these individually make SA uncompetitive. Add them together and we are nowhere."*

For high-growth firms, growth continues even after the startups surpassed the defined SME demarcations. Losing this protection can come at a time when high-growth firms are still midway in their growth trajectories, impeding, or even completely disrupting their progress.

For this reason, some founders forego the opportunity to grow, choosing to remain small, and rather avoid the red tape and other limitations involved in operating a large firm.



*Local regulations, especially in regard to tax and BBBEE compliance, are forcing us to turn into something we don't want to be."*

**Best to stay small: Size matters in South Africa** explains how founders set up multiple structures to manage growth without exceeding statutory limitations, doing so at great cost as well as weakening opportunities to become industry leaders and globally valuable businesses.

### The need to play to our own strengths and leverage local advantages of cost and talent

The eighth case study recounts how the founders of a local startup and its investors realised that its business model should rather be flipped on its head. The founders recognised that a better strategy could be to **Play to our strengths** by raising money for the US operations, in the US, thereby allowing for payment of US sales and marketing expenses in US dollars; whilst on the flipside capitalising the South African development hub where the company had a clear cost advantage.

Doing so in practice though, brought the startup in direct conflict with Exchange Controls.

### The purpose of a business is to create a customer – Peter Drucker

When firms pursue opportunities in new markets, **it is not always about the red tape**. In this case study, the efforts of leading South African engineers solving a problem in a niche market based outside South Africa, shows that sometimes, the founders have no choice other than to move the business to a foreign market. But for the South African economy to have any future benefit from this, requires an enabling regulatory regime that allows founders to do relocate in a way that benefits both their startups,

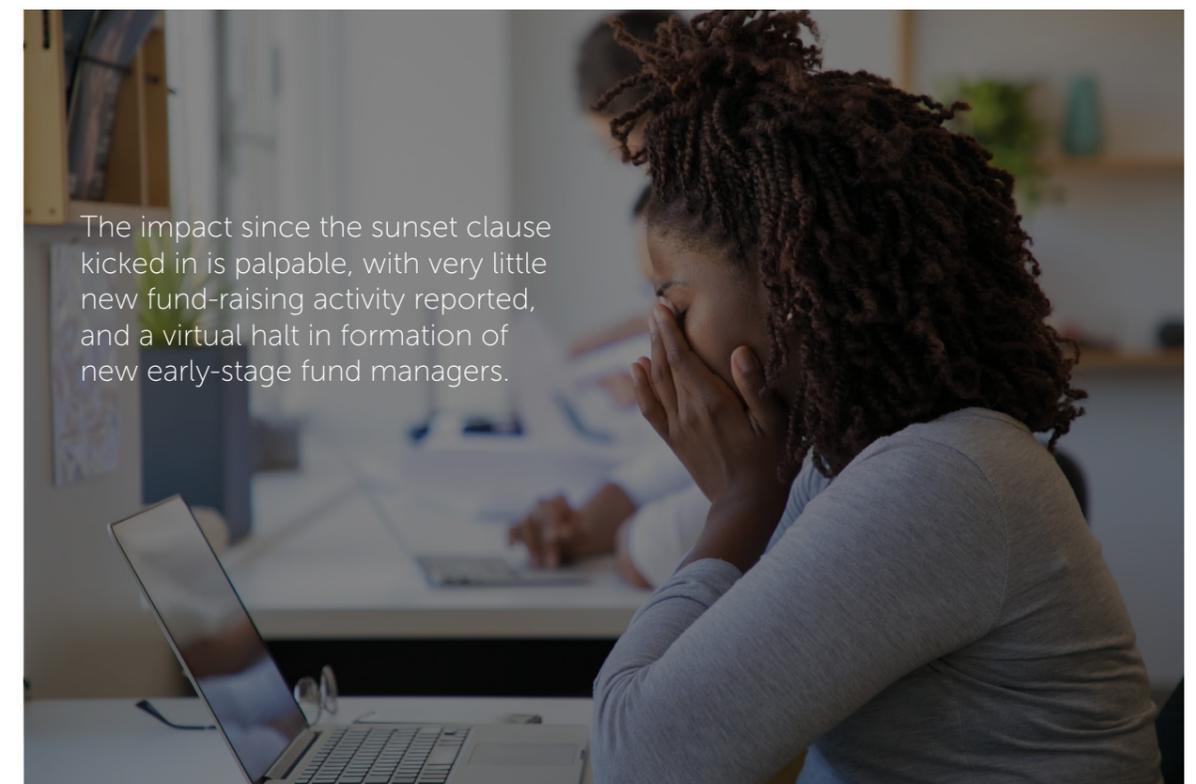
and the South African economy.

### Capital follows incentives. We have no incentives left to invest in startups.

Capital and access to markets are key constraints facing startups anywhere in the world. Obtaining capital and supportive partners in our home market would be considered a logical place to start, especially given enviable financial systems, and the difficulties South African founders experience in trying to acquire foreign capital; the subject of the first two case studies. But despite having high net-worth individuals interested and willing and able to invest in startups, local conditions don't align to make this happen.

This wasn't always the case as R12 billion was raised from private investors between 2017 and 2022 through the so-called Section 12J tax incentive. National Treasury in 2021 announced its decision to discontinue the incentive following its own review of the impact of the scheme. National Treasury threw out the **baby with the bathwater**. Rather than make additional adjustments to the incentive as was the case in many other developing countries trying to improve the investment conditions for their startups, it was simply terminated.

Apart from enlarging the pool of funding that saw actual high-growth tech entrepreneurs draw on much needed early-stage capital from South African investors, 12J created opportunities to slow the brain-drain of young fund managers hungry to ply their trade in their home country.



The impact since the sunset clause kicked in is palpable, with very little new fund-raising activity reported, and a virtual halt in formation of new early-stage fund managers.

### Investors, geographically unconstrained, prefer foreign to local startups

Local investors are not limited to invest in South African startups, as capital is global, and so too are investment opportunities. By having to overcome the various challenges outlined in the above case studies, some investors choose to rather invest in foreign owned startups free of the red tape and uncertainty inherent in South African businesses. In the competition for capital, South African founders are at the back of the line, sometimes even from their own investors, because of the comparative complexities they bring to investments.



The investor interviewed for the last case study reported having screened upwards of 820 investment proposals in the last three years, **1 in 5 involving a South African domiciled startup**. Because of Exchange Controls and additional regulatory burdens, it ended up not making a single investment into any of the South African domiciled opportunities.

The last two case studies reveal how local early-stage venture capital is not currently incentivised to invest in South African founders. **Put the baby back in the bathwater** profiles the missed opportunity when local incentives for investing in entrepreneurial businesses were terminated by the South African government, whilst **The World is an investor's oyster** recounts the experiences of a local investment firm snubbing an impressive South African pipeline, to invest solely in non-South African domiciled businesses.

### Enabling growth by removing Exchange Controls and easing the red tape

The Startup Act Position Paper proposes four broad relaxations, aimed at exponentially fast-tracking the contribution from high-growth startups to the social and economic transformation of our economy.

#### RELAXATION

# 1

### Provide incentives to encourage investment in qualifying startups

**Put the baby back in the bathwater** and **The World is an investor's oyster**, speaks to Relaxation One and the need for appropriate incentives to encourage investment in South African startups. Capital is critical to fuel the growth of any business. South Africa, with a large base of high-net-worth individuals and globally recognised capital markets should not have a lack of early-stage capital with which to empower its own entrepreneurs.

The SA Startup Act Movement calls for appropriate incentives with which to channel South African capital to our future entrepreneurs. This can be achieved by applying the lessons from the South African 12J experience, as well as similar incentive programmes offered in startup-friendly tax jurisdictions in India, the UK, US, and Chile. By removing the complexity and uncertainty presented by startups in having to comply with South African regulations such as Exchange Controls and IP assignment to offshore entities, South African founders will be able to compete on level terms for local and international capital.

#### RELAXATION

# 2

### Ensure access to talent

Access to talent is a critical challenge facing all startups, especially those in the Fintech sector where there is a global demand for financial engineering and technology skills. **The Golden goose shoved offshore** outlines some of the competitive forces at play in growing and leveraging the Fintech Cluster in South Africa. It speaks also to the need for a complete rethink of Exchange Controls as this accelerates the brain-drain by making it less attractive for entrepreneurs to utilise South African based skills and IP.

So too are foreign citizens wanting to start and operate businesses in South Africa disincentivised from localisation, because of the difficulties in obtaining employment visas. **Is South Africa really open for business?** concludes with many foreign

founders choosing to operate as foreign citizens in South Africa, thereby defeating the objectives of growing the local tax base, attracting FDI, and creating South African job opportunities.

An aspect critical to the SA Startup Movement is the need to value foreign skills and efforts, both in contributing scarce skills to the pool of talent vital to drive local technology and business clusters and creating skilled employment positions in the

South African technology clusters. Equally, foreign investors should be assisted to swiftly localise and invest in their South African operations through an inward investment desk competent in the needs and objectives of technology startups.

In some instances, **it is not always about the red tape**, as South African startups take their business interests offshore in pursuit of a specific market opportunity in another country.

#### RELAXATION

# 3

### Remove barriers to entry

The single biggest obstacle in the quest to position our high-growth startups with international market potential, and truly transform the economy, is the difficulty of obtaining and operating amidst Exchange Control approvals. This is a theme running through the experiences of most startups, investors and their advisors and is covered

extensively in **Going global requires global investors**. The reasons why founders' cross paths with Exchange Controls and the causes for such frustrations are outlined in this case study, setting the scene for the rest of the research. **Journey without a destination** and **When chickens come home to roost** zooms in on the specific experiences of two South African startups trying to chart a course through the complexities and costly knock-on effect entailing Exchange Control approvals.

#### RELAXATION

# 4

### Exemption from preferential procurement limitations

**"The top 10% of South African companies earn 86% of all income."**

This shocking statistic informs the question as to why the South African economy, having globally recognised startup ecosystems, and countless small firms, is not seeing a larger share of revenue earned by startups? A key challenge is the exclusionary implications of preferential procurement policies that effectively entrench the monopolistic behaviour of large and established enterprises, cementing their grip on the opportunities so important to the growth of startups. Founders **need Level playing grounds** as many through experience have surmised that it's **Best to stay small** and avoid the regulatory and compliance overhead that comes with

growing beyond the demarcated boundaries for SMEs.

The SA Startup Act Movement respects and endeavour to uphold the principles of South Africa's pursuit of racial transformation and equality. Prioritising startup growth is not about the one or the other, but both, as growth leads to social and economic transformation. The Movement proposes that startups for the duration of meeting the requirements of being graded as qualifying startups be given automatic Level 1 BBBEE status, when accessing the supply chains of Corporate and Public South Africa.

Qualifying startups would still need to comply with the provisions of Level 4 BBBEE relevant to the size of the startup business and the industry in which they operate. But, by not being automatically disqualified from rendering services or supplying products in South Africa, qualifying startups will have a better chance when competing head-on with large suppliers and foreign multinationals, and in doing so accelerate the transformation of the South African economy.

### South African founders want to live and do business in and from South Africa

The case studies covered in this research demonstrate the tangible costs and fallout of a system that is not conducive to assist South African entrepreneurs - black, white, male, or female, local or foreign - from reaping the benefits with which to transform our economy.

In doing so, it outlines the case for the various relaxations proposed in the 2021 South Africa Startup Act position paper, to reduce the burden of compliance faced by South African startup businesses, many of which are both counterproductive and some going so far as to entrench the monopolistic behaviour of large firms and multinationals which result in the loss of local ideas, talent, capital, and future taxes.

### Solving the single biggest impediment - Exchange Controls

Red-tape and regulatory barriers will always be the Achilles heel of entrepreneurs the world over. Some of these featured in the above case studies are truly unique to South Africa and deserve a revisit if we want to increase the meaningful contribution of startups to the South African economy.



The single biggest impediment though, is South Africa's Exchange Control regime

The SA Startup Act Movement calls for the removal of Exchange Control approvals for qualifying startups, so that founders can easily establish a foreign company, enabling access to international growth capital. It furthermore proposes relaxations that allow for reporting, rather than pre-approval when assigning the IP rights held by the qualifying startup to its foreign company.

In this way, South African founders will have the opportunity to acquire international capital by establishing a foreign based company, able to resource its global pursuits, and become globally valuable. By accelerating the process of bringing on board foreign capital for international market expansion - without the South African founders needing to emigrate financially or physically - the national economy can benefit from the job creation and increased taxes made possible by the efforts of South African founders.

The intention of the SA Startup Act is to create a special dispensation for firms meeting the requirements to be considered high-growth, to streamline regulatory compliance through a reporting, rather than approval process. But this should not be limited to a once off introduction of a new Act or waiting for the process to amend an existing act, as many of the constraints can be removed through other interventions, such as immediately lifting the onerous limitations of exchange control approvals.

### Guide to using the document

The document contains eleven individual case studies, some of which include additional interviews with founders and investors relevant to the main themes. To make it easier for consumption, each case study is introduced with a short extract that explains the background and primary theme and contextualise that by referencing applicable relaxations in the Startup Act Position Paper.

Quotes taken from interviews conducted during the research phase have been inserted throughout the text and can be seen easily because they are anonymous and therefore not attributed to any specific individual. Other quotes and references taken from literature including research reports and publications have been cited where used.

Some of the underlying constructs such as Exchange Controls, Intellectual Property and red-tape appear in most of the case studies. The case studies were written to be consumed as a whole, or individually. For this reason, the definitions or background to some of the constructs are repeated in several case studies to allow the reader make sense of the content even if only reading them one by one.

It is suggested that a reader wanting to read case studies individually start with the first case study, as it introduces the constructs and context relevant to the rest of the document.



# TABLE OF CONTENTS

## Foreword from the Chairperson.....(iii)

### Executive Summary..... 1

South Africa Startup Act .....	1
Startups are significant and growing employers in South Africa .....	1
South Africa has functioning and well-resourced capital markets.....	2
Small firms matter more when they grow: the need to enable growth.....	2
To truly scale into global markets require accessing global capital .....	2
Going global brings high-growth startups into conflict with SARB Exchange Controls .....	3
Managing Exchange Controls and other regulations beyond the skills of most founders .....	3
Unicorn in a cage: coping with Exchange Controls can be difficult, costly, and self-defeating .....	3
Isn't it easier to simply relinquish ties with South Africa and operate offshore? .....	4
Red tape keeps foreign founders and their investors at bay .....	4
No country for small firms .....	5
BBBEE ownership impedes investment.....	5
Red tape forces many startups to forego growth and remain small .....	5
The need to play to our own strengths and leverage local advantages of cost and talent .....	6
The purpose of a business is to create a customer – Peter Drucker .....	6
Capital follows incentives. We have no incentives left to invest in startups .....	6
Investors, geographically unconstrained, preference foreign to local startups .....	7
Enabling growth by removing Exchange Controls and easing the red tape .....	7
Relaxation one: Provide incentives to encourage investment in qualifying startups.....	7
Relaxation two: Ensure access to talent.....	8
Relaxation three: Remove barriers to entry .....	8
Relaxation four: exemption from preferential procurement limitations .....	8
South African founders want to live and do business in and from South Africa .....	9
Solving the single biggest impediment - Exchange Controls.....	9
Guide to using the document .....	9

## 1 Going global requires global investors....13

1.1 Offshoring IP and company ownership are vital steps in taking on the global market .....	14
1.2 A law firm focused on the needs of South African startups and founders.....	14
1.3 Positioning a startup to attract foreign capital is constrained by SA Law .....	14
Why venture capital?.....	14
Why an international VC?.....	14
Why the need to establish a foreign-based company for the South African startup?.....	14
Is it about paying less tax?.....	15
1.4 The impact on South African startups.....	15
It's about the IP.....	16
Dealing with IP rights already held by the South African startup.....	16
Owning IP developed in the future by the foreign company.....	19
1.5 Is this really affecting South African startups?.....	19
1.6 Applicable relaxations in the Startup Act.....	20
1.7 Doomed if you do, doomed if you don't.....	20

## 2 Journey without a destination - 21

2.1 Startups are running blind due to regulatory uncertainty and lack of awareness.....	22
2.2 Background description of the subject/candidate's business.....	22
2.3 Experience vis-à-vis red tape and regulatory burdens.....	22
2.4 Impact explained.....	23
2.5 SA founders aim for the stars, but get as far as Exchange Controls.....	24
2.6 Applicable relaxations in the Startup Act.....	24
2.7 How will relaxations improve the above?.....	24

## 3 When chickens come home to roost - 25

3.1 Local regulations increase the legal and operational complexity for SA startups.....	25
3.2 Background description of the subject's business.....	25
3.3 Experience vis-à-vis red tape and regulatory burdens.....	26
3.4 Living with an Exchange Control structure is complex, costly and inhibiting .....	26
3.5 Red-tape keep South African startups from global markets.....	27
3.6 Applicable relaxations in Startup Act targeting this.....	28

## 4 Golden goose shoved offshore.....29

4.1 The need to value, nurture and leverage innovation clusters.....	29
4.2 Background description of the subject's relevance to startups.....	30
4.3 Experience vis-à-vis red tape and regulatory burdens.....	30
4.4 Costs constrain startups, their advisors, and investors.....	30
4.5 Entrepreneurs are becoming a South African export commodity.....	31
4.6 Applicable relaxations in Startup Act targeting this.....	31
4.7 Appropriate relaxations can stem the tide and retain South African talent.....	31

## 5 Is South Africa really open for business? .....32

5.1 The political and economic environment and the contributions from foreigners .....	33
5.2 Background description of the foreign startup..	33
5.3 Experience vis-à-vis red tape and regulatory burdens .....	33
5.3a Absence of incentives and support mechanisms to establish locally compliant businesses .....	33
5.3b International compliance and quality standards not sufficient to satisfy local requirements .....	33
5.3c Cost-benefit of local compliance for foreigners a disincentive to localise.....	33
5.3d Inward investment desk can help to navigate local policies, regulations and compliance .....	33

5.3e Founders and investors simply want certainty as to compliance and regulatory requirements .....	34
5.3f The perception of Exchange Control uncertainty a deterrent to investment .....	34
5.4 Red tape and regulations keep foreign skills and investment away .....	34
5.5 Well-meant policies have the opposite effect .....	35
5.6 Applicable relaxations in Startup Act targeting this .....	35
5.7 How will relaxations improve this? .....	35
5.8 Conclusion .....	35

## 6 Need for level playing grounds.....37

6.1 Can startups truly become our future champions of industry? .....	38
6.2 Background description to the business of the respondent .....	38
6.3 Death by paper: the role of supply chain rules and processes .....	38
6.4 Supply chain policies entrench South African monopolies .....	38
6.5 Does transformation empower successful Black entrepreneurs? .....	39
6.6 Applicable relaxations in Startup Act targeting this .....	39
6.7 How will relaxations improve the above?.....	39

## 7 Best to stay small: Size matters in South Africa.....40

7.1 Red-tape and regulatory barriers increase exponentially with business growth.....	41
7.2 Background description of the subject's business .....	41
7.3 Experience vis-à-vis red tape and regulatory burdens.....	41
7.4 Unproductive capital and time wasted in the effort to avoid red tape .....	42
7.5 Staying small a deterrent to investment and alienates global suitors .....	42
7.6 Applicable relaxations in Startup Act targeting this .....	43

## 8 Play to our strengths.....44

8.1 Startups can leverage the SA cost-base and take on global markets .....	44
8.2 Background description of the subject's business .....	45
8.3 International investors lose patience when subjected to uniquely SA rules .....	45
8.4 Operating a dual South African and foreign legal structure is complex and expensive.....	46
8.5 Local jobs and opportunities lose out to the demands of the global market .....	46
8.6 Applicable relaxations in Startup Act targeting this .....	47

## 9 It's not always about the red tape.....48

9.1 The business of business is to service and follow its customers .....	48
9.2 Background description of the subject's business .....	49
9.3 Choose between allowing foreigners to South Africa, or founders moving offshore .....	49
9.4 Setting up overseas should not have to involve relinquishing citizenship .....	49
9.5 Applicable relaxations in Startup Act targeting this .....	50
9.6 How will relaxations improve the above? .....	50

## 10 Put the baby back in the bathwater - 51

10.1 Mobilising local capital to fuel our future economy .....	51
10.2 Background description of the subject's business .....	52
10.3 Yes, we sinned. But failure is the 1st step to getting it right .....	53
10.4 Count the lessons, not just the money spent on the tutors .....	53
10.4a 12J proved that South Africans remained keen to back their entrepreneurs .....	53
10.4b 12J slowed the brain-drain amongst young black investment professionals .....	53
10.4c 12J created a much-needed audit trail that enabled measuring impact and accountability .....	53
10.4d Decline in fund-raising successes post 12J .....	53
10.5 Turning off the supplies at a time when our entrepreneurs are stepping up .....	54
10.6 Applicable relaxations in SUA targeting this .....	54
10.7 How will relaxations improve the above?.....	54

## 11 The World is an investor's oyster - 55

11.1 Investment in startups is a global game .....	55
11.2 Background description of the subject's business .....	55
11.3 Red tape affects the founders more than the investors .....	55
11.4 SA founders bring more baggage to deals than their foreign peers.....	56
11.4a Investing in SA startups take up more time and costs for investors .....	56
11.4b South Africa is classed no different than all other high-risk emerging markets .....	56
11.4c Investors want founders to domicile in trusted domains or where they are based .....	57
11.5 Need to back our own before putting hands out to foreign markets .....	58
11.6 Applicable relaxations in Startup Act targeting this .....	58
11.7 How will relaxations improve the above? .....	58

## 12 Context for supporting the SA Startup Act ..... 59

12.1 Immediate impact foreseen.....	59
12.2 Interventions premised on the concept of Qualifying Startup categorisation.....	59
12.3 Social economic justification.....	59

About the initiative.....	(i)
SA Startup Act Case Study Research .....	(i)
SA Startup Act Movement.....	(ii)
Financial Sector Deepening (FSD) Africa .....	(ii)
Research partner for the project .....	(ii)
Project Objectives contained in the FSD Africa Terms of Reference.....	54
Relaxations contained in the 2021 SA Startup Act Position Paper .....	54

# 1. Going global requires global investors



International investors are not predisposed to invest in South African-based technology startups. SA founders in the pursuit of overseas expansion and attracting foreign VC capital must therefore establish international companies when trying to access global VC. Doing so involves overcoming the restraints of South African Exchange Control regulations.

Exchange Controls restrict South African tech startups directly and indirectly in various ways:

- (i) an outright prohibition on structuring the startup as being held by an offshore holding company,
- (ii) the need to obtain Exchange Control approval when taking South African IP offshore;
- (iii) the financial and administrative impact on day-to-day business when receiving payments from foreign customers,
- (iv) making payments to foreign operations, because such payments are regulated by Exchange Controls; and
- (v) investors see exchange controls both as a contradiction of global open market policies and as a threat to their ability to earn and receive profit from the South African startup.

The SA Startup Act calls for the removal of Exchange Control approvals for qualifying startups, so that such startups can easily establish a foreign company, enabling the South African founders to access international capital. It additionally proposes relaxations that allow for reporting, rather than pre-approval when assigning the IP rights held by the qualifying startup to its foreign company.

In this way, the South African shareholders will have the opportunity to acquire international capital for the foreign based company with which to fund global activities and become globally valuable. By accelerating the process of bringing on board foreign capital for international market expansion – without the South African founders needing to emigrate financially or physically – the national economy can benefit from the job creation and increased taxes made possible by the efforts of South African founders.

The following account chronicles the experiences of a South African law firm in helping founders navigate the legal and compliance aspects typical of the entrepreneurial journey. It is included here first, because it sets the scene in so far as the underlying challenge when entering foreign markets with South

African IP, being the need to operate within the confines and realities of South African Exchange Control regulations. This theme permeates most of the experiences of South African founders, some of whom are featured in the rest of the case studies.

## 1.1 Offshoring IP and company ownership are vital steps in taking on the global market



*“The market locally is too small for most businesses to attract investment. However, the SA Market is a good place to start and prove new business ideas.”*

To become financially feasible and play a meaningful role in an economy, startups need to grow and improve their valuation. Without this, job creation and expanding the tax base cannot materialise. In this journey, South African technology startups may relate to the global market in different ways, be it to sell products and services, or to tap into capital markets. Startups in most instances need to have a physical footprint near their customers. This may require the founders to open an offshore office if its customers are based in another country.

Setting up business in any foreign market can be complex and risky. Where should we go? Do we need to register a new business? How and to whom do we pay tax? How do we transact and pay our employees? Startups require specialised legal and commercial advice when planning to enter foreign markets.

## 1.2 A law firm focused on the needs of South African startups and founders

Legal professionals skilled in the unique needs of startups and founders and willing to forego fees earned from corporate South Africa, are few and far between. Corporate law firms cater to large firms, dispensing advice different to that relevant to startups.

A South African-founded law firm servicing entrepreneurial firms has developed expertise to address the above questions. Counting clients amongst startups with technology and intellectual property-based products and services, the firm has walked the road with many South African founders.

## 1.3 Positioning a startup to attract foreign capital is constrained by SA Law

The principal challenge impeding the growth and success of the firm’s clients, recalled by the firm’s founder, are the difficulties founders experience when attempting to attract and retain foreign capital. Often-cited challenges – securing the right markets for the client’s products; ensuring tax compliance; or even employing foreign talent – have been solved

legally in one way or another. But in the experience of the law firm, bringing on an international investor into a South African startup company is fundamentally constrained in South African Law.

Startups aim to use venture capital funding from a global investor to fund its global growth and ambitions. Notwithstanding a range of services suited to the entrepreneurial journey, the firm today primarily helps South African startups in the quest to establish legal structures indispensable to securing such international capital.

### Why venture capital?

Simply because startups – in need of capital to fund growth – do not have the assets for collateral to obtain credit. Having limited options such as self-funding, founders turn to Venture Capital investors, or VC.

Also referred to as early-stage risk capital, VC would see a specialised investor taking an equity stake in a business to offset the risk of losing its investment capital. The ability to assess, value and guide the development of the business in which it holds equity, is fundamental to its ability to recover its capital at a later stage. The aim is to attain a higher valuation of its equity stake, as it needs to earn a return on capital to justify the risk and costs of having made the investment in the first place.

### Why an international VC?

An investor becomes a partner in the startup. A desirable VC will be active in the target market, as the partner is critical not only to securing capital, but to empower the founders with its networks, market insights, and most significantly, its experience in operating in said market. The choice of finding a fitting partner is influenced by the business strategy of the startup, the nature and location of the market opportunity, and the aspirations of the founders.

### Why the need to establish a foreign-based company for the South African startup?

The investor – taking all reasonable measures to reduce risk and transact in a way where it can direct its interests in a familiar context – must do everything it can to guarantee its ability to recover its capital in the future. VCs, being future partners and shareholders in the startup, would in almost all instances stipulate that the equity be held in a business (usually a head-quartered company) domiciled in the same legal jurisdiction as itself, or as a compromise, a domicile complimentary to the interests of both the investor and the startup.

The need to domicile in international VC and startup-friendly territories is not limited to transactions involving South Africans; it is global practice. For South African startups like their global peers, this involves registering a legal entity in an investment friendly jurisdiction such as the state of Delaware in the USA, London in the UK, Netherlands, Jersey and even Singapore.



*"A misconception amongst many, possibly even some in the South African Revenue Services, is that doing the above is about tax structuring or even tax avoidance."*

#### Is it about paying less tax?

The law firm, accustomed to this view from both the business media in SA and even some among policy makers, explains that this is clearly not the case. Startups during foundation years are tax neutral: they don't yet generate taxable profits as every cent is reinvested into the growth of the enterprise.

The lawyer further explained that: "... their goal is typically to show that they have created valuable Intellectual Property which can be used by an acquirer to generate material profits, not be profitable themselves. The value of a startup to the shareholders is that the shareholders can sell their shares for value. If they manage to do that, the shareholders will pay tax on their capital gain. All South African-resident shareholders will pay this tax in South Africa, regardless of where the startup headquarter company is based, due to South Africa's residence-based tax system."

#### 1.4 The impact on South African startups

This all sounds reasonable and easy to do. So what is the problem?

South African Law in the context of startups has provisions unique to South African ideals, such as to protect and manage capital flows; safeguard local intellectual property especially if funded with public funds; and to enable the social and economic transformation of our economy. Despite best intentions, these regulations and statutes create risks that deter international investors – and those regulations then become barriers to the growth of new startup enterprises, thwarting the attainment of the very social and economic ideals it aims to defend. Nowhere is this truer than the tribulations of securing foreign capital as a South African startup.

In the experience of the law firm, South African startups creating offshore businesses to access global markets, is neither a personal prerogative of the founders nor of the law firm **but done on the insistence of international investors.**

A short survey aimed to better understand this was distributed amongst South African founders during this research project, involving startups through the combined networks of Endeavour South Africa,

Silicon Cape and SiMODiSA.

The results are telling and validate the assessment of the interests and practices of international VCs vis-à-vis South African startups outlined above. Of the 52 founders responding to the survey, 80.8% had moved their businesses offshore to raise capital from international investors.

In doing so, 67.3% of the sample ended up having to create an offshore company. They did so on the insistence of their investors, and reported that setting up the offshore company was a precondition for investment.



The US was the preferred choice for setting up a new company (34.7% of those with offshore companies), followed closely by the UK & Ireland (30.6%). The state of Delaware in the US was the preferred legal jurisdiction for those targeting the US.



Mauritius was the preferred option outside South Africa on the African continent.



*"We lost out on an international tender which would have been implemented at group level (Australia, SA, South America) because the product and IP was South African – they felt that SA was just not stable enough. This would have been a game changer. Hence the move to Delaware"*

#### It's about the IP



The choice is clear: SA startups must set up an offshore company, or forego foreign capital as a source for growing and scaling into global markets.

The primary assets of a startup, most often the only assets, are the ideas, know-how, data, technology, and products developed by the startup, loosely referred to as the Intellectual Property of the startup. Growth capital, be it seed money from founders or capital from its investors, will be used in the process of developing such IP: taking rough ideas on a white board, and turning those into valuable products.

Without IP, most startups will have no tangible value. An investor critically needs to ensure that the rights to such Intellectual Property are held by the company into which it risked its capital. Such rights in most instances involve tangible ownership of the IP, as most investors reportedly won't invest into an exclusive licence either, where the IP is still held in a South African company. In both instances, the reasons given include the insistence that the company must be based in a jurisdiction whose laws are trusted and familiar to the investor. Otherwise, the investment will have no principal value.

Intellectual property (IP) refers to creations of the mind, such as inventions; literary and artistic works; designs; and symbols, names and images used in commerce.



IP is protected in law by, for example, patents, copyright, and trademarks, which enable people to earn recognition or financial benefit from what they invent or create.

Establishing a foreign domiciled company by a South African startup is fundamentally about housing the startup's IP rights in the foreign territory, both existing and future IP. This enables both the founders and the investor to have ownership in the entity that will have title to future IP created through the deployment of the investor's capital. If not, the investor cannot and will not invest.

For a South African tech startup, setting up a foreign company involves the movement or assignment of IP rights held in South Africa, based on IP developed to

date if that is the case, as well as IP created from the date of investment going forward, so that both existing and new IP belong to the company in which the investor is a shareholder.

#### Dealing with IP rights already held by the South African startup

The South African Reserve Bank has the national mandate to protect the value of our currency in the interest of balanced and sustainable economic growth. The SARB, through Exchange Control regulations introduced back in the 1960s, aim to guard South Africa's foreign currency reserves and prevent the loss of financial capital assets held in South Africa.

Intellectual Property is considered a capital asset in accordance with international tax law and therefore falls within the domain of Exchange Control regulations.

**When assigning South African IP to an international company, compliance with SARB Exchange Control regulations is non-negotiable, and must be done before the conclusion of the investment.** If not, the entity conducting the assignment, being the founders of the startup may be liable to penalties and even imprisonment. More troubling to the prospective investor is the possibility outlined in terms of Exchange Control Regulation 22, which allows the South African Reserve Bank (SARB) to seize both tainted and untainted assets, in connection with an exchange control contravention that has not been regularised.



Regulation 10(1)(c) states that "no person shall, except with permission granted by the Treasury and in accordance with such conditions as the Treasury may impose, enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic".

The need for obtaining Exchange Control approval extend also in some instances where the South African IP is licenced exclusively to a non-South African legal entity.

Investors will hold off deals until Exchange Control approval to ensure that newly acquired assets and the future revenues generated from it don't become ensnared in an international legal dispute, or worse are lost through cross-border asset forfeiture.



*"Investors know that SA has very restrictive laws that makes doing business difficult which in turn makes fund raising difficult. Our investors did not want to invest in a South African based company and forced us to create an American offshore company before they invested."*

In many instances, SARB simply rejects requests to assign the IP offshore, and if approval is obtained, then that can take months or even years.

if the foreign investment is conditional on assignment of South African IP to an offshore entity, on becoming aware of this timeous and uncertain complication, investors as reported in the survey, will simply walk away from the deal.



*"The Exchange Control restrictions that oversee cross-border funds transfer have far-reaching effects on the acquisition of South African IP as well. Foreign acquirers of South African IP or startups with proprietary IP must register the transaction as a cross-border exchange of capital, which can have tax implications."*

*– Tech entrepreneurship Ecosystem in South Africa (Google and OC&C)*

Aiming to relax Exchange Control, SARB in 2021 delegated some Exchange Control approvals to designated Authorised Dealers, being the South African commercial banks. However, this approval does not include assignment of IP to related, offshore companies: Section B.2(A)(ii) of the Currency and Exchanges Manual for Authorized Dealers.

Commercial banks servicing the financial and investment interests of retail clients, rarely receive Exchange Control requests involving IP.

Being neither specialised nor experienced in transactions involving IP - and extremely conservative about the prospects of incurring fines and penalties, let alone jeopardise its banking licence – SARB reportedly either stall in getting back to Banks (who send the requests on behalf of clients), or decline such requests.

This uncertainty (at best), delay (in every case) and possible denial of consent (in many cases) is fatal to a startup's ability to secure growth capital.

### How can SA startups set up offshore holding company structures?

This legal structure was made possible, in theory, after the developments in South African exchange controls in January 2021, in terms of which SARB appeared to announce a complete lifting of the loop restriction, which previously limited a South African's ability to set up an offshore holding company of their South African business. This could have huge potential implications for South Africans because for the first time, South Africans have the ability to present their international businesses in the conventional manner. Also, foreign holding companies can now loan and fund their South African subsidiaries subject to compliance with pre-existing exchange controls.

### Ongoing frustrations

In subsequent engagements with SARB, they have expressed reluctance about its position spelled out in the regulations that permitted loops. SARB's (informally expressed) position is that they never intended the loop permission to allow South African shareholders to simply externalize their companies. "Externalizing" a company means to move ownership and control to an offshore holding entity, which effectively represents the same, South African shareholders. Rather, SARB's intention was to facilitate funding of South African businesses from international sources of investment (and, in some cases SARB has gone so far as to say that it was aimed at attracting investment from offshore assets owned by South Africans!) At the time of writing, SARB have said that they are preparing and issuing a new circular "to provide more clarity". Six months later, no such clarifying circular has been received.

**Exchange Control approval is the primary bottleneck in South African law obstructing access to foreign capital, and thus impedes SA founders from doing business in foreign markets and taking on opportunities with which to build value and transform our economy.**

### Owning IP developed in the future by the foreign company

In the pursuit of building valuable businesses, the second aspect critical to the commercialisation journey, is to ensure that the IP developed by the internationally based company, using a global VC's money, belongs to the legal entity in which both the founders and the foreign VC has equity. This goes without saying.

However, South African Law complicates this, because if the founders remain South African and the newly developed IP is seen to have been developed through instructions and oversight from South Africa, and not the efforts of the actual foreign company, the operations even if funded entirely with non-South African capital, may still be considered South African. This has implications for the day-to-day trade using the IP, its future disposal, as well as tax implications when doing so.

Why is this a problem? An investor for the same reasons in basing its interests in its own territory, would want to base its investments in a legal and tax jurisdiction that it is well versed in and have experience in trading in.

Achieving this position of independence from the South African operation requires specific processes and activities to ensure that the foreign company is the actual owner of the IP developed from this point forward.

It's therefore not as simple as setting up a shelf-company. The international business needs to have a physical presence from which actual business activity is conducted, by the foreign workforce, under the supervision of its foreign based management. Failing which, the entire operation may be an obvious extension of the South African startup by South African tax and Exchange Control authorities. In such a situation, the intellectual property developed abroad may still be considered South African IP, as may the business operations be taxed in accordance with South African tax law.

Why is this a problem? Shareholders of the foreign startup, being the South African founders and the international investor, will want to have absolute certainty as to being free from any future unwarranted claims to the IP by anyone, including the South African government. So too do the founders need to ensure having complete Freedom to Operate in so far as its IP, with no future actions that may limit the tradability of the IP, or demands on the profits other than the tax incurred by the South African shareholders as and when profits accrue to them. It needs to be a truly foreign owned and driven operation.

To achieve this position entails considerable capital for setting up the legal entity, but more so when creating a physical presence in the foreign office where the commercially relevant decisions are taken in so far as the development of the foreign-owned IP. In other words, significant costs will be incurred at

the international base to commercialise the IP, even if parts of the IP are developed in South Africa, doing so under clear and undisputed supervision of the foreign office.



*Many startups which would otherwise be registered in South Africa may instead be registering their innovation-based businesses outside, to take advantage of jurisdictions that enable freer transfer of IP between parties where there are international investment interests*

*– Tech entrepreneurship Ecosystem in South Africa (Google and OC&C)*

### 1.5 Is this really affecting South African startups?

Through the survey, respondents demonstrated the extent to which South African founders have been using this avenue to pursue foreign capital. Out of a sample of 52 respondents, more than 80% moved their business offshore to raise investment from international investors.

Most respondents in the sample reported the need to establish a physical presence and not only a legal presence. 56% of respondents reported the need to physically relocate some of the company's staff to the offshore company (as opposed to hiring offshore personnel); 8% reported having to move the founders and entire staff compliment to the offshore location.

Most startups that were polled explained that they had retained business interests in South Africa, with less than 10% moving the entire human resource to the foreign office. This may turn out to be a temporary situation, as the foreign office over time is expected to take up more and more of the resources, both human and financial; the capital resides in the foreign company, not in South Africa. Moving people abroad permanently or semi-permanently comes at a substantial cost and one would be surprised if this position was overturned in the short to medium term, having already made the investment into the foreign operation.



Out of a small sample of 52 startups, 122 of those individuals and their families formally emigrated.

When asked what the number one reason was to relocate away from South Africa, the majority cited the ability to attract foreign investment as the primary reason, followed with the limitations of Exchange Control.

33% of respondents would relocate back to South Africa if Exchange Controls were scrapped. Another 25% would relocate if they were able to keep the IP offshore without any future actions, including taxing from the SA government.

This is not news to the law firm. A well-known, internationally awarded South African startup, founded in 2014 and co-funded by South African VC investors - one a state entity - took 18 months to establish the legal and compliance structures needed to enable a multi-million-dollar investment by a European manufacturing company. Through the investment, which it attained at great cost and administrative burden to the founders, the company was eventually able to double the headcount of its South African engineering base where the company builds products pivotal to the Fourth Industrial Revolution (or 4IR). The opportunity costs and risk of alienating investors because of Exchange Controls and IP assignment have become par for the course, not only for this company, but many clients of the firm.

Most South African founders don't have the financial resources available to the company and will simply forego seeking foreign capital. Or worse, give up on the business and pursue other interests, as is the case where foreign investment or establishing a company in a foreign country was a key determinant for business continuation.

### 1.6 Applicable relaxations in the Startup Act

RELAXATION

3

**Remove inhibiting regulatory barriers that hampers globalisation and investment into qualifying startups**

- **Title:** Address Exchange Control Limitations
- **Startup ecosystem pillar:** (iv) Conducive regulations and the appropriate regulation of business activity relevant to startups

### 1.7 Doomed if you do, doomed if you don't

Most startup founders in South Africa will not be able to justify pursuing a strategy of setting up foreign structures if the business opportunity is unproven. Most simply can't afford it. Adhering to both common wisdom and best-practice, founders will first attempt to prove the concept in their local

market, leveraging local market insights and utilising a lower-cost base in comparison to moving offshore. In doing so, founders end up creating South African IP even before they have considered the future implications or become aware of the need to move the IP offshore.

## 2. Journey without a destination



Being aware of, understanding and complying with the regulatory and administrative policies and requirements involved in scaling South African startups globally, are mostly beyond the skills and knowledge of our startup founders. Securing the necessary approvals, including Exchange Controls, as well as ensuring international freedom to operate for the startup's IP, can absorb the entire efforts of the commercialisation team. This can lead to the demise of the startup as the founders have to shift their efforts and resources away from single-mindedly focusing on getting products into the market.

The SA Startup Act premises the concept of a qualifying startup, whereby startups compliant to specific criteria can automatically be absolved from the need to obtain Exchange Control approvals. By applying and meeting the criteria for 'qualifying startup' status, the above, including streamlined fulfilment with tax and other regulations, will greatly simplify the compliance process in a transparent and predictable way, becoming part of the normal business practices of South African entrepreneurs.



*"There is no country in the world where it's as easy to find venture capital in the stock market as the United States."*

*Ron Chernow*



*No foreign LP will invest in a South African domiciled company*



*"We met with many investors in USA, EU and UK to seek investment into our SA startup. Whilst our metrics and proposition were very well received and "ticked the boxes" for indicators that we are an exponentially growing tech company, we were declined by more than 50 investors. Their reasoning always included that we did not have a presence in one of the major markets: USA, EU or UK, and that investing into a vehicle in a SA jurisdiction would not fit their investment mandate."*

### 2.1 Startups are running blind due to regulatory uncertainty and lack of awareness

Warren Buffet and Bill Gates, famously concluded their very first meeting agreeing on absolute and undeterred focus as the most important building block for success. When new entrepreneurs set off on the journey to chase a new market, or transform an untested idea into a commercial product, the successful ones are often the ones that early on picked out the critical aspects in their commercialisation journeys. Focus is key.

Entrepreneurs are perceived as individuals able to live with the uncertainties and toils of bringing new products to market. They typically have the aptitude and skills to solve technical and even commercial challenges. When these are lacking, experts and advisors are on hand to help.

But South African founders are typically unaware of, and unskilled in the intricacies of South African Tax laws, let alone Exchange Control, Intellectual Property, and International Laws. Immersed in the minutiae and confronts of turning ideas into products, founders during the early stages are less concerned with the legal implications of their growth ambitions, bringing on lawyers only when the business starts running into legal and regulatory obstacles. And those that did so, found the road to success still fraught with legal and regulatory uncertainty, even after consulting with experienced advisors.

The magnitude of this challenges hits home when founders must stop commercialisation to rethink their approach to ensure that what they are doing is both legally feasible and compliant.

The following is the story of one such entrepreneurial journey, where the founders were still in limbo at time of writing, awaiting regulatory approvals as they were busy running out of money.

### 2.2 Background description of the subject/candidate's business

Building products and solutions that meet industry standards does not happen in isolation. This is more true today than ever before as the market for software and applications is digital, online, and global. Apple AppStore and Google Play enable widespread market adoption, meaning competing from day one with the rest of the world, even if the product was not meant for the global market.

So too has the notion of the company head office been disrupted as companies can and are truly global. Developers, support offices, and sales teams can work from anywhere. This allows startups to bring competitive products and services to the market, drawing on teams scattered around the world. So too are many South African software engineers contracted and paid by leading international companies like Amazon and Microsoft, earning US or UK wages from the comfort of their

South African living rooms.

A couple of South African founders, with money to spend and experience from a previous successful venture, decided to apply their newfound acumen, and start a second venture.

A key insight from the first undertaking, was the value to retain world-class software engineers, being professionals that understood the product development process against the backdrop of international competition and the pressures of rapid market deployment. Such individuals come at a significant price.

Given this, the founders felt that they needed to raise capital from international markets in the US, UK or EU, as they sensed they would otherwise not have sufficient capital with which to offer competitive salaries to lure local software engineers to their startup.

The founders tactic was to raise foreign capital with which to pay software engineers based in South Africa for the development, installation, and implementation of the startup's products. In turn, products would be sold on the international market, facilitating a cost premium between foreign currency-based revenues and disbursements in Rands.

The ability to demonstrate products and customer support through trust and authenticity - fundamental to solutions for the security industry targeted by the startup - further strengthened the founders belief in the need to have a physical footprint in the target market. One of the founders subsequently moved with his family to the EU. Their duties included pitching the startup's case to international investors and pitching the firm's prospects to international customers.

### 2.3 Experience vis-à-vis red tape and regulatory burdens



*"We have missed out on several acquisition attempts by international companies once they found out that we are headquartered in SA due to the red tape and bureaucracy involved in acquiring an SA registered company."*

The internationalisation strategy made a lot of sense to the founders, being software engineers themselves. More importantly though did the strategy need to pass the crucial test of making sense in South African Law. This it turned out, posed very different challenges that the software engineers quickly had to come to grips with.

The first challenge was the difficulty of making salary payments from the South African office to offshore operations as such payments needed to obtain Exchange Control approval. The Founders expected help from somewhere in the South African Government, feeling that the frequency of making such payments would command a special concession. No help materialised.

Engaging with the government in which the startup set up its international office proved a completely different experience. The Founders received offers of incentives for trade relocation and inward assistance and help in navigating legal and other requirements.

The second challenge would prove to be the undoing of the overall strategy: enticing international investors to put money into a South African startup. In the minds of the founders, their approach offered a fantastic return-on-investment for investors: using Dollar and Euro dominated capital to fund a South African based team; leveraging the cost benefits of revenues accrued from selling products and services at international market prices and doing so using a low OpEx South African based operation.

After months of pitching to more than 100 potential suitors, the founders got used to the standard feedback received: none of the investors were interested in putting capital into a South African domiciled company.



In fact, in nearly all cases, the investor mandate required investing in startups that were either domiciled in the US, UK or EU.

Not only this, but investors clearly favoured proposals where a company was already registered or would set up its offices in the investor's own country. Investors it turned out didn't trust what was not in their own market.

They found it impossible to explain the South African story to international investors. The required loop structures, being a necessity for setting up a company with South African IP in an international market, did not make sense to any investor. On the contrary, international investors quickly preferred other candidates, none of whom had any of the complications involved in the South African startup's business proposal.

In instances where pitches progressed as far as an

initial review, the amount of uncertainty and unusual legal risk in the eyes of foreign investors created a feeding frenzy amongst their legal advisors.

The founders themselves obtained their own legal opinions, trying to find an unfindable solution with which to make their strategy work. One such instruction led to a further setback when a legal review came across a particular subset of South African Law dealing with the regulation of international shareholding activity.



Conducted by the Takeover Regulation Panel (TRP) this instrument of the Department of Trade and Industry was established as a juristic person in terms of section 196 of the Companies Act No 71 of 2008 (the Act).

In layman's terms, the TRP potentially comes into play when a South African registered company, considered within the SA Company Act as a regulated company, engages with international investors for transactions involving assets of the company, including shares.

This may very well not have been relevant to the South African startup but threw yet another straw on an already teetering heap of bad news.

#### 2.4 Impact explained

The result was that the founders, in this case specialised software engineers, with no experience or expertise of local and international law, spent days and months navigating the complexities of South African and International Law, Exchange Control, and seeking clarity on the way forward, all in the pursuit of securing growth capital. Their focus shifted to compliance, away from being single-minded about building the very products and services with which to fuel the value of the business.

The costs of the founder that relocated to the European country with his family added to the financial woes of the business. Doing so impaired the startup's debt position at a time when the company was frantically seeking funds with which to build its products.

Legal bills alone amounted to more than R2 million, with the founders hitting a brick wall of regulatory and legal uncertainty. At the time of writing, the South African business had run out of cash, not able to pay salaries for the foregoing five months, effectively challenging the going-concern status of the business. Had it not been for the previous successful exit, the founders would not have had the

financial resources with which to incur the legal fees it did. For most South African startups, the road would have ended long before the first step was taken.

#### 2.5 SA founders aim for the stars, but get as far as Exchange Controls

South African high-tech entrepreneurs are not appropriately informed of the complexities and costs associated with penetrating international markets. Going offshore isn't simply about ambition or 'doing the logical next thing'. It can make or break a company.

One account from a South African fund manager, is having spent a million rand in setting up an offshore structure for one of its investments, only for this to not be utilised at all.

#### RELAXATION

### 3

#### Remove inhibiting regulatory barriers that hampers globalisation and investment into qualifying startups

- **Title:** Address Exchange Control Limitations
- **Startup ecosystem pillar:** (iv) Conducive regulations and the appropriate regulation of business activity relevant to startups

#### 2.7 How will relaxations improve the above?

According to the South African Startup Ecosystem Report 2022 conducted by Disrupt Africa, Tech startups in South Africa, as of May 2022 employed over 11, 000 people between them.

Despite growing into a notable employer, South African tech startups are however effectively excluded from the international market, due to Exchange Controls. This means that those having products and services relevant to the international market, cannot attract international investors without rescinding the South African ownership of their companies and the technology and IP developed by South Africans.

Yes, founders can raise money in South Africa. But raising Rands to make payments in Dollars or Euros is an inefficient way to utilise capital which, in the context of global markets may anyway prove insufficient. Furthermore, will the business be hamstrung when trying to make payments from South Africa to the international office, due to the need to obtain Exchange Control approval for such transactions.

The value and role of an early-stage investor is vastly more than the money it brings to startup. Bringing in global investors not only supplements the pool of capital available to South African entrepreneurs, but empowers South African entrepreneurs with the experience, networks and resources needed to operate successfully in foreign markets. So too are

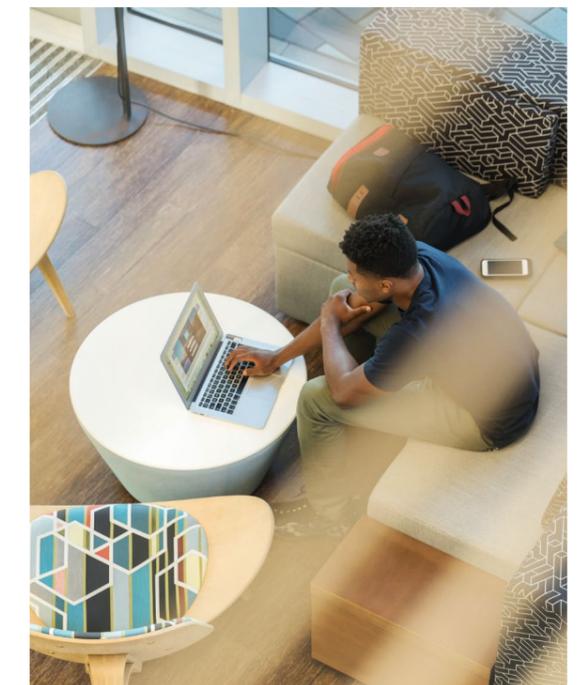


"It's like the blind leading the blind."

The root cause is the impenetrable deterrent of securing Exchange Control approval for moving South African IP offshore, and by extension, enabling payments between South African and offshore operations.

This impediment in one way or another affects all startups wanting to create international operations, whether an international investor is involved or not.

#### 2.6 Applicable relaxations in the Startup Act



entrepreneurs able to seek better valuations than what may be possible in South Africa.

By not solving the Exchange Control impediment, South Africa's hope for future job creation and economic transformation is eliminated even before it has begun.

### 3. When chickens come home to roost



A partner indispensable to several South African financial institutions, having clients in several overseas markets, had to endure the restrictions of an Exchange Control approval obtained almost a decade ago. The ownership interests of its founders and investors were held through a bloated legal structure, over the years becoming more and more complex in trying to balance setting up offices in overseas markets, whilst having to operate within the confines of the original Exchange Control approval. The founders of the Unicorn-in-waiting is single-minded in presenting a simple and unified prospect to the international market but having to do so with an over-complicated governance structure that is both administratively and financially inhibiting.

The SA Startup Act proposes relaxations that will enable qualifying startups to develop businesses with global market appeal and value, doing so through the simplification and alignment of regulations and administrative requirements relevant to SA startups by a qualifying startup, and in doing so greatly increase the prospect of nurturing local skills and stimulating the South African tax base.

*"Simplicity is the ultimate sophistication"*  
Leonardo da Vinci

*"That's been one of my mantras – focus and simplicity. Simple can be harder than complex"*  
Steve Jobs

Entrepreneurs pursue a dream but in South Africa, the complexity of regulatory compliance can turn a seemingly simple ambition into a legal and financial nightmare.

Complexities mount when the market and growth opportunities are located internationally. This includes not only countless manhours lost in obtaining and managing regulatory approvals, but also managing the uncertainty created amongst founders, partners, and investors. When faced with the ongoing and never-ending fallout of securing regulatory approvals, and managing the subsequent business structures required by the Regulators, the question is asked if the business has any chance at all operating as a South African entity, or is it better to simply do business as a foreigner?

#### 3.2 Background description of the subject's business

A leading startup servicing both local and

international clients had to implement a loop structure following its Exchange Control application several years back.

#### 3.3 Experience vis-à-vis red tape and regulatory burdens

It has been several years since the original restructuring of the business in accordance with the conditions of its Exchange Control approval. The business underwent significant growth and was able to expand despite the onerous and complex legal structure inherited due to said ExCon agreement. It is positioned to become a truly global Unicorn.

The startup over time created legal entities in several markets with most of its technology and products still built on the original and vastly improved IP created in South Africa. The biggest challenge in the lifecycle of a Unicorn facing the business at time of writing now, was to simplify its complex ownership and legal structure to enable a global listing, or exiting to a foreign suitor.

The company today faces severe implications for the business based on the ownership structure enforced through its original Exchange Control approval, many of which were not foreseeable at the time, and are now starting to play out for the company.

*"Due to exchange control laws, we were unable to process credit card payments in USD (they are always converted to South African Rands) which is a big problem as most of our customers are located in the U.S.; thus, our pricing is in USD and this affects our credibility."*

*"Exchange control laws make it difficult to pay offshore suppliers and contractors which makes us uncompetitive. The payment process is slow, and invoices are often rejected, and more information is requested."*

Counterproductive implications of its legal structure imposed through Exchange Controls, have added more costs, admin, and burdens. The business had to incur additional administrative and financial overhead in making disbursements to international teams and sub-contractors. Paling in comparison to other consequences of the loop structure, these are examples of the unnecessary and non-value-adding activities needed to manage loop structures.

The biggest challenge facing the business in its growth path was however the need to find a simplified ownership structure for the entire group, including unifying dual structures created following its Exchange Control approval. Doing so would significantly reduce costs and administrative overhead but more so is fundamental in the startup's journey of positioning itself to appeal to a global suitor or possibly list on an international exchange.

The company, following its original engagements with Exchange Control decided to keep the company's intellectual property in South Africa as it would have been difficult to offshore the IP to enable the growth needs for the company. The conditions of the approval stipulated that the South African entity be contracted by the US entity when doing further product development, including research and development. The IP would then be assigned to the foreign domiciled company in a way that it is licensed in a royalty free manner between the two companies.

Structured this way, a tax leakage resulted because the inward flow of money to the South African company - thus turnover generated from international orders - could not be offset financially against the expense of using the IP, because it is royalty free.

The loop structure enforced through the Exchange Control regime made daily management of investors, governance, and accounting complex and costly. The result was that the startup paid double for everything, including the need for parallel due diligences every time a potential investor engaged with the startup, as the company had to be assessed both for its South African and US operations. One might say this is not unusual, except that both the SA and US operations were completely mirrored entities, but legally different.

The company subsequently set up an office in a European country where additional IP was developed. Employing technical staff such as developers from South Africa through the group office became impossible as it impeded on the terms of the original Exchange Control approval. In addition, doing so would imply moving IP offshore.

#### 3.4 Living with an Exchange Control structure is complex, costly and inhibiting

The first impediment which proved costly and served as a permanent complication to day-to-day business, was the realities of managing international

interests from a South African head-quartered business. Accordingly, financing subsidiaries, including personnel and business activities in other countries, including making mundane disbursements such as paying vendors and renting offices, necessitated the South African-based company to interact regularly with its own bank, being the custodian for Exchange Control of the South African Reserve Bank, before such payments could be made.

Likewise, there was a requirement as a SA legal entity, to repatriate all foreign currency earned from offshore clients within 30 days. This meant that there was a constant requirement, including human resources- and associated costs, to administer foreign capital flows.

The second complication referred to the so-called loop structure where the company had to institute a duplicated legal structure (also referred to as a mirror structure), whereby a foreign company was set up with the same ownership structure as that of the South African company. This created significant administrative and financial overhead, as everything, including accounting, financial reporting as well as conducting due diligence had to be done in duplicate. However, the biggest downside of this type of structure, was explaining the need for this to investors and potential business partners. A "simplified explanation" would result in significant costs incurred in the process of subjecting such structures to the legal scrutiny of foreign law firms acting on behalf of the foreign investors. Such firms had never previously come across Exchange Controls, BBBEE or South African IP law, adding complexity to already exorbitant legal processes.

The Minister of Finance in 2021 announced a relaxation in this regard, allowing structuring in a normal manner, whereby the offshore company may own the South African operation. But even this had not been flushed out completely.

The company in question however set up the traditional loop structure several years preceding the relaxation, and faced substantial tax implications, including going through a process of assessing the implications for the South African base, as the company at the time of writing wanted to sell less than 50% of its ownership to a foreign investor. In accordance with SARS regulations, such a situation could see the international company, having 50% or more shareholding from South Africa, as a "Controlled Foreign Company", and thus the shareholders could have been taxed as if they earned the profit directly in South Africa.

Operationally, the loop structure had been a challenge for the company, having developers and employees in many overseas jurisdictions. The nature of technology development is that there is continuous contracting with third parties for licences, sub-contracting parts of the software development efforts, as well as making every-day disbursements for rental, furniture, connectivity and so forth. By having to make payments from the South

African base to its international operations triggered an engagement with SARS through its agents to get approvals. This extended to the issue of visas and moving resources around as and where they were needed.

The paperwork for this and visas became very complex and required the startup to have specialised and expensive inhouse resources to drive this.

The company had to obtain further legal counsel to determine if its international structure complied with applicable tax laws, especially in so far as creating operational distance between the South African office, and the foreign offices. International operations had to pass the test of being foreign business establishments in their own rights, meaning that actual business was conducted from a foreign based physical presence, including presence of actual personnel involved in the day-to-day business decisions and management of such operations. Failing which, such a company could be considered under South African tax law as being a "Controlled Foreign Company" and the South African shareholders taxed on the profits accrued from the international portion of activities.

Further compounding the tax position of the South African shareholders, was another provision in SA tax laws whereby a foreign domiciled company having more than 50% shareholding of South Africans may see those South Africans having to pay tax on their share of the profits of the company, even if such profits were not distributed to them. In other words, the shareholders could be out of pocket for taxes even though they did not receive the actual money on which such taxes were based!

An additional constraint for the company, servicing a range of blue-chip South African companies, was the need to retain its BBBEE status as this was a supply chain requirement of all firms in the financial services sector. The moment the company brought onboard a major foreign shareholder, the new ownership structure would be diluted, obliterating its BBBEE status, and jeopardising its ability to secure work from its current clients in South Africa.

Servicing the banking industry through secure software solutions required the company, including its legal status to be completely above board and unquestionable. The possibility for Grey Listing of South Africa widely discussed in 2022 cast an additional negative light on the South African ownership of this financial services startup, serving as a strong motivator to move all operations abroad.

### 3.5 Red-tape keep South African startups from global markets

The implications of the above hold South African entrepreneurs ransom in many ways. No South African company is shielded from these implications as the laws apply equally to all South African legal entities, regardless of size or type.

The issue, some counter, is that South African

startups are trying to avoid paying tax. This issue is not at all about paying tax, especially given that most startup businesses are profit-negative for the first number of years in trying to bring new products and services to the market, thus not liable for tax. The issue is rather the daunting prospects of setting up new businesses - done almost in all instances by entrepreneurs that are not tax experts - having to conceptualise business models that are able to scale

and not create future problems for the founders, doing so amidst an utterly daunting amount of tax and legal regulations.

Many founders only become aware of the above realities when they get to the point of having to engage with government for Exchange Control approvals, long after they've possibly already conducted business in a way that ran afoul of regulations and compliance requirements.

### 3.6 Applicable relaxations in Startup Act targeting this

RELAXATION

3

**Remove inhibiting regulatory barriers that hampers globalisation and investment into qualifying startups**

- **Title:** Address Exchange Control Limitations
- **Startup ecosystem pillar:** (iv) Conducive regulations and the appropriate regulation of business activity relevant to startups

RELAXATION

4

**A qualifying startup to be exempted from preferential procurement limitations**

- **Title:** Automatic Level 1 BBBEE status for procurement and supply chain grading
- **Startup ecosystem pillar:** (vii) Local and global market access



## 4. Golden goose shoved offshore



Business accelerators, including those associated with leading financial institutions in South Africa, are advising clients even before incorporation, to establish foreign legal entities. This is done to avoid the complications and outright impediments involved in securing Exchange Control approval in the effort to access foreign capital with which to grow South African startups. Some accelerators advise this practice even if the candidate did not initially intend to take on international clients or capital.

By mainstreaming the creation of foreign companies by South African founders, the opportunities for retaining local skills and expanding the South African tax base are greatly jeopardised.

The South Africa Startup Act proposes relaxations to remove the need for Exchange Control approvals if the development and international commercialisation of such IP is conducted by a qualifying startup, and in doing so greatly increase the prospect of nurturing local skills and stimulating the South African tax base.



*"On a global basis, the WEF ranked South Africa 19th as a financial hub and recognised the country for its well-developed equity, insurance and credit markets."*



*"The wider financial sector makes a significant contribution to gross domestic product (GDP), which is growing at 2% annually."*

### 4.1 The need to value, nurture and leverage innovation clusters



Fintech is the largest employer amongst South African startups, with 4,387 jobs accounting for almost 40% of all startup jobs.

Financial Technologies involves the development of software solutions and other technology used to support or enable banking and financial services. According to the 2022 South African Ecosystem Report, Fintech was a major driver of activity within the startup space, with 30 per cent of South African startups active in this sub-sector of financial services. According to the annual 2022 SAVCA VC survey report, Fintech at 15.9% was the top sector amongst the five sectors that attracted the greatest number of deals in 2021 in South Africa. Fintech also attracted the second largest rand value of investments (R298m).

### 4.2 Background description of the subject's relevance to startups

Most of the large financial services institutions in South Africa in the drive to bring cutting edge products and services to its customers and remain competitive, have established inhouse business accelerators to capitalise on the new supply of fintech innovations coming from local startups.

These accelerators assist startups in structuring products and services for the financial services market, where sector specific regulations and tough operating conditions require a level of sophistication that is not always easy to achieve for a startup entrepreneur by him or herself. Services on offer from such accelerators include market access, integration with procurement and supply chains of applicable banks and insurance companies, and in some instances also making available grant and early-stage funding.

Being inhouse, accelerators wear different hats in so far as the South African startup ecosystem. Financial services accelerators firstly look at priming suitable candidates for integrating products and services into the portfolios of the host institution, be it the bank or insurer. The nature of almost all business accelerators is to support a large number of candidates since many end up with products and services that may not be relevant to, or timed for the market. This can be for several reasons, let alone the normal challenges associated with setting up entrepreneurial ventures. But because this outcome is not known at the onset, accelerators deploy a portfolio approach like that used by VC investors, backing several candidates in the hope of finding the One.

Fintech is a global hive of startup activity and local accelerators come across prospects that not only appeal to the local business of the accelerator host, but that potentially have significant upside in the international market, including generating favourable investment returns. Accelerators in most instances have the mandate to support such a startup, even if it turned out not of immediate interest to the host institution.

### 4.3 Experience vis-à-vis red tape and regulatory burdens

Through working with local fintech startups, one South African accelerator in supporting its portfolio companies has had numerous experiences in hitting the proverbial glass ceiling presented by Exchange Controls and the relevant tax and IP legislation. This resulted in the fintech startup not only of incurring additional legal and advisory costs, but also impeding the ability of the accelerator to nurture successful companies, which in turn had a direct impact on opportunity costs and potential return on investment.

In having to navigate such confronts, the accelerator gradually changed its own policies to straightaway encourage potential candidates to set up offshore holding companies into which to house IP and possibly in the future accommodate international investment.

This however proved not to be a straightforward solution either. South African financial institutions such as banks and insurance companies must comply with strict regulatory requirements and associated procurement policies which in most cases require Level 3 or higher BBBEE ownership of companies involved in supply chains or benefiting from funding. A blanket policy of offshoring ownership, especially if this involved taking on international shareholders such as a foreign investor, was therefore not an effective solution, as doing so might destroy the BBBEE credentials of the startups when changing local for international ownership. Without the necessary BBBEE credentials, founders would be disqualified from serving the very customers that paid their school fees.

A major concern voiced by the accelerator was the difficulty of attracting and retaining foreign skills. This had been compounded in recent times due to losing local talent to international markets because of the incredible demand for fintech skills and experience across the globe.

### 4.4 Costs constrain startups, their advisors, and investors

The compliance burden and cost of setting up international holding companies is a cost that comes at the time and resource expenses of both the startup and the investor. The accelerator in question disbursed millions on legal fees.

One of the accelerator's clients was an internationally recognised South African startup and globally awarded fintech player. The startup set up a

foreign legal structure in its quest to scale its business and service a very lucrative foreign client base. This enabled it to attract and absorb foreign investment. To be able to do this, the startup set up a holding company in Mauritius as far back as 2012. The accelerator invested in the company in 2016 and was immediately faced with the need to redo the entire offshore transaction because it was not suitable and compliant with the Exchange Control regulations as they were interpreted at that time.

This meant that the transaction took a year longer to make investment of several million rands, which came very close to not happening at all. The accelerator then ran into the realities related to the impact of the international investment on the local operations of the Fintech, and the implications for its BBBEE status vis-à-vis its South African customer base. This again saw another round of delays, which took a further 18 months to resolve. The international investment came very close to not materialising at all.

#### 4.5 Entrepreneurs are becoming a South African export commodity

The accelerator, same as its peers, have since changed its internal policies and procedures for taking on new clients, to encourage them to offshore everything right from the start, and thus trade and operate as non-South African entities.

Offshoring as a standard policy may result in South Africa increasingly seeing less of the exit activity from such deals, including the financial and investment upside, as these will accrue to the international shareholders. This is alarming when considering that one in four startups will make use of the services of an accelerator.

This implies not only a loss of future investment revenues to South Africa, but a loss to the country's tax base as investors will generate revenues in non-South African domains, and thus pay taxes in those domains. The extent of this may be even bigger as some founders follow their businesses abroad, financially and physically leaving the South African tax base.

#### 4.6 Applicable relaxations in Startup Act targeting this

RELAXATION

### 3 Remove inhibiting regulatory barriers that hampers globalisation and investment into qualifying startups

- **Title:** Address Exchange Control Limitations
- **Startup ecosystem pillar:** (iv) Conducive regulations and the appropriate regulation of business activity relevant to startups

#### 4.7 Appropriate relaxations can stem the tide and retain South African talent

South African Exchange Control impacts startups mainly on two fronts, being the repatriation or offshore movement of South African intellectual property, and secondly limitations placed on the amounts of money moved offshore.

The Startup Act calls for automatic approvals, and amnesty from current and future Exchange Control regulatory actions or pursuits against the startup that may impact negatively on the legal status of the assets in question; and through granting amnesty, maximise the portability, commercialisation, and investment into South African intellectual property.

In addition to the above, the Startup Act calls for the removal of limitations on, and automatic Exchange Control approval for the moment of money by a qualifying startup to finance the expansion of its South African operations in other markets. This could include the offshore movement of money to cover the costs of employment in other markets as well as other working capital costs involved in setting up branches, offices and operations in other countries.

It is additionally proposed that the Startup Act include the following two specific interventions in regards to Exchange Control:

- Extend permissible loop structures for startups and high-growth firms to allow them to raise international capital by creating a non-cash-settled share swap at market value that would not require pre-approval from the South African Reserve Bank, but rather reporting after the transaction.
- IP transactions for exchange control purposes should be aligned to a reporting framework rather than the current pre-approval model. Such reporting should be done within 30 days of the transaction's effective date. Furthermore, transactions between unrelated parties should not require reporting or approval, as reporting would be included in the tax framework.

## 5. Is South Africa really open for business?



The cost and complexity of setting up a business compliant with tax and other requirements were deemed too cumbersome and time-consuming for a foreign owned startup having offices in South Africa. So too did the international founders and its investors opt not to invest in the South African operation, as doing so would have posed unacceptable risks to its IP ownership. Additionally, if domiciling in South Africa, managing payments between the South African and European offices would need constant engagements to obtain Exchange Control approvals for making such payments.

The founders moreover gave up applying for local visas for the European individuals based in South Africa, eventually finding it easier to simply conduct business as foreign citizens representing a foreign business in South Africa.

A critical aspect of the SA Startup Act is the need to value foreign skills and efforts, both in contributing scarce skills to the pool of talent that is vital to drive local technology and business clusters and creating skilled employment positions in the South African technology clusters. Equally, foreign investors should be assisted to swiftly localise and invest in their South African operations through an inward investment desk competent in the needs and objectives of technology startups.



*"I am a foreigner in South Africa; you fight tooth and nail for everything. The political and economic environment doesn't really support positive contributions from foreign nationals."*



*"Our supplier would not grant us a license to resell in South Africa unless we had a company set up in a first world market such as the UK. Our South African entity is affiliated to our UK entity and can resell in South Africa."*



*"The South African business environment is awesome. Until you get involved with government."*

### 5.1 The political and economic environment and the contributions from foreigners

Speaking with the US President in September 2022, President Ramaphosa reiterated that "Building strong partnerships with other countries is important, but it is not enough. That is why we are working to make our economy more competitive, more efficient, and more attractive to both international and local companies."

The next case study asks the question if the regulatory and other impediments facing South African founders apply similarly to non-South Africans. Surely, if a foreign national is willing to invest in South Africa, and wanting to set up shop here, the doors will be thrown wide open?

### 5.2 Background description of the foreign startup

A South African based software engineering firm develops software in the domain of security management. The company was founded by foreign nationals, with most business operations located in South Africa. The legal ownership of the business is held in an offshore company.

### 5.3 Experience vis-à-vis red tape and regulatory burdens

#### 5.3a Absence of incentives and support mechanisms to establish locally compliant businesses

The inward registration of local operations, including tax registration and complying with local regulations and requirements, are collectively the mainstay of most international inward investment desks or localisation initiatives. This is to help those not familiar with local laws, regulations, and policies to quickly navigate the intricacies of compliance.

The President's vision should serve as incentive for the South African government to swiftly enable foreign startups and investors to become operational in the new territory and deliver the social and economic benefits sighted by the President: creating local jobs, paying South African suppliers and paying local taxes.

This is not the case in South Africa, where the

The Blue Card Programme in Germany is an example of a foreign visa assistance programme that helps foreign companies bring skills into Germany, if said individuals have certain qualifications and salaries are above a certain threshold.

foreign national that founded the business related his experience of having to set up her business without any assistance or incentives from the South African government, amidst, as reported by the founders, a regulatory and policy complex environment unlike any experienced before.

#### 5.3b International compliance and quality standards not sufficient to satisfy local requirements

The company deploys electronic hardware developed in Europe, in compliance with strict European and US industry standards and regulations. Its international compliance status however was not recognised by local telecoms authorities (ICASA) which required the company to reapply within the ambit of South African policies. This despite all devices certified with the CE and FCC standards which are global benchmarks of quality management in their own rights, including benchmarks to the SABS and by implication, ICASA.

#### 5.3c Cost-benefit of local compliance for foreigners a disincentive to localise

Complying with local quality standards was the least of its problems. Keeping with international business practice, the company at first tried to localise ownership and the employment status of the founders by registering with SARS and applying for South African work permits and foreign skills visas. The registration processes and requirements were experienced to be vastly more complex and time-consuming than expected, with the founders eventually opting to simply operate in South Africa as foreign nationals.

In doing so, they were, and continue to be legally working in South Africa but doing so as the local representatives of a foreign company, with employment positions held with the foreign office. This means that income generated in South Africa was declared as sales from Europe to an international market, with salaries and most contract disbursements conducted from the European office. In other words, the tax base was not South Africa, and the net impact on the South African economy accordingly vastly less than would have been the case if the company was set up as a South African entity.

And this, not out of principle, but because it took too long and was deemed too cumbersome for the international founders to establish themselves in South Africa.

#### 5.3d Inward investment desk can help to navigate local policies, regulations and compliance

The biggest issue reported by the foreign nationals, was the lack of clarity and transparency of the various regulations, laws and certifications required to set up business in South Africa. This is where a foreign inward

investment desk, such as those operated in many European countries and the US, could have greatly assisted in setting up the foreign founders in a South African company, and enable foreign investment into the South African startup.

Such a helpdesk needs to create a positive investment and professional image for foreign nationals, especially those looking to invest into the country. Considering the above experience, such services need to be visible and able to engage with foreign nationals before the opportunity for second guessing arrives. Rapid service delivery is even more important given the international competition for both talent and investment. Help in any form when setting up in South Africa was not available as reported by the above startup.

#### 5.3e Founders and investors simply want certainty as to compliance and regulatory requirements

Regulations and compliance issues sometimes involve aspects of South African Law, and statutory bodies that are not publicly known, or typical of the ecosystem relevant to startups. The startup in question, by virtue of operating in the security industry, became aware of the Private Security Industry Regulatory Authority (PSIRA), a statutory body established in terms of a South African Act to regulate the private security industry and exercise effective control over the practice of the occupation of security service providers in the public and national interest. The founders interpreted the PSIRA regulations – being quite broad and unspecific in nature – to not apply to their startup, but nevertheless wanted to have certainty on this, to avoid any future comebacks.



The founders filed a proactive exemption application to PSIRA and endured three years of uncertainty before a response was received.



#### 5.3f The perception of Exchange Control uncertainty a deterrent to investment

Registering the South African operation as a South African legal entity would have incurred Exchange Control oversight, as the company regularly moved money between South Africa and its EU office.

Based on the above challenges, and those experienced in navigating Exchange Controls, the founders when considering investing in its South African startup, ended up investing in the foreign company as it was easier to do so, and didn't entail the potential risk of future taxation or regulatory uncertainty as was perceived to be the case by investing in the South African company.

### 5.4 Red tape and regulations keep foreign skills and investment away

Having been active in South Africa for a few years and deriving the benefits of local market access and skills, the company founders later reconsidered its decision to operate as a foreign company in South Africa. The founders built a successful business in South Africa and was more than willing to invest in the country.

On conclusion of its due diligence investigation, it made the decision not to do so and continue to operate as a foreign-owned, foreign-taxed company. In addition to the complexities and limitations, the founders felt that the purported constraints of Exchange Control and the complexities of managing the ownership and location of IP posed insurmountable challenges and costs which it did not have the appetite to incur.

In addition to the well-documented constraints of Exchange Controls, the company had uncertainty as to the impact localisation would have on its total IP position, because some IP was historically brought to South Africa by the founders. If the company was set up as a South African entity, controlled and operated locally, then new IP created in South Africa, if completely developed by, and funded in South Africa, could be considered purely South African, negatively influencing its global IP position.



Waiting two years to obtain a South African Trademark Registration, and three years for a response from PSIRA were unacceptable delays in the race to bring products to market in the shortest possible time. Such considerations, some perception, and others reality left the investors to take the route of least resistance.

In this instance, rather than investing money into the South African operation, the company loaned the money from the foreign office to the South African company, amounting to an investment loss of approximately 2 million Euros. The overall assessed GDP loss including both investment and taxes expatriated in the above way, was estimated by the company to be between 3 and 4 million Euros.

During interviews, the founders recounted several of their foreign peers working in South Africa, all opting in the same way to operate from companies set up in Europe and therefore taxed in Europe, not South Africa. So apart from not investing in South Africa, such activities were tax flow negative, not growing the South African tax base.

### 5.5 Well-meant policies have the opposite effect

Apart from the fact that we are not meeting the President's call for opening our doors to foreign startups and their Dollars, Euros and Pounds, the following two examples illustrate how South African citizens arrived at the same conclusion, namely that it was easier for them and more cost-advantageous, let alone less risky, to operate in South Africa through a foreign-held company.

A South African entrepreneur, educated in the US, returned to South Africa and set up operations in the country. However, the company itself was registered in the state of Delaware in the US, and all shareholding, IP and executive management run through the US office. The company had tremendous success, being hailed as one of the so-called African Unicorns, except, from a legal and tax point of view, was never in any way a South African business.

Another South African serial entrepreneur and investor with several years of starting, selling and investing in startups operated out of Hong Kong, despite living in South Africa.

Why not operate as a South African business? In both instances, the founders recounted the same experience of the foreign entrepreneurs interviewed for this case study, namely that it was far easier, more cost-effective, and vastly less risky, to establish, operate and seek investment as an international based company.



*"Operating as a foreign owned company is night and day compared to the challenges of doing business as a South African owned entity".*

In both instances, employment relationships in South Africa were done through third-party entities to avoid the overhead and administrative burdens of managing PAYE and ensuring statutory compliance. Similarly did both South African entrepreneurs sidestep the challenges of complying with Exchange Controls and SARS regulations pertaining to IP ownership, because the businesses and IP were foreign registered and owned.

### 5.6 Applicable relaxations in Startup Act targeting this

RELAXATION

## 1 Provide tax breaks and incentives to encourage investment in Qualifying Startups

- **Title:** Venture Capital Companies and appropriate incentives to increase access to capital
- **Startup ecosystem pillar:** (i) Access to financial capital

RELAXATION

## 2 Remove barriers that inhibit access to skilled talent

- **Title:** Employment flexibility and special skills visas
- **Startup ecosystem pillar:** (iii) Access to skilled talent

### 5.7 How will relaxations improve this?

Automatic, fast-tracked, and flexible immigration for access to, and continued retention of foreign talent, including foreign talent willing to invest in such South African business opportunities, if such recruitment and appointment is done by a qualifying startup.

### 5.8 Conclusion

A South African entrepreneur by virtue of being based in the home country and being more familiar with local conditions and engaging with government, will most probably try to navigate the intricacies of her local SARS branch, or navigate CIPC processes. For a foreign founder, setting up a business is a decision of minimising costs and time. Increasingly, the benefits of operating from an internationally owned company is becoming an option also for many South African founders.



*"The importance of migrants was underlined during the Covid-19 crisis when it was revealed that the founders of both BioNTech and Moderna, two of the companies at the forefront of the development of a vaccine against the virus, are immigrants to the United States and Germany respectively. Wharton research further elaborates on this point by pointing out that immigrant founders not only create jobs, but also bring considerable finance with them."*

*The importance of immigrants for the future of tech; Forbes Magazine.*

By not recognising the need to support foreigners in bringing skills to South Africa, whilst in parallel giving no tangible incentive for the localisation of foreign startups, South Africa is turning its shoulder on generating positive financial, social and growth benefits for our local economy, perpetuating the very principles of colonisation that such regulations and local laws claim to work against.



## 6. Need for level playing grounds



Research shows that the South African economy, dominated by large companies and multinationals, is not friendly to the products and services from small startups. This applies also to the public sector, conducting almost 50% of all procurement in South Africa, where Level 1 BBBEE is in many instances a non-negotiable for any business wanting to do continuous business with the State.

Startups don't have the financial or administrative capacity to coordinate and drive the various efforts required to pursue Level 1 BBBEE, including running schemes for skills development to earn BBBEE points; administrating compliance through annual audits and reports; or making permissible disbursements to Level 1 BBBEE suppliers. The biggest impediment though for many startups is the ownership requirement of Level 1 BBBEE, whereby a majority shareholding from black individuals, sometimes as much as 100% shareholding, is the only way to achieve this. This impedes investment as most VC investors, especially foreign VCs, don't meet this requirement. Taking on a non-black investor even when the founders are black, will further weaken or potentially obliterate the BBBEE position of the startup.

The SA Startup Act Movement respects and endeavours to uphold the principles of South Africa's pursuit of racial transformation and equality. Prioritising startup growth is not about the one or the other, but both, as growth leads to social and economic transformation. The Movement proposes that startups for the duration of meeting the requirements of being graded as qualifying startups be given automatic Level 1 BBBEE status, when accessing the supply chains of Corporate and Public South Africa. Such qualifying startups still need to comply with the provisions of Level 4 BBBEE relevant to the size of the startup business and the industry in which they operate. In this way, qualifying startups will have a better chance when competing head-on with large suppliers and foreign multinationals, whilst contributing to the transformation of the South African economy.



*"BBBEE costs us millions in terms of trying to meet the skills development requirements."*

### 6.1 Can startups truly become our future champions of industry?

The Competition Commission in 2021 published its first economy concentration tracker report, highlighting the dominance of firms across several key sectors in South Africa. The report shows a high degree of inequality in company income when considering the overall distribution of income across all tax-paying companies, says Heather Irvine, a partner at law firm Bowmans.

South Africa's private sector is often derided for monopolistic behaviour and making it near impossible for newcomers to enter the market. But startups and innovative businesses are vital to the revitalisation, growth, and relevance of any sustainable economy.

This asks the question of whether startups in South Africa are truly able to compete with the establishment and in doing so fulfil the role of innovation critical to the growth and sustainability of modern-day economies.

### 6.2 Background description to the business of the respondent

An all-female team having specialised engineering and technical skills grew their startup into a market leader in South Africa. The startup serviced both large corporate and public enterprises, finding appeal for its services and technology-based products also in the US and other international markets.

### 6.3 Death by paper: the role of supply chain rules and processes

Meeting supply chain criteria was a critical business imperative for the startup, especially those of large South African companies and state-owned enterprises. Competitors of the startup, being large engineering firms with fulltime HR departments and administrative resources, could ensure Level 1 BBBEE compliance through a combination of taking on strategically positioned black shareholders, maximising BBBEE points through skills development initiatives, and spending on BBBEE suppliers. These were not within the means of the all-female startup. The ownership portion of the BBBEE scorecard specific to the industry sector relevant to this startup, amounts to 40% of total points. Because the business - 100% owned and managed by white females - did not have black ownership, it was disqualified from achieving Level 1 BBBEE status.

The founders, investigating the possibility of meeting Level 1 requirements by selling shares to a suitable black candidate, did a valuation of the business.

The investigation showed that making available 26% of the shareholding would require an investment of R30 to R40 million. This proved the undoing of this option, as no suitable Black shareholder could be found having both the financial means to afford such a share in an early-stage startup business, whilst having the necessary skills and experience to participate meaningfully in the management of an engineering business, the latter a key requirement of

the BBBEE codes.

The startup resorted to pursue BBBEE points through skills development involving staff members and invested millions in skills development and making available staff equity. This was still not enough.

### 6.4 Supply chain policies entrench South African monopolies



*"It's almost impossible to find any senior software developers/engineers, female software developers/engineers are almost non-existent but there are substantial points for black female. That's really hard to find in our sector. And, if they do exist, they are snatched up by corporates and banks."*

Without the ability to address the ownership component of the BBBEE codes, the company was automatically capped at being a Level 4 on the BBBEE scorecard. During tender reviews, the startup was further downgraded one BBBEE level because it was penalised for having no black shareholding. Thus, the company at maximum could operate as a Level 5 BBBEE company. This, notwithstanding the Woman-in-STEM (Science, Technology, Engineering and Mathematics) startup recognised as an international role-model for gender transformation in a male dominated engineering sector.

The company growth placed additional pressure on its emerging BBBEE status as it would lose additional BBBEE points once it passed the R50 million turnover threshold.

Spending millions on staff upliftment and empowerment and having to invest substantial efforts in completing skills audits to attain additional BBBEE points did not change the outcome. Doing annual internal skills audits reportedly took as much as two months of senior executive time, requiring a separate department for compliance and completing tender applications, where compliance aspects took up most of the bidding process, rather than the technical virtues and capabilities of the firm.

The above experience served as a palpable disincentive to grow, as missing out on additional BBBEE points saw the company being automatically disqualified from supply chains with which it was already doing business.

The company at time of writing was testing a new

growth strategy to rather focus entirely on international growth, moving both its ownership and IP to the US. This would enable the company to bring onboard international investors and focus on the US market, rather than South Africa.

The startup clearly experienced how South African procurement legislation upholds the stranglehold of large companies and multinationals on the economy, by disqualifying startup firms that are not Level 1 BBBEE from participating in local supply chains.

### 6.5 Does transformation empower successful Black entrepreneurs?

Government's intention with the above regulations and compliance aspects facing this business is understandably to safeguard the South African economy from losing capital, whilst encouraging transformation. But is this really happening? Does it work?

A Black male entrepreneur participating in this research project outlined how his business, set up in the US but operating from South Africa, opted to establish an international footprint to allow for international investment. The business has been hailed in local and international press as being a new breed of African success.

Except, none of this success reverts to South Africa. The business is not seen or registered as a South African entity, and neither is the founder heralded as a BBBEE success story, principally because BBBEE is irrelevant to its operations. Local employees are employed through a Payroll Provider, to ensure compliance with labour and tax laws, and none of these, including the contributions of the founder would carry any meaningful BBBEE status.

Likewise, the founder established a Delaware based legal entity that houses both the shares for investors, and the intellectual property of the business. It has become a truly international business, with the CTO of the business a non-South African.

The impact of local visa regulations resulted in the team deciding not to employ anyone from its South African office and didn't choose South Africa as the base for further software development and R&D either, meaning that IP created by the business will not be South African.



Is this business in any way affected by South African laws and red tape? Not anymore, because the business has been set up in a way that it has no touchpoints with South Africa, despite being founded by a South African citizen, operating in South Africa.

Getting international investors into the South African entity didn't make any sense either as the ownership rules of BBBEE would have resulted in the company having no BBBEE points due to henceforth being foreign owned, despite being founded by a Black South African citizen. This, because foreign investors in tech businesses, as reported by the Silicon Valley trained founder, will never invest in a South African holding company.

### 6.6 Applicable relaxations in Startup Act targeting this

#### RELAXATION

## 4 A qualifying startup to be exempted from preferential procurement limitations

- **Title:** Automatic Level 1 BBBEE status for procurement and supply chain grading
- **Startup ecosystem pillar:** (vii) Local and global market access

### 6.7 How will relaxations improve the above?

The female founders in the last financial year incurred more than a million Rand in trying to set up its US entity to retain the arms-length agreements in place needed to ensure continuity from the South African base. The process, which has already taken up more than 12 months to conclude is still not complete. Setting up the US company from which all future contracts will be implemented entailed legal fees of only US\$ 5,000 and resulted in the immediate creation and complete regulatory compliance for its Delaware based US office.

The Startup Act proposes automatic relaxation in the extent of BBBEE scrutiny for the purposes of procurement and supply chain grading, enabling quicker access to the supply chains of Corporate South Africa and the public sector. This will directly benefit qualifying startups by (i) radically increasing the opportunities for market access, (ii) without the restraints and costs intrinsic to obtaining and maintaining BBBEE points and schemes, as well as (iii) enabling capital raising from offshore investors without risking the loss of BBBEE status when local equity is taken up by non-South African investors.

## 7. Best to stay small: Size matters in South Africa



South African legislation and regulations contain special provisions appropriate to small enterprises, recognising the potential value such businesses hold for the national economy in so far as job creation and transforming the economy. These provisions dissolve once a small enterprise grows beyond the demarcation for small firms based on turnover, jobs, and capital base. On exceeding these demarcations, such businesses will be subjected to the normal regulations and requirements intended for large and multinational firms.

Many founders have chosen to forego growth, to rather stay small to avoid the punitive effect of losing its small enterprise status.

The SA Startup Act proposes that small firms meeting the requirements of the Startup Act be given the opportunity and time to grow into meaningful businesses without impeding regulations and administrative barriers intended for large established businesses.



*"If you want to stay and work in South Africa, then you have to play the game of dodging regulatory hurdles by remaining small and nimble."*



*"Local regulations, especially in regard to tax and BBBEE compliance, are forcing us to turn into something we don't want to be."*



*"It was the combination of inefficient tax (via lack of African Double Taxation Agreements, high corporate tax and lack of investor tax incentives); Exchange Controls (and associated loop structure issues); trapping of IP; and rigid visa regime (making it difficult to attract offshore skills needed). Each of these individually make SA uncompetitive. Add them together and we are nowhere. All these need to be addressed urgently if we want SA to become a competitive location for building tech businesses."*



High-growth startups, especially those commercialising new technology, continue to grow for longer periods than that of non-tech enterprises such as guest houses and franchises.

The legal and regulatory protection in South Africa Law disappear once the demarcated thresholds are crossed. When this happens, small firms must comply with the same regulatory and statutory obligations applicable to large and established firms. In the case of high-growth firms, losing this protection vital to growth, comes at a time when the firms are still midway in their growth trajectories, impeding, or even completely disrupting such growth.

This effectively functions as a disincentive for the very growth sought from small firms, as the founders choose to forego the opportunity for further growth in exchange for avoiding the often punitive and very costly impact of losing its status as a small firm. These decisions in one way or another undercut the very objective of supporting and nurturing small firms, namely, to create social and economic value to the country through the growth of small enterprises.

#### 7.2 Background description of the subject's business

A local software development house over the years positioned its products and services for payroll and customer relationship management amongst leading large enterprises, both locally and internationally. It did so through a portfolio of small companies managed through a holding-company structure. The main business at time of writing employed serviced clients in 20 countries, many of which were in Africa.

#### 7.3 Experience vis-à-vis red tape and regulatory burdens

In the quest to establish footprints in key markets, the company historically undertook the sale of part of its business rights to penetrate a foreign country market. Following an unsolicited offer, a portion of the South African business operating in the overseas country was sold at a very good valuation to investors based there.

The founders never contemplated the need to ensure a globally robust corporate structure, being up to that time a wholly owned South African operation. Compounded by the fact that this happened in a relatively short period of time, the founders were unaware of the financial and tax implications involved in a South African entity disposing its assets offshore. The company, unwitting to the South African tax implications of

doing the deal, ended up with a tax liability far exceeding expectation. The founders in hindsight felt they would have reconsidered the entire transaction, had they at time of investment been aware of the costs of doing so.

The company, at significant cost to the founders, since restructured the business by creating different units and setting up an international holding-company in Mauritius.

The business saw a steady growth in staff numbers because every new client required the appointment of additional support staff. The founders quickly realised that a significant downside to growth was the impact that labour and workplace laws had once the threshold for staff numbers surpassed the demarcation for small enterprises. Responding to this, the founders steered a course whereby they would create new subsidiaries or completely independent businesses, every time one of these got to a point that it would exceed the SMME demarcation.

Staff growth was not the only challenge. The business's BBBEE status was critical for procurement purposes because the company sold its products and services to large South African companies, including government. However, because of the ownership aspect of BBBEE, the company opted to remain "small" since labour law implications became punitive once the company crossed the R 50 million turnover mark.

For this reason, the company again opted to create affiliates rather than keeping growth in the main business. This required additional efforts and administrative overhead but was felt a better strategy than having to jeopardise its BBBEE status made possible by meeting the size attribute for Qualifying Small Enterprises.

Qualifying Small Enterprises (QSEs) are part of one of the categories of South African businesses as per the Broad Based Black Economic Empowerment Act. QSEs may automatically achieve Level 4 BBBEE status if meeting the size, turnover and/or capital demarcations stipulated by the DTI,

The initial sale of a stake in the business was therefore just one of the reasons why at time of writing, the business operated several legal entities housing the various interests of the combined business.

Coming at a significant cost to the founders, the above shows that many South African founders intentionally keep their startup businesses small in the effort to eschew the wrath of regulations and costs associated with large and established businesses.

#### 7.4 Unproductive capital and time wasted in the effort to avoid red tape

The first impact is the extent to which founders incur unproductive capital and management time in having to create multiple legal entities, each with its own shareholding, governance, financial and tax administrative requirements, simply to stay under the radar. Such startups are less profitable by virtue of wasting money on non-productive administration, but more importantly, are their founders hampered in their abilities to create jobs.

The second impact relates to the South African imperative of fostering the growth of valuable companies. When companies through competitive products and service, and job creation grow to become valuable, they generate shareholder wealth. Bigger dividends and more profits mean more taxes for the South African fiscus. Jobs address unemployment and local positions strengthens the local tax base.

#### 7.5 Staying small a deterrent to investment and alienates global suitors

By artificially keeping startups small, South African startups are less likely to reach their potential value. The founders of the above startup know this well. They would ideally like to have developed the business into a software powerhouse like its international competitors, as this would drive up its valuation and create lucrative future exit opportunities such as appealing to the interests of a large player in the global CRM and Payroll market.

But because it kept the different businesses small to reduce the regulatory overhead and associated operational burden, the overall business holdings were less attractive and difficult to market to local and international suitors. Notwithstanding growth in profits due to world-class software products and services to an international clientele, it had to date not been able to convince anyone to invest in its disaggregated and complex business structure.

## 7.6 Applicable relaxations in Startup Act targeting this

### RELAXATION

# 1

**Provide tax breaks and incentives to encourage investment in Qualifying Startups**

- **Title:** Special tax dispensation for qualifying startups to increase availability of financial capital
- **Startup ecosystem pillar:** (i) Access to financial capital

### RELAXATION

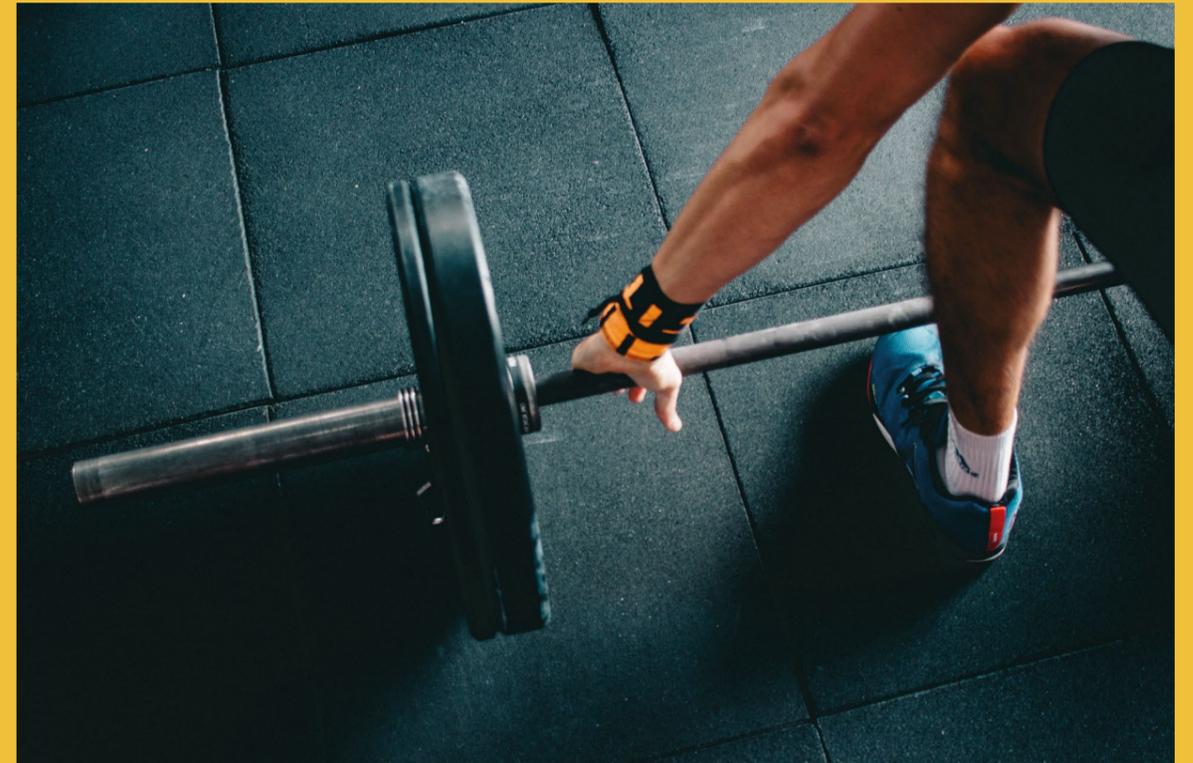
# 4

**A qualifying startup to be exempted from preferential procurement limitations**

- **Title:** Automatic Level 1 BBBEE status for procurement and supply chain grading
- **Startup ecosystem pillar:** (vii) Local and global market access



## 8. Play to our strengths



The South African economy offers startups the opportunity to leverage affordable skills, a diverse and sizeable marketplace, and world-class talent streaming from globally recognised academic institutions. It offers opportunities for innovation and bringing new ideas to the market. Collectively, these attributes combine to give South Africans a foot in the door for competing for global market and capital.

The South Africa Startup Act in recognising and valuing these attributes, aims to remove the barriers that are forcing some founders in the pursuit of accessing global markets and capital, to completely offshore their businesses. By enabling South African startups to operate globally without the need to relinquish their South African ownership or citizenship, the Act through its relaxations aim to empower our founders to create job opportunities for South Africa's youth, and grow our own tax base, addressing both employment and creating resources with which to fund social and economic development.

### 8.1 Startups can leverage the SA cost-base and take on global markets

Harvard Professor Michael Porter made famous the value of clusters and the role these economic hubs play in forming world-class competitive centres able to drive social and economic development. Policy makers in South Africa over the years heeded Prof Porters' advice and incentivised the growth of our own clusters: automotive hubs in Rosslyn, Durban, East-London and Gqeberha, as well as the new hydrogen Platinum Valley Corridor project spearheaded by the Department of Science and Innovation.



In a global market, to stay relevant and compete for relevance, countries across the globe have had to find their own defensible competitive advantages.

More than our minerals and resources, South Africa is blessed with talented people, having a knowledge sector that annually yields and leverage large numbers of highly skilled and qualified people, graduating talent at a fraction of the cost compared to the US and Europe.

Similarly, as evidenced from SAVCAs annual VC surveys, do South African startups require less capital when starting up new enterprises compared to their international peers. Together, these two aspects, against the backdrop of a well-run economy, globally recognised financial markets, and an English-speaking business culture enable our entrepreneurs to take on international markets and competitors.

The role and value of high-tech clusters have been documented ad infinitum and are clearly visible in the successes of global hubs including Silicon Valley and the manufacturing successes of the East. Can we do the same in South Africa?

## 8.2 Background description of the subject's business

South Africa, blessed with good weather and a healthy appetite for sport offers an enviable assortment of sports grounds and training facilities. Tapping into this, South African founders in 2014 saw an opportunity for an easy to use and scalable solution for the management of sports facilities. The system lets the owners of the facilities generate higher profits through more efficient and productive scheduling of usage. The founders were able to secure initial capital with which to build the first product, receiving a relatively small financial contribution from the proverbial family, friends, and fools, being the friends and networks of the founders.

The founders quickly charmed the South African market, helping their clients to generate increased profits whilst offering a better all-round experience to the end-users. They then realised that the solution had global potential and next targeted the United States, the US having the largest number of sports facilities suited to the app.

Operating in the United States as a South African based company proved difficult and costly. Apart from the need for sports management solutions to be in the target market to service the customers, it necessitated the hands-on support demanded typical of the target market. Compounding this were the challenges of expanding the marketing and sales side of the business from a relatively viable but small South African market to a global behemoth that is the United States.



Marketing to sports facilities in the US required on-the-ground sales personnel, paid in US dollars, and having dollar-based expense accounts.

This, over and above the costs of flying between South Africa and the US quickly saw the need for more capital, especially to fund market uptake in the US. The founders secured an additional round of capital, building on the initial investment of roughly US\$50 000.

The startup strategy involved using the South African market to test and prove its technology, getting ready for rapid scalability. It quickly found itself in an enormous growth market with ample opportunity to expand. It had no difficulty adding new clients, endowed with technology virtually able to sell itself. The question of funding the rapid expansion of the business soon came up again, with the original investors showing interest in putting more capital into the business.

## 8.3 International investors lose patience when subjected to uniquely SA rules

Already at the time of the second investment round, again made up mostly of angel investors, the issue of the location of the company's intellectual property, and the need to engage with Exchange Control regulations became significant concern. The first question current and prospective investors posed to the founders, were the issue of where they (the investors) would be exiting from if the Intellectual Property was still based in South Africa.

Further to this was the question of overcoming the practical and operational challenge of raising money in South Africa whilst disbursing the money outside South Africa. Making such payments – such as paying foreign workers' salaries, contracting with service providers, and funding the US and global marketing campaign – required significant administrative overhead to every time having to explain typical day-to-day disbursements to the agents of the South African Reserve Bank, custodians of South Africa's Exchange Control regime.

The founders and their investors realised that the business model should rather be flipped on its head: surely it would make more sense to use the strong dollar as an investment vehicle and then fund the relatively lower cost expenses through the South African base? In other words, raise money for the US operations in the US or in a dollar-friendly jurisdiction; pay US sales and marketing expenses in US dollars; and capitalise the South African development hub where the company had a clear cost advantage.

Variations of this "obvious" business model appeals to many South African entrepreneurs, building on Porter's model of leveraging local competitive advantage by building technology in South Africa,

and then competing internationally by selling products and services and earn foreign revenues in global markets. Theory and practice don't always align.

## 8.4 Operating a dual South African and foreign legal structure is complex and expensive

The company, in the context of Exchange Controls and the need to solve applicable regulations, was advised by its legal team to set up a stapled structure. Accordingly, the business established an offshore company in Ireland with the exact same shareholding as that of the South African company. New capital was raised in the EU-based company, with which to fund international operations, being mostly payments to the US market. By doing it this way, the foreign owned company was able to make payments without needing South African Reserve Bank approval, as the payments used foreign investor capital invested into a non-South African legal entity.

IP ownership posed a significant additional challenge. A primary concern when dealing with Intellectual Property is the issue of ownership: where and by whom it was created? For this purpose, IP ownership could still be deemed South African if all the development effort was undertaken locally, even if it was funded entirely with foreign capital.

The issue of IP ownership is critical not only because of Exchange Controls viewing IP as a form of capital, thus regulated through Exchange Controls, but also from a tax point of view. IP – thus capital – may increase in value once it is used to derive revenues, such as through royalties from licencing, or through its contribution as goodwill to the overall valuation of the company. This may trigger capital gains tax and, in some instances, have seen South African founders having to pay CGT to SARS upon assigning SA IP to the foreign-held company, at a time when the IP was not yet fully developed, and earned no revenues.



Founders, in the pursuit of capital to grow their businesses, end up having to find money to pay tax as a precondition to getting foreign capital?!

Absolutely and upfront certitude on this matter is not about tax avoidance, but about clarifying the path to exit for investors in the initial assessment of the financial viability of deploying its capital.

In the instance of the investors featured in this case study, the prospect of having to incur additional and unforeseen tax in a domain in which it wasn't even invested in in the first place, raised red flags even before the investment was presented to the investment committee.

The mix of Angels invested in the company involved non-South African individuals. During the third round of investments, the capital requirement became such that it could not be met through individuals. The company engaged several South African and international venture capital firms.

The investors were offered an investment that would see it put capital into a non-South African owned legal entity, where the entity held an exclusive licence to the technology from the South African company. The licence was needed since mostly all the IP was still owned by the South African head office and the founders were not yet able to obtain approvals to assign the IP to the foreign based company.

The non-South African investors were clearly not favourable towards investing into a company that held a technology licence, rather than being the outright holder of the IP rights, even less so as the licence was held in South Africa, a non-US and non-EU legal territory.

Likewise would an exclusive licence still require Exchange Control approval. All the above impacted directly on the business, both in needing additional disbursements required to pay for and manage Exchange Control applications, but also due to double valuations for the staple structure and duplicated administration of the dual company domiciles. Double the legal and accounting fees; double the administrative and financial staff time including salaries; and significantly, added opportunity costs.

A further impact, considerably more costly, was the risk premium assigned by investors to the transaction, to offset the risk of investing within the context of Exchange Controls, dual company structures and the overall political and economic risk profile of South Africa.

## 8.5 Local jobs and opportunities lose out to the demands of the global market

Together, the above impacted on the job creation opportunity for the startup, as it was not able to attract as much capital as it felt it could. This remains a conundrum for the founders, keen on operating from South Africa, as it continued to seem more feasible and desirable to shift operations and ownership to the foreign part of the business, rather than doing it in South Africa.

The company thus far managed to retain the largest part of its development skills in South Africa, because the cost advantages of paying for local software skills outweigh the cost benefits associated with moving the entire business offshore. This may not be the case in the long-term as the cost and complexities of managing the stapled structure are constantly questioned by foreign investors not otherwise incentivised to entertain South African loyalties.

### 8.6 Applicable relaxations in Startup Act targeting this

RELAXATION

3

**Remove inhibiting regulatory barriers that hampers globalisation and investment into qualifying startups**

- **Title:** Address Exchange Control Limitations
- **Startup ecosystem pillar:** (iv) Conducive regulations and the appropriate regulation of business activity relevant to startups



## 9. It's not always about the red tape



Establishing business interests in overseas markets is not always about finding bigger markets. Occasionally, customers are simply not present in the startup's own market. The demand for products, services and capital obliges founders to locate their businesses close to customers and investors, which can mean having to relocate the actual business to a foreign country. This is a natural aspect of the global marketplace and applies equally to South African startups.

By removing the barriers of Exchange Control and the limitations in the current dispensation relevant to assigning Intellectual Property to offshore entities, the SA Startup Act aims to facilitate the ability of South African founders to use local insights and market opportunities to tap into opportunities anywhere in the world.



*The purpose of a business is to create a customer*  
Peter Drucker

### 9.1 The business of business is to service and follow its customers

Targeting foreign markets is not always the result of trying to tap into larger markets or seeking better valuations from foreign investors. Customers and niche markets discovered by South African entrepreneurs are sometimes found only in other countries. Founders must set up shop in foreign territories driven by access and proximity to such markets, including accessing critical technical skills.

## 9.2 Background description of the subject's business

A South African startup active in a niche field of science developed a truly unique line of products. The company founded four years ago already sold its products to leading high-tech manufacturers around the globe.

Most of its clients were based in the US and EU with some in the East. The company had no clients in South Africa and used South Africa as its design and production base purely because the founders were all located here. The demand for the company's products increased to the extent that its production facility was not able to keep up. It prompted the founders to look for an investor to help it fund a larger production facility.

The company founders have had previous successes in creating startups in South Africa, and are well-known amongst local investors, having had South African investors in previous successful ventures. However, because the local community involved in this science niche was extremely small, local investors pulled up their noses. They did not understand the global market for products based on this alcove of physics.

Therefore, due in large part to the nature of the company's products, and the location of the major markets for its products, the company reached out to European and American investors. The number of players in this niche market was such that the local governments in said countries quickly got wind of the company's interests and reached out to encourage them to set up production facilities in their respective countries.

This made sense to the company, as the skills pool relevant to the design and scaling of the company's products were to be found in the same regions.

## 9.3 Choose between allowing foreigners to South Africa, or founders moving offshore

This case study has been included for the sake of demonstrating that companies must make decisions about taking on foreign investment, not only for the sake of minimising the impact of uniquely South African regulatory burdens such as Exchange Control, but founders ultimately must follow the market based on purely market related dynamics. In this case, proximity to skills and production offset.

One of the sub-contractors of the startup, being a main contributor in recent development efforts was based in a European country. The choice for sub-contracting the individual on an arms-length basis, was because the startup found it impossible to arrange a foreign skills visa for South Africa.

If the founders were able to obtain foreign visas, this individual would have moved to the South African design hub. The knock-on effect based on the need for highly specialised support personnel was expected to see the company training, and recruiting local experts in the field.

## 9.4 Setting up overseas should not have to involve relinquishing citizenship

*"The primary market we serve is in the US. Operating in a foreign jurisdiction as a South African start up business (where revenues are yet to be established, but ongoing costs high), without being able to move capital abroad easily in order pay for operating activities has been extremely challenging and has forced us to create an offshore company to raise capital in transact from."*

This scenario is not unique to this company, as many startups across the globe are moving a part or all of operations to be based in the target market, or in the country where the main investors are based. However, what is unique, is that by taking on international investment, this company had no choice but to do so in a way as to completely isolate its operations and future design activities from South Africa, failing which Exchange Control limitations and future IP ownership may hamper its ability to attract international capital.

So too were the founders reportedly looking at emigrating to the future base of the firm, as doing so would qualify them for support incentives and grants which preferencing citizenship in the target country. In the pursuit of this strategy, the probability is that

the future ownership of the business will be completely non-South African, meaning that future IP including profits derived from products developed from such IP, will not be due to South Africa. Similarly, will the employment and spending on

third-party suppliers benefit the offshore tax position, and not that of South Africa.

## 9.5 Applicable relaxations in Startup Act targeting this

### RELAXATION

# 2

## Remove barriers that inhibit access to skilled talent

- **Title:** Employment flexibility and special skills visas
- **Startup ecosystem pillar:** (iii) Access to skilled talent

### RELAXATION

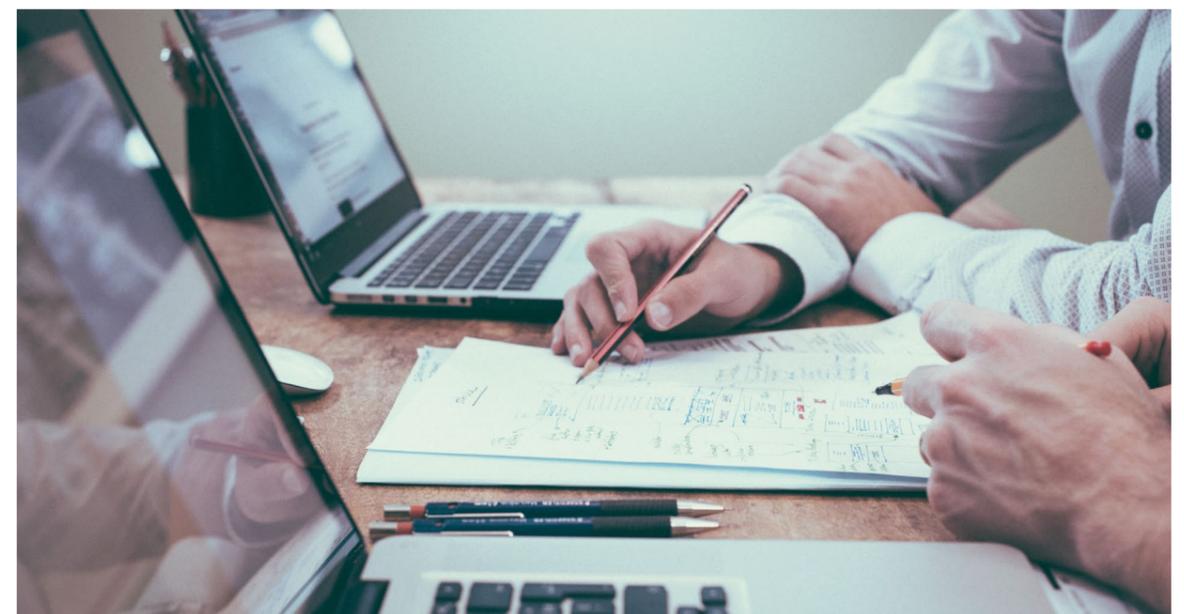
# 3

## Remove inhibiting regulatory barriers that hampers globalisation and investment into qualifying startups

- **Title:** Address Exchange Control Limitations
- **Startup ecosystem pillar:** (iv) Conducive regulations and the appropriate regulation of business activity relevant to startups

## 9.6 How will relaxations improve the above?

Automatic, fast-tracked, and flexible immigration for access to, and continued retention of foreign talent, including foreign talent willing to invest in such South African business opportunities, if such recruitment and appointment is done by a qualifying startup.



# 10. Put the baby back in the bathwater



South African founders report difficulty when accessing global capital markets, due to (i) representing an emerging market located far from international investors, and (ii) having to overcome the constraints of South African Exchange Control regulations. But South Africa has working and effective capital markets including - as demonstrated by the recent uptake of the Section 12J tax incentive - high-net worth individuals willing and able to back South African founders.

The SA Startup Act calls for appropriate incentives with which to channel South African capital to our future entrepreneurs. This can be achieved by applying the lessons from the South African 12J experience, as well as similar incentive programmes offered in startup-friendly tax jurisdictions like India, the UK, US and Tunisia.

## 10.1 Mobilising local capital to fuel our future economy

Most of the accounts from South African founders, many covered in the preceding case studies, outlined the need to pursue foreign investors to fund the scaling of their startups, and position the founders to tap into global markets.

South Africa, with a larger GDP than Finland, the world's leading innovation economy, is blessed with enviable capital markets. Local VC fund managers - according to the 2022 South African Venture Capital Association survey - at the end of 2021 managed a combined portfolio of just over R8bn, with R1.3bn invested into early-stage startups in 2021. Other asset classes such as South African Private Equity have assets well over R 200 billion; the South African pension fund industry in 2020 was estimated to include assets worth USD 157 billion.



South Africa does not have a shortage of risk capital.

Surely then should South African founders be able to tap into such envied resources especially given the difficulties they experience when trying to access foreign capital?

Also, why should foreigners back South African founders if South Africa, clearly rich in mineral wealth and having enviable capital markets won't invest in its own people?

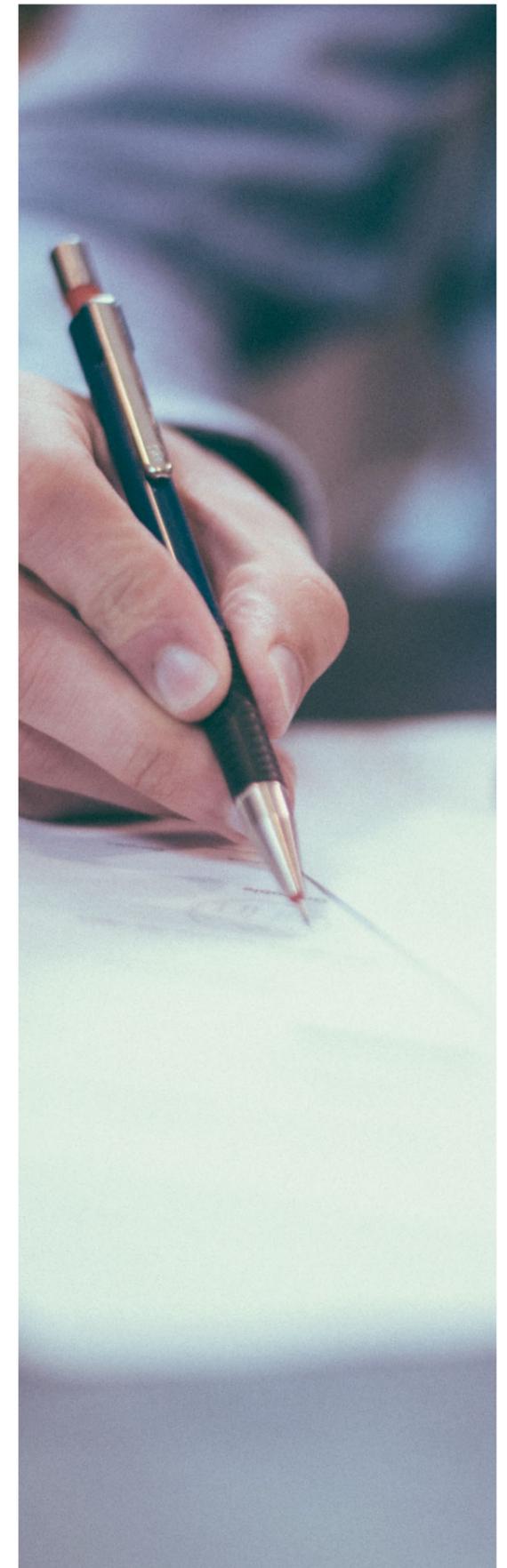
## 10.2 Background description of the subject's business

R12 billion was raised from private investors between 2017 and 2022 through the so-called Section 12J tax incentive. The incentive, intended to channel investment by private high-net worth individuals to South Africa's entrepreneurs through a special-purpose tax concession, was one of the most successful ways in which private money was raised for venture capital investment in South Africa. This is evident from the 2021 Budget Review, based on information obtained from 100 VCCs and 360 qualifying companies. It showed that:

- R 5 billion had been invested at VCC level (on which a 100 per cent tax deduction was applicable), with R4.2 billion invested at qualifying company level.
- The total tax contribution from qualifying companies was R 207 million for 2019/20, half of which was VAT.
- Qualifying companies employed 8 239 people, of which 4 035 people were in direct employment. In total, only 37 per cent of qualifying companies added new jobs after receiving VCC funding.
- Over 50% of the investments appeared to be in low-risk moveable asset rental structures, low-risk income-producing investments and guaranteed-return real estate investments.
- Since 2015/16, total tax revenue foregone due to the incentive was R1.8 billion, of which R1.7 billion went to individuals who had a taxable income and VCC investment above R1.5 million per year.

National Treasury in 2021 announced its decision to discontinue the incentive following its own review of the impact of the incentive.

One of the Venture Capital Companies (or VCCs) registered to access the tax incentive disclosed the impact this incentive had on its business and the outlook for entrepreneurs seeking risk capital in South Africa.



### 10.3 Yes, we sinned. But failure is the 1st step to getting it right.



*“Do not judge me by my successes, judge me by how many times I fell down and got back up again.”*

Nelson Mandela

Despite addressing various loopholes identified through Treasury and SARS reviews and addressing weaknesses in regulations relating to the types of allowable structures and investment opportunities, Treasury still insisted on its decision to discontinue the incentive.

Doing so left a complete absence of any incentives with which to attract more money into the early-stage venture capital class, a very significant impact given the fact that there is effectively no investment by South African institutional investors such as the pension funds or insurance industry in this important asset class.

Industry players and fund managers benefiting from the Section 12J scheme appealed to Treasury to reconsider the incentive, but to no avail.

National Treasury did not appear to want to invest further time and effort to revisit the lessons learnt during the implementation of the Section 12J incentive, as the cost to the National Fiscus was deemed too high to justify the returns, or short-term impact.

This, at a time when total debt redemptions for state-owned companies, including Denel, the Road Accident Fund, SAA and others was expected to average R33.1 billion a year over the medium term. But investing in startups and entrepreneurs is not about creating debt: it is about building the future South African economy.

### 10.4 Count the lessons, not just the money spent on the tutors

One of the leading Venture Capital Companies (or VCCs) drawing on the incentive was interviewed for this research project. The fund manager remained stunned in Treasury's decision to discontinue the incentive, not only because of the costs and efforts invested by local fund managers to set up structures in compliance with the Section 12J incentive, but because of the benefits to the economy, as perceived by the fund manager in question.

#### 10.4a 12J proved that South Africans remained keen to back their entrepreneurs

The fund manager reported that the 12J tax incentive demonstrated that there was an appetite amongst South African taxpayers to invest in the country's entrepreneurs. Yes, there were areas that could be improved, but this should have been addressed as an iterative process rather than an all or nothing decision.

With thousands making use of the 12J allowance, the fund manager forecast that wealthy individuals drawing on the incentive will move this money to other investment opportunities that are not based in South Africa. Apart from losing money to the fiscus, local South African entrepreneurs will be excluded from a capital source that was one of the few options available amidst a highly constrained and thinly spread local early-stage asset class.

#### 10.4b 12J slowed the brain-drain amongst young black investment professionals

The fund manager, a role-model and mentor to many investors, saw the incentive as an effective way to get young and inexperienced fund managers into the asset class, with the largest cohort qualified from SA universities black and previously disadvantaged individuals. In his experience, such individuals, regardless of race, were faced with limited local employment opportunities in the investment class and were rapidly going offshore to seek employment.

Apart from making available funding to early-stage businesses to obtain investment in South Africa, by South African investors, a major impact of 12J in his view was that it created an opportunity to slow the brain drain, 12J offered young fund managers and those interested in the asset class an opportunity to ply their trade in South Africa.

#### 10.4c 12J created a much-needed audit trail that enabled measuring impact and accountability

An important benefit of the 12J regime, as seen by the fund manager, was that VCCs created a great audit trail to ensure compliance, not historically a trait of a sector having few regulations and no requirements for public disclosure. He experienced through some of the products offered, that VCCs helped with addressing many of the challenges South Africa faced, including the current crisis facing the energy sector. VCCs were forthcoming in rapidly deploying equity into several successful ventures that brought new and renewable energy to the South African grid.

#### 10.4d Decline in fund-raising successes post 12J

The impact since the sunset clause kicked in is palpable, with very little new fund-raising activity reported in so far as stimulating and

backing South African fund managers.

At the time of writing, funds raised through the Section 12J incentive were winding down. In the absence of incentives, the fund manager could not see any way in which returns would be reinvested in South Africa, as the 5-year window to have return funds closed would see funds taken offshore to tap into higher returns not currently available in the South African economy.

Now, South Africa is left in the cold without any way to compete for taxpayer incentives against the rest of the innovation economy.

### 10.5 Turning off the supplies at a time when our entrepreneurs are stepping up

South African investors registered more than 100 Venture Capital Companies (VCCs) with SARS during the time of the tax incentive. This was one of the biggest injections of personnel and capital into the early-stage venture capital asset class and resulted in substantial investments into early-stage startups.

#### RELAXATION

# 1

**Provide tax breaks and incentives to encourage investment in Qualifying Startups**

- **Title:** : Venture Capital Companies and appropriate incentives to increase access to capital
- **Startup ecosystem pillar:** (i) Access to financial capital

### 10.7 How will relaxations improve the above?

The relaxations call for incentives that will result in increasing access to capital for early-stage startup enterprises. This can be achieved through a new incentive scheme, or by revisiting the lessons from the Section 12J incentive and implementing an improved programme, or a combination of both.

The 12J experience demonstrated the need for clarity and clearly demarcating asset classes and investment categories targeted by the incentive.



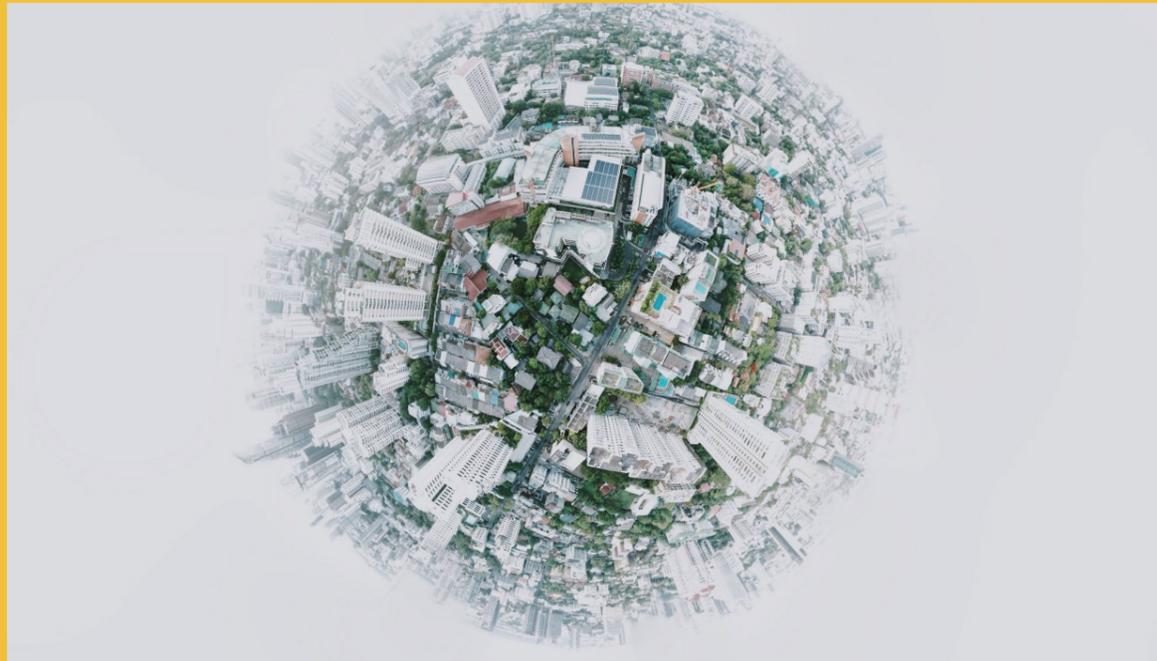
Since its discontinuation, no new venture funds have been formally registered.

The impact of the above extends not only to the investors and the subsequent loss of local startup capital made possible through the Section 12J VCCs. In light of incentives offered by other countries, some startups have moved their R&D from South Africa so that they can benefit from large scale grants for R&D, many of which are pre-revenue.

Some countries offer incentives to angel investors in recognition of such high net-worth individuals play in supporting entrepreneurship and backing founders during the early stages of their startups. The African Business Angel Network (ABAN) offers to double up on Angel investor money across Africa and pay the incubator that originated the investment 20% for their work.

### 10.6 Applicable relaxations in Startup Act targeting this

# 11. The World is your an investor's oyster



Capital access and international capital flows don't impede South African investors from backing new ideas and businesses anywhere in the world. In the competition for capital, South African founders are at the back of the line, sometimes even amongst South African investors, because of the comparative complexities they bring to investments.

By removing the complexity and uncertainty presented by startups in having to comply with South African regulations such as Exchange Controls and IP assignment to offshore entities, South African founders will be able to compete on level terms for international capital, including that offered by local investors.

## 11.1 Investment in startups is a global game



*"The UK government kept us alive during the pandemic. We are now 50 engineers strong after three years in business. We tried for months in South Africa, but nothing materialised. In the UK we received funding in minutes."*

## 11.2 Background description of the subject's business

An early-stage venture capital firm based in Cape Town and operational for more than fifteen years oversees a portfolio comprising deals based in many non-South African jurisdictions. The fund manager operates an international investment portfolio, having co-investors into individual deals made up of South African and non-South African investors alike.

## 11.3 Red tape affects the founders more than the investors

The fund manager mandate, set by its limited partners, was to invest for the purposes of securing returns in deals involving scalable technology. The mandate did not limit the investor by geography, seeing it able to conclude transactions in various countries across the globe. Although being based in

South Africa, it is not limited to making investments into South African domiciled opportunities. Given easy access to local and international deal-flow, the investor has not had difficulty in meeting its investment mandate. Rather, in the view of the investor, is it South African founders, not investors that are plagued by South African regulatory constraints and red-tape.

Accordingly, the investor reported that it did not experience a drop in investable deal-flow. It did however mean that fewer local transactions were considered because investing in non-South African deals involved less complexity and lower costs in comparison to South African domiciled opportunities subjected to local regulatory burdens and red tape.

This was not always the case, as the investment firm was originally founded with the intent to invest specifically in the South African startups. However, in doing so, the investor experienced various challenges, not only in so far as itself having to monitor the scope and impact of local regulations, but more so due to the challenges faced by local startups in having to secure regulatory approvals and overcome red tape.



*"We participated in various workshops and other consultations with SARB and treasury on Exchange Controls via SAVCA in 2015 and 2016. SARB was always keen to participate in these sessions, but the regulatory amendments never live up to the ask and eventually we just decided that it was pointless to continue participating in those programs. We just invest offshore and will look at SA startups again if this is ever fixed."*

## 11.4 SA founders bring more baggage to deals than their foreign peers

### 11.4a Investing in SA startups take up more time and costs for investors

The above impacted the investor on two main fronts, being extra time needed to review proposals that involved lengthy efforts needed in obtaining Exchange Control approval, and secondly wasting time and money in conducting due diligences only to realise that

the candidate was not properly structured and/or ready to engage regulators, both critical when needing to engage SARB for Exchange Control approval. In some cases, proposals involved business models that in the eyes of the investment team would never meet the approval of South African regulators, and thus had to be rejected.

As an investor, having to review numerous investment pitches, many of which were not from South African startups, the key determinant was the amount of additional uncertainty associated with investing in most South African startups: will the startup be able to obtain the necessary regulatory approvals? This compounded the existing investment risks associated with this early-stage investment class.

The investor reported having to assess each opportunity on a case-by-case basis even before initiating any due diligence, reason being that the circumstances of each startup was different, and the regulatory approvals and processes required startups to engage on a one-by-one basis with the applicable regulatory authorities. Not able to streamline this process added to the extra time and effort needed to engage with South African founders.

Operating with very small teams having limited capacity, the time and financial impact from SA deal-flow started influencing the choice of deal-flow and the way in which investment targets were graded.

### 11.4b South Africa is classed no different than all other high-risk emerging markets

The primary issue reported by the investor is not the perception shared by regulators that startups want to take their IP away from South Africa, or that they are preoccupied to seek better tax dispensations for the founders.

Investors want deals that offer regulatory and go-to-market certainty.

The same holds true for international investors in their views towards emerging markets. South Africa, categorised as an emerging market is considered by international investors as being no different from any of the high-risk investment territories associated with emerging markets



*"We are all grouped as high-risk, even if we think we are different."*

Regulatory uncertainty pertaining to the complexities of navigating Exchange Controls or setting up loop structures for IP ownership are not helping our case as an investment destination.

The above complexities have seen the local VC investor deprioritising local proposals and allocating its time and capital to foreign based opportunities. But from this investor's point of view, the choice of not investing into South African based companies is not really because of such local complexities as Exchange Controls and BBBEE.

**11.4c Investors want founders to domicile in trusted domains or where they are based**

As outlined in other case studies, startups the world over when raising international investment and penetrating large markets such as the US, UK or Europe, end up setting up companies in the markets where they either intend to raise international investment, and/or where they plan to base their operations, thus creating companies in the US, UK or Europe.

The investor, managing deals based locally and in the United States, strongly felt that even if South Africa dropped Exchange Controls in its entirety, and made it easier to move and assign IP, that international investors would still not invest in South Africa companies, as they would require startups to domicile in a territory in which the investor had operations.

Roughly 93 percent of 2022 initial public offerings in the United States were registered in the state of Delaware. Furthermore, Delaware is home to almost 67% of all Fortune 500 companies.

In other words, it's not really us, it's them. In the ways of the world, the one with the money is the one with the last say.

It therefore does not matter how much South Africa improves its investor-appeal, local companies, or any startups for that matter that want to operate in a non-South African market, will have to domicile in that market.

Therefore, Exchange Control and other regulations need to empower SA founders to set up international businesses easily, quickly and without incurring excessive legal and other costs.

One of the concessions made by the South African Government, was to delegate to the candidate's banker (being registered South African financial institutions), the approval for the movement of money from a South African business to an offshore beneficiary. This was intended to reduce the waiting times for applications to the SARB, believing that the financial institutions would be faster in processing such transactions.

The reality, as reported by the investor, is that the South African banks don't receive such requests on a regular basis, meaning that it also has to be handled on a case-by-case basis, which it ends up taking very conservatively as it is not the main business of the bank and many banks frown on the potential risk this poses for risk of running afoul of SARB regulations for a single transaction. Furthermore, because of the nature of Exchange Control transactions and loop structures, such applications to local financial institutions challenge the availability of skilled and experienced individuals able to interrogate the legal structures involved in such deals. The approvals are therefore still taking too long.

A case in point for the investor in question, is a R 5 million startup deal into a South African company that was cancelled during 2022 because the necessary regulatory approvals were not made forthcoming from the startup's banker. So even before the startup had the opportunity to engage with the SARB for regulatory approval, it got stuck because it could not pass the ExCon desk of the bank in question.

**11.5 Need to back our own before putting hands out to foreign markets**

By the end of June 2022, the investor in question reviewed more than 820 startups over the past three-year period. 20% of these were South African with the balance of proposals domiciled internationally. The Investment Committee of the Cape Town based investor ended up not making a single investment into any of the South African startups.

**11.6 Applicable relaxations in Startup Act targeting this**

**RELAXATION**

**3**

**Remove inhibiting regulatory barriers that hampers globalisation and investment into qualifying startups**

- **Title:** Address Exchange Control Limitations
- **Startup ecosystem pillar:** (iv) Conducive regulations and the appropriate regulation of business activity relevant to startups

**11.7 How will relaxations improve the above?**

South African Exchange Control impacts startups mainly on two fronts, being the repatriation or offshore movement of South African intellectual property, and secondly limitations placed on the amounts of money moved offshore.

The Startup Act calls for automatic approvals, and amnesty from current and future Exchange Control regulatory actions or pursuits against the startup that may impact negatively on the legal status of the assets in question; and through granting amnesty, maximise the portability, commercialisation, and investment into South African intellectual property.

In addition to the above, the Startup Act calls for the removal of limitations on, and automatic Exchange Control approval for the movement of money by a qualifying startup to finance the expansion of its South African operations in other markets. This could include the offshore movement of money to cover the costs of employment in other markets as well as other working capital costs involved in setting up branches, offices and operations in other countries.

It is additionally proposed that the Startup Act include the following two specific interventions in regards to Exchange Control:

- Extend permissible loop structures for startups and high-growth firms to allow them to raise international capital by creating a



noncash-settled share swap at market value that would not require pre-approval from the South African Reserve Bank, but rather reporting after the transaction.

- IP transactions for exchange control purposes should be aligned to a reporting framework rather than the current pre-approval model. Such reporting should be done within 30 days of the transaction's effective date. Furthermore, transactions between unrelated parties should not require reporting or approval, as reporting would be included in the tax framework.

## 12. Context for supporting the SA Startup Act



The South Africa Startup Act is a call to the President of South Africa to unleash the growth and innovation embedded in our entrepreneurs and youth, by exempting qualifying new enterprises with a turnover of less than R100 million from the limitations of existing policies and red-tape that constrain their growth and ability to contribute to job creation, and in doing so accelerate the social and economic spill over of such startups to the rest of South Africa.

### 12.1 Immediate impact foreseen

The following outcomes are foreseen as the immediate impact of implementing the Act:

- Free qualifying startups from the compliance costs, inhibiting policies, and bureaucratic practices that prohibit South African domiciled startups from (i) attracting foreign investment

and (ii) doing business internationally as a South African company.

- Give South African startups the opportunity to operate, attract and receive foreign investment and expand globally, without having to repatriate and/or give up their South African status.

By removing the constraints that come with operating a South African startup business, substantially increase the probability to achieve rapid growth by creating a growth platform based on (i) benefiting from being uniquely positioned in the South African market (i.e., local market insights, access to local talent, local cost benefits); (ii) being attractive to global investors, and (iii) operating globally as a South African business.

- Address the objectives of the NDP by adding significant momentum to the economic and social transformation of the South African economy, including its competitiveness and ability to meet the needs of her citizens, as a direct result of the incentives and relaxations made possible through the South Africa Startup Act.

The following are interventions that feature in startup acts across the globe. These interventions were further gauged through a process of studying global startup acts - some of which are in force, whilst others are still in development - as well as reviewing available research on the impact and range of startup act provisions effective around the globe; the latter of which was made possible through the assistance of the World Bank. The identified interventions were sound-boarded with members of the South African startup ecosystem, through a range of public engagements taking place in 2021.

### 12.2 Interventions premised on the concept of Qualifying Startup categorisation

The interventions can be grouped according to the main pillars of a startup ecosystem, being:

- Access to financial capital.
- Presence of a supporting entrepreneurial culture.
- Access to skilled talent.
- Conducive regulations and the appropriate regulation of business activity relevant to startups.
- Quality and depth of startup networks.
- Supportive infrastructure.
- Local and global market access.

The proposed South Africa Startup Act does not have to include provisions for each of the above pillars as not all areas of the SA startup ecosystem requires interventions in law.

### 12.3 Social economic justification

The contribution of small businesses to the national GDP has increased by almost 40% between 2013 and 2019, despite large businesses still dominating the

economy. The South African startup ecosystem is clearly growing and increasingly contributing to the national GDP<sup>4</sup>. The events of July 2021 in Kwazulu-Natal and Gauteng are a stark reminder that the country is at a critical crossroad in so far as socio and economic policy, with national unemployment and the impact of COVID-19 lying bare the failures of not attaining the objectives outlined in the National Development Plan. South Africa is missing out on the benefits to its economy from startups and high-growth enterprises by remaining slaves to a resource driven economy, and negating the opportunities embedded in our burgeoning services sectors.

South Africa can ill afford to wait patiently for the eventual trickling down effects from current levels of entrepreneurial activity, especially if these are reduced to organic growth at best. A 2019 World Bank report on the Digital Economy in South Africa cautioned that the country couldn't afford the status quo. The report highlighted recent successes in the form of globally recognised tech and startup ecosystems, successful fund raising for digital ventures, as well as the reinvestment into the sector by an increasing number of up-and-coming South African digital entrepreneurs. But, it highlights various weaknesses in the South African policy and regulatory frameworks such as an insufficient supply of digital skills, inadequate access to funding, lack of ecosystem coordination, and inclusivity to name a few<sup>5</sup>.

The report published by the Presidential Commission on the 4th Industrial Revolution<sup>6</sup> highlights the need for "strategies that place emphasis on leveraging and harnessing capabilities in the private sector to find scalable and profitable solutions that simultaneously unlock social and economic value". Small enterprises are earmarked to fill the void left by jobs made redundant through the 4IR, by using innovation and digitalisation to create new opportunities and drive economic renewal<sup>7</sup>.

"The Fourth Industrial Revolution is about more than just technology-driven change; it is an opportunity to help everyone, including leaders, policy-makers and people from all income groups and nations, to harness converging technologies in order to create an inclusive, human-centred future. The real opportunity is to look beyond technology, and find ways to give the greatest number of people the ability to positively impact their families, organisations and communities<sup>8</sup>."

<sup>4</sup> According to StatsSA, the contribution of small business to national GDP increased from 16% in 2013, to 22% in 2019, eating into the comparable share of large business, which has seen its share wane from 75% to 68% over the same period. "Three facts about small business turnover in South Africa". Last accessed from [www.statssa.gov.za](http://www.statssa.gov.za) in July 2021.

<sup>5</sup> World Bank Group. 2019. South Africa Digital Economy Diagnostic. Washington, DC: World Bank. License: Creative Commons Attribution CC BY 3.0 IGO.

<sup>6</sup> Department Of Communications And Digital Technologies Notice 591 Of 2020

<sup>7</sup> <https://www.weforum.org/agenda/2019/09/startup-business-india-fourth-industrial-revolution/>

<sup>8</sup> The World Economic Forum, last access in August 2021 from <https://www.weforum.org/focus/fourth-industrial-revolution>

But the global economic revolution toward a more important role for startups is clearly happening also in South Africa. The Startup Act has its objective to LEVERAGE this global movement, so that the full potential of South Africa and its people can be realised. South Africa was ranked 52nd in the 2020 StartupBlinks 3rd global startup ecosystem report. On the city rankings Johannesburg skyrocketed 88 spots to 160. Regionally in Africa, South Africa ranks number one.

A 2021 Endeavor impact report based on 28 South African Endeavor Entrepreneurs demonstrates first-hand the impact of supporting and nurturing South African high-growth startup entrepreneurs:

- Total revenues generated by the 28 companies amounted to R5.6bn in 2020, with average revenue of R200m per year per business, representing an increase of R 2.7bn additional revenue since 2017.
- More than 4,234 additional jobs created between 2017 and 2020, 75% of which were black.
- The cost of jobs created in this way is estimated at R 5,000 per full time employment position, considerably lower than that required by the Jobs Fund (R70, 000 to R120, 000) and the Black Umbrellas initiative (R64, 000), both of which are exemplary initiatives that respectively focus on earlier stage and/or grassroots entrepreneurs, thus in general not primarily targeting high-growth entrepreneurs.

Investment into South African startup enterprises is accelerating and increasingly attracting the attention of local and global early stage investors. This is apparent from the latest SAVCA Venture Capital survey report published in 2021:

- South African early stage fund managers concluded a record year of investments in 2020, despite a difficult trading year as a result of the global pandemic, investing R1.39bn into 122 entities; collectively managing an active portfolio of 841 deals amounting to R6.87bn.
- In the last five years, SA VC fund managers invested more than R5.6bn into early stage opportunities, up from R1.3bn in the preceding five-year period, capping off eight consecutive years of year-on-year growth in the total amount of capital allocated to early stage companies.
- The public sector is a major investor into startup enterprises, holding 28.1% of all active portfolios by value of deals, amounting to R1.75bn.
- The appetite for investment into startups is not limited to South Africa, and our entrepreneurs have to compete for investor attention with other startup ecosystems on the continent.
  - Alarmingly though has South Africa lost ground to Nigeria with VC investment in dollar terms almost four times more in 2019 in Nigeria (USD 747 million) compared to South Africa (USD 202 million).



<sup>9</sup> Endeavor SA Impact Report 2020, published in May 2021.



### Join the SA Startup Act Movement

Calling all owners of high impact technology driven, innovative and scalable startups, investors, capacity building providers, incubators, accelerators, governments agencies, civil society organisations, and other organisations that provide assistance and aid startups in South Africa, to Join the Movement and raise their voice to government for much-needed policy reform in the startup space.

*<https://www.startupact.co.za/join-the-movement>*

For more information contact [info@simodisa.org](mailto:info@simodisa.org)