

## Early-stage VC in South Africa: The time to unlock socio-economic development is now

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South Africa is the third largest economy in the African continent, and the most diversified. Recognising that there are significant economic and social challenges, the underlying natural endowments South Africa is blessed with positions it as one of the highest potential countries globally. With a population of some 60 million, and a median age of below 20, resilient infrastructure, deep capital markets, plentiful natural resources (both renewable and mineral) and a wealth of talent suggest that, provided critical issues such as power and unemployment are resolved, South Africa will reclaim its role as the most dynamic in Africa.

A healthy startup ecosystem can, as put by the South African Startup Act position statement of 2021, “unleash the growth and innovation embedded in our entrepreneurs and youth”<sup>1</sup>, accelerate socio-economic development, competitiveness and the transformation of economies. The Start-up Act lobby group also focus on the most pressing issues that younger generations care about, given the relative youth of founders. High on their priority list are issues around energy transition and climate change, along with the varied consequences of this. This is why we have seen, for example, between 2021 and 2023, climate-tech startup funding increasing by anywhere between 25%<sup>2</sup> and 37%<sup>3</sup> depending on the sources (The Big Deal and Partech, respectively).

### *Early-stage funding is critical for a thriving innovation ecosystem*

Historically, startup founders relied on angel investors in their close friend and family circles. This was revolutionized in 2012 by President Obama’s Jumpstart Our Business Start-up Act (JOBS Act) in the United States<sup>4</sup>. (BIC Africa, 2021)

What do we mean by early-stage funding? Early-stage funding includes pre-seed (first funding a startup gets at the outset), seed (first official institutional funding, raised in exchange for equity, and usually used to launch in the open market), and pre-series A (thin funding stage between seed-stage and series A, to help startups gain more traction in the market and prove the product is ready for growth and thus ready for series A funding) stages<sup>4</sup>.

This funding is critical for nascent innovations to get off the ground, gain some traction, and help startups be geared for successful fundraising to scale up. But early-stage investment also comes with mentoring, a network of contacts, and accessing specialized industry knowledge, all critical components to success<sup>4</sup>.

In a country characterized by a historical legacy of inequalities based on race and gender, access to early-stage funding is particularly critical to secure a more equitable and inclusive ecosystem of entrepreneurs.

The years 2020 and 2021 were very encouraging in terms of Venture Capital funding: On the one hand, early-stage investment in Africa peaked in September 2020 at the height of the COVID-19 pandemic given an unprecedented demand for tech-enabled solutions such as food and grocery delivery, edtech and healthtech<sup>4</sup>. Closer to home and following from the trend, 2021 saw funding in the South African

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<sup>1</sup> South Africa Startup Act (2021) *South Africa Startup Act Position Paper*

<sup>2</sup> The Big Deal, *South Africa Startup Act Progress Report 2022/23*

<sup>3</sup> Partech (2023). *South Africa Startup Act Progress Report 2022/2023*

<sup>4</sup> BIC Africa (2021) *How investors are betting on Africa's early-stage startups*

ecosystem reach the top of its apex – bringing the country to second in terms of total funding to startups in 2022. But it was short-lived: In 2022, South African startup funding fell to fourth behind Nigeria, Kenya and Egypt, with early-stage funding particularly hard hit<sup>5</sup>.

Reluctance toward early-stage funding is not surprising: South African investors are known to be traditionally risk-averse<sup>6</sup>. It is also true that, in the recent past, South Africa has become a higher risk investment destination – the recent greylisting of South Africa by Financial Action Task Force (FATF), the continued unpredictability and the unreliability of power or logistics services, make for an additionally risky environment. The wisest investors therefore diversify across other geographies (such as East Africa) and currencies that yield lower overall portfolio risks; however, this means that South Africa becomes a critical component of a risk-diversified portfolio, rather than a singular investment destination.

And while early-stage investment is risky, experts advocate its benefits – not only do they offer the greatest opportunity for returns (according to Zach George, Managing Partner at Launch Africa Ventures, from three to ten times the original investment), they are also critical for a viable pipeline of start-ups throughout the investment value chain<sup>7</sup>.

#### *A changing environment – fertile ground for startups in SA*

A number of promising changes are brewing in South Africa, aimed at de-risking the local environment and supporting systemic growth in innovation.

Promising progress has been made in advocating for a Startup Act in South Africa. As the South Africa Startup Movement puts it, “a Startup Act is essentially a component of policy or legislation that aims to make it easier for startups to establish, grow and scale”<sup>8</sup>. The recently launched progress report for 2022/23 reported: Over 2022, traction was gained with the public sector, with the introduction of the SONA announcement on Startup Visa and Red Tape reduction by President Cyril Ramaphosa, among others. Successes hailing from Tunisia and Kenya show promise, and South Africa can greatly benefit from such a regulatory framework<sup>9</sup>.

The establishment of the Innovation Fund by the DSI in 2021, although recent, has already shown early successes. It supports tech innovation and commercialization in high-risk technology development initiatives, to balance the risk aversity of commercial investors.

Awareness about early-stage funding importance is growing, and funds such as the University Technology Fund, ANZA Capital, Grindstone Ventures and Savant among others are aiming to address this gap.

#### *A call to action*

Despite these promising early successes, we are far from having the critical mass needed for a visible impact. More resources, expertise and activity are required. South Africa and other African nations can

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<sup>5</sup> D. Saunders and M. Adebola, Briter Bridges (2023) The Ugly, the Bad and the Good: South Africa's 2022 Venture Finance and Investment Landscape. In S. A. Act, *South Africa Startup Act Progress Report 2022/23* (p. 38).

<sup>6</sup> S. Lotz, SAVCA (2023). Where to next for the South African venture capital industry? In South Africa Startup Act, *South Africa Startup Act Progress Report 2022/23* (p. 36).

<sup>7</sup> BIC Africa (2021) *How investors are betting on Africa's early-stage startups*

<sup>8</sup> South Africa Startup Act (2021) *South Africa Startup Act Position Paper*

<sup>9</sup> South Africa Startup Act (2023) *South Africa Startup Act Progress Report 2022/23*

continue gaining traction if as a collective the early stage Founder, Investor, policy makers and development organisations focus on a combination of efforts.

This includes private sector Series B funds getting involved in startup financing earlier in the pipeline, with emerging fund managers. It also entails public sector maintaining its efforts to build successful public-private partnerships, and a more enabling regulatory environment, such as better tax incentives to encourage early-stage and angel investment and improve existing regulatory barriers with the various considerations outline in the South Africa Startup Act.

The 2023 South African Innovation Summit is around the corner, happening in Cape Town on the 27 and 28 September. The topic of critical importance which will be up for discussions is capital availability. To this end there will be a roundtable event where influential LPs and VCs will converge to discuss the future of venture capital and investment opportunities. To participate in this conversation or obtain the results of it connect with [www.innovationsummit.co.za](http://www.innovationsummit.co.za)