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Innovative financing of development: Partnering, approaches and instruments

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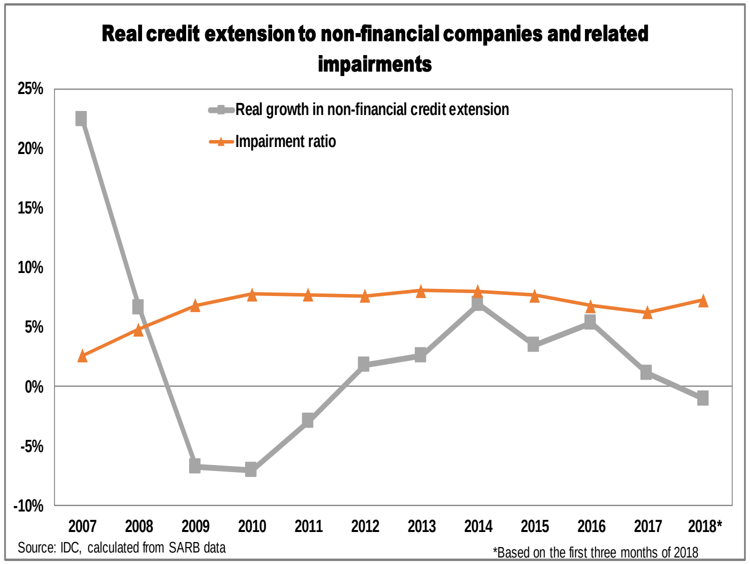
Introduction

- Financing (access, cost, available options) remains arguably the most prominent constraint for new/emerging and growing enterprises, particularly for those with high risk profiles.
- The rate of growth in credit extension has slowed in recent years, reflecting a subdued economic environment, but also tighter lending conditions by commercial banks.
- Various types of funding are available in SA, ranging from bank finance to governmental and parastatal grants and funds (incl. DFIs); angel investor funding; venture capital funds; and, among others, the broader private equity market.
- Although still limited, different funding options are emerging and, in certain cases, their development is gaining momentum.
- Public sector support in facilitating/improving access to and the cost of financing, as well as in broadening the funding options available for business, particularly emerging enterprises, is crucial.
- This presentation outlines select innovative financing approaches and instruments for enterprise development.



Partnership: UIF, PIC, IDC
UIF Fund II

- The Industrial Development Corporation (IDC), a state-owned development finance institution, continuously seeks sources of funding at concessionary rates in order to enhance its financing potential and developmental impact

- The Unemployment Insurance Fund (UIF), a Schedule 3A National Public Entity under the PFMA, was established in terms of section 4 (1) of the Unemployment Insurance Act, 2001, to:
  - Alleviate poverty by providing short-term financial relief to employees who have lost their jobs or who are temporarily unable to work due to illness, maternity or adoption leave.

- Areas of mutual interest encompass poverty alleviation through strategies that would reduce the level of unemployment and promote more equitable and sustainable development.

- The UIF reported a surplus of R130 billion in 2017. The funds are invested, through the Public Investment Corporation (PIC), in various investment instruments, including: government and public corporation bonds; listed equity; money market instruments; listed property equity; and socially responsible investments.

Partnership: UIF, IDC, PIC
UIF Fund II (cont.)

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- In their quest to reduce unemployment, the UIF and IDC partnered to provide funding to assist companies that will save and create new jobs. This was facilitated by the PIC.
- Rationale:
  - UIF contributing towards maintaining employment levels, securing against future claims / preventing drop in contributions / enhancing contributions;
  - IDC has the skills, capacity, track record in financing employment-creating transactions, as well as in providing assistance to companies in distress, thereby saving jobs.
- The merits of a partnership between institutions with such mandates has been demonstrated globally – e.g. Brazil's Banco Nacional de Desenvolvimento Económico e Social (BNDES) and the Fundo de Amparo ao Trabalhador (Workers Assistance Fund), or FAT.
- The Agreement to bring into effect UIF Fund 2 (UIF II) was signed by the IDC and PIC in March 2017 and a R1 billion drawdown of the approved R5 billion took place in mid-May 2017.

Partnership: UIF, IDC, PIC
UIF Fund II (cont.)

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Objective: Contribute towards sustainable employment by supporting job-creating/saving transactions, providing concessionary funding.

Instruments: Loans. Limited to R50 million per transaction. Counterparty limit of R200 million applies.

Qualifying criteria:

- Applicants can be start-ups and existing businesses whose applications are geared to saving and/or creating jobs.
- Cost per job of up to R600 000 for the duration of funding.
- UIF II funds blended at a leverage level of at least 30% financing from normal IDC risk-priced funding.
- Applicants need to demonstrate compliance with the UIF regulations.
- Transactions in distress (job-saving): Dividends not to be paid to shareholders over period of loan.

Pricing:

- Maximum rate presently at 10.9%, but can be discounted by 2.5% at most to 8.4% based on client's developmental scores, BI status and job efficiency at the time of the application.
- UIF II maximum pricing is based on CPI (at the time active tranche is released to IDC) + 0.5% + operational cost margin + expected losses + risk margin).

Partnership: UIF, IDC, PIC
UIF Fund II (cont.)

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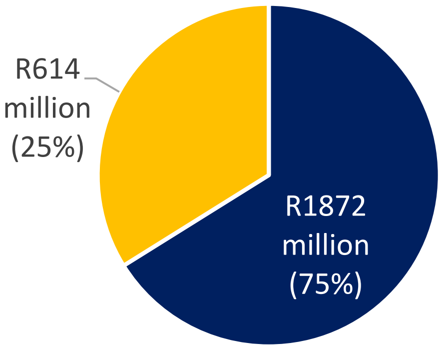
<u>Achievements</u>

- Through UIF II, the following was achieved up to 31/03/2018:
  - 34 qualifying transactions approved, totalling R614 million:
    - 22 SMEs accounting for R266 million in terms of approved value.
    - Youth empowered companies (>25%) make up 2 and R58.4m in terms of numbers and value of the approved deals respectively.
    - Women empowered companies (>25%) make up 10 and R157m in terms of numbers and value of the approved deals respectively.
    - 11 new businesses (start-ups) totaling R291.6m were funded.
  - Approved transactions resulted in 6 575 jobs to be created (3 463 of which already created) and 216 jobs to be saved/sustained.
- Breakdown of the leverage of the total approved funding as illustrated.
- IDC takes the full credit risk of these transactions.

UIF to IDC Funding



Partnership: UIF, IDC, PIC
UIF Fund II (cont.)

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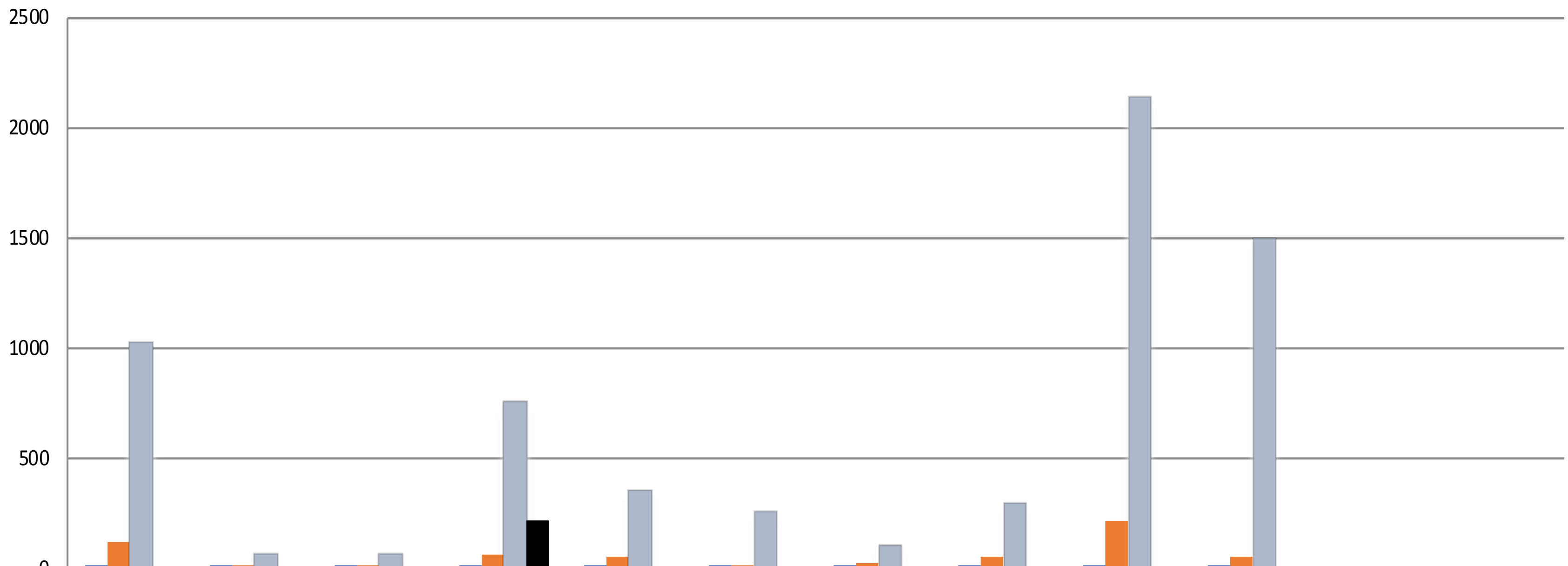
Sectoral spread as at 31/03/2018



	Agro	Automotive & Transport Equipment	Basic & Speciality Chemicals	Basic Metals and Mining	Chemical Products & Pharmaceuticals	Clothing & Textiles	Heavy Manufacturing	Industrial Infrastructure	Light Manufacturing & Tourism	Machinery & Equipment	Media & Motion Pictures	New Industries
No of deals	5	2	1	2	7	2	1	1	8	5	0	0
Value (Rm)	122.5	15.3	17.3	64.0	49.7	6.4	18.7	50.0	218.4	51.6	0.0	0.0
No of jobs created	1026	65	62	753	358	259	105	299	2146	1502	0	0
No of jobs saved	0	0	0	216	0	0	0	0	0	0	0	0

Partnership: EDD, IDC
Agro-Processing Competitiveness Fund

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- Agro-processing sector prioritised in national economic policies not only due to its employment creation potential, but also to ensure food security, affordable basic food products.
- The Agro-Processing Competitiveness Fund (APCF) was established to facilitate increased competition, growth and development in the agro-processing and beverages sector through the provision of finance to non-dominant players.
- The APCF was capitalised through the penalty imposed by the Competition Tribunal on Pioneer Foods for its role in a bread cartel.
- R250 million fund to be utilised as follows:
  - R225m for investments;
  - R12.5m for business support grants; and
  - R12.5m for research grants.

Partnership: EDD, IDC
Agro-Processing Competitiveness Fund (cont.)

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Instruments: Equity, quasi-equity, loans. Minimum R250 000, maximum R30m per transaction.

Qualifying criteria:

- Applicant can be a start-up or an expanding business (excluding businesses in distress) in the agro-processing and beverage sector.
- Applicant must be non-dominant players in the market.

Pricing: Interest free loans and zero return on quasi-equity. Max. repayment period of 10 years.

Achievements

- Through APCF, the following was achieved up to 30/09/2017:
  - Total approvals valued at R292.2 million;
    - 39 direct investment transactions, totalling R286.2 million.
    - 16 business support transactions, valued at R6.0 million.
  - Total value of IDC co-investments = R249.4 million
  - 2 449 jobs created, with a cost per job of R211 059.

Partnership: EDD, IDC
Downstream Steel Industry Competitiveness Fund

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- SA's downstream steel industry in the metals and engineering sectors, particularly SMEs with up to 50 employees, has been in continuous decline.
- Structural factors that appear to be common challenges across sub-sectors (e.g. foundries, fabricators, components' manufacturers) include a lack of fixed investment in modern plant and equipment, under-investment in skills and R&D, among others.
- This has resulted in an alarming number of firm closures and job losses. Furthermore, if this trend continues unabated, there will be limited capacity in the sector to participate in manufacturing and industrial investment initiatives when economic growth gains traction.
- Government has responded with a no. of targeted initiatives aimed at addressing some of the structural problems facing the sector. These include:
  - The National Tooling Initiative;
  - The National Foundry Technology Network;
  - The designation of inputs into state procurement; and, among others,
  - The Black Industrialist scheme to accelerate transformation in the sector.
- However, more needs to be done if the downstream steel sector is to be placed on a sounder footing.

Partnership: EDD, IDC
Downstream Steel Industry Competitiveness Fund (cont.)

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- National Treasury allocated R95m from the fiscal revenues to EDD for the purpose of supporting the distressed downstream metals and engineering sectors.
- EDD approached the IDC, through the Steel Industry Task Team, with a proposal for the R95m allocation in the form of a grant to the IDC to be leveraged as an interest rate subsidy, so as to establish a sizeable Fund to support downstream steel industry.

Objective: Assist the struggling industry with an interest subsidy Fund that will offer discounts to qualifying clients. The Fund is capitalised through a grant of R95 million over 3 years. IDC will leverage about R500 million of funding per annum towards the Fund.

Target sectors:

- Foundry industries; fabrication sectors (focusing on pressure vessels, pipes and pipe fittings sub-sectors; structural steel and any fabrication work in support of steel intensive designated sectors/products); parts and component manufacturers of steel-intensive products; valve and pump manufacturers; machining plants; any other steel-intensive business.
- Exclusions: Integrated steel mills; components' manufacturers that qualify for other incentives, large multinational OEMs and assemblers and their subsidiaries.

Partnership: EDD, IDC
Downstream Steel Industry Competitiveness Fund (cont.)

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Application of funding:

- Modernisation of plant, machinery & equipment.
- Capacity expansion of existing plants.
- Process improvements for cost efficiencies, productivity improvements, plant optimisation.
- Working capital requirements / revolving facility.
- Assist firms to achieve appropriate industry quality certification and standards.
- Establishment of start-up enterprises.
- Development and testing of prototypes, as well as testing and certification of new products.

Investment criteria:

- Pricing: firms with turnover less than R123.5m, discount of 2% on IDC Risk Pricing; those with turnover above R123.5m, discount of 1.5%.
- Maximum investment size –the Fund offers a maximum of R75 million.
- Type of funding instrument – the Fund will only apply to debt (or quasi-debt) instruments.
- Maximum term – 5 years including any moratorium periods.

Partnership: EDD, IDC
Downstream Steel Industry Competitiveness Fund (cont.)

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Achievements

- 7 transactions totalling R136.2 million approved since inception of the Fund on 1 June 2017.
- Total indicative interest subsidy for the transactions amounts to R5.9 million.
- Examples of production operations financed: Producers of components for shot blasting industry; security fencing; underground mining equipment; and fabricated steel components largely for the rail transportation and telecommunications industries; among others.

- Satisfactory pipeline at present (ca. R116 m) is indicative of significant demand for this type of interest subsidy product.

Partnership: EDD, IDC, Fund Trustees Tirisano Construction Fund

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- In 2009, the Competition Commission initiated investigations into the construction industry after receiving complaints over certain instances of collusion.
- As a result of its findings, the Competition Commission launched the Construction Fast-Track Settlement process in 2011, which fined the construction companies a collective amount of R1.5 billion.
- The construction companies entered into a settlement agreement with government, through EDD, on the terms of contribution, use and structure of the Tirisano Construction Fund.
- The Tirisano Construction Fund is formed as a Trust regulated by a Trust Deed, with IDC having been appointed the Trust Administrator by EDD.
- The settlement agreement stipulates that the construction companies have to collectively pay R1.5 billion over 12 years (average of R125m p.a.).

Partnership: EDD, IDC
Tirisano Construction Fund (cont.)

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- The Tirisano Construction Fund will provide funding for the following category of projects, initiatives and programmes:
  - *Enterprise Development Programme* – through the provision of concessionary loans aimed at upgrading firms owned and managed by Black people, and building capacity and sustainability through direct technical assistance to emerging contractors. Max. limit of R50m per applicant, max. term of 4 years of assistance. Concessionary funding rates to be determined by the Trustees.
  - *Special Social Upliftment Programme* – provision of grants for social infrastructure.
  - *Black Built Environment Bursaries* - provision of bursaries to previously disadvantaged undergraduates to study at any accredited tertiary institution in South Africa.
  - *Black Built Environment Artisan support* – provision of bursaries to previously disadvantaged persons being trained as artisans within the built-environment.
  - *Maths, Science and Technology Projects* – support towards Maths, Science and Technology at public schools.
  - *Engineering Resource* – assistance provided to government projects that require engineering, project management and other services.

Concluding remarks

- South Africa's public sector has a very important role to play in ensuring an efficient and effective financial environment for the proliferation and growth of business enterprises, and financial inclusion.
- From an IDC perspective, progress has been made:
  - Lowering the cost of funding for the benefit of clients by
    - Entering into funding partnerships with other state-owned companies in pursuit of respective mandates (e.g. UIF, PIC).
    - Enhancing collaboration with other financiers, including other DFIs, both local and foreign, and private financiers.
    - Leveraging on agreements reached between the competition authorities and corporates.
  - Contributing to the establishment and management of third-party funds, which can be accessed directly or, when combined with IDC finance, lower the cost of blended funding, such as the Funds highlighted in this presentation.
- Effective collaboration between public sector entities, as well as between public and private sector stakeholders, is critical in this regard, focussing on improving access to finance, providing funding options more in line with customer needs, reducing the cost of funding; and providing other forms of business support.