Key success factors for investments in South Africa

by Adriaan Brouwers, Leverage, and Isaac Shongwe, Letsema

To make the attractive investment opportunities South Africa offers a success, the international investor needs to meet the following criteria. The investor needs to understand the fundamentals of the South African economy to appreciate the economic successes which have been achieved since 1990. The investment needs to focus on one of the promising economic sectors and have a sound strategy for black economic empowerment in place. Last but not least, the investor needs to place the strengths, weaknesses and risks of South Africa in the perspective of its young and robust democracy.

This chapter is a stand-alone guide intended to help investors identify opportunities created by the country's mineral resources and manufacturing sector and by the restructuring programme for state assets, as well as those that exist in the technology, media and telecom sector.

Summary

The fundamentals of South Africa[1]

Despite the global economic slowdown South Africa is performing reasonably well. Financial authorities have complimented South Africa on its determined pursuit of a prudent economic policy[2]. The economy continues to grow (GDP rose from -2.2% in 1992 to 3.4% in 2000 and about 2.2% in 2001. For 2002 a growth of 2.3% is expected rising to 3.3% in 2003[3]; inflation[4] has been reduced (from an average of 12.5% between 1990 and 1994 to 5.2% in 1999. Although it rose to 7.6% in 2000 and might reach 7.9% in 2002, it is expected to return to the 3%-6% target next year); the budget deficit is narrowing (from 10% in 1993/4 to 2.1% in 2001/02); and, finally, interest rates have also fallen sharply (the prime rate is now 15.5%). The country has shifted from creating sound fundamentals to concentrating on micro-economics, projects and delivery.

The Rand is recovering (presently around 1US$=10.50 R) after December's slide to almost 14 Rand to the US$, with exports increasing some 20% and a decline of about 10% in imports. This has created opportunities for any sector with products priced in an international currency (e.g. motor vehicle component manufacturing, technology sector) and input costs in Rands.

[1] Euromoney, Venture Capital & Private Equity Yearbook 2000/2001, pages 83-86.
[2] The Economist October 12, 1996; December 13, 1997; May 29, 1999; February 24, 2001; IMF and World Bank; Financial Times November 26, 2001.
[3] Budget speech February 20, 2002.
[4] CPIX inflation (consumer prices excluding mortgage interest).

Figure 1: Current structure of the South African economy

GDP (billions of rand) [1]	1998	%	1999	%	2000	%	2001	%
Agriculture [2]	25.6	*4*	26.6	*4*	29.8	*4*	27.3	*3*
Mining and Quarrying	44.2	*7*	47.1	*6*	49.7	*6*	66.8	*7*
Manufacturing	128.6	*19*	132.6	*18*	147.7	*18*	163.8	*18*
Construction	20.7	*3*	20.9	*3*	23.3	*3*	25.5	*3*
Electricity, Gas & Water	22.5	*3*	23.8	*3*	25.2	*3*	23.9	*3*
Transport [3]	65.0	*10*	73.1	*10*	81.4	*10*	88.4	*10*
Trade	89.3	*13*	95.2	*13*	105.5	*13*	115.8	*13*
Business Services	124.3	*18*	140.6	*19*	156.6	*19*	182.2	*21*
Others	155.7	*23*	168.2	*23*	187.7	*23*	193.3	*22*
Total	**675.9**	***100***	**728.1**	***100***	**806.9**	***100***	**887.0**	***100***

1. South African Reserve Bank, GDP by sector. 2. Including forestry and fishing. 3. Including communications.

Successes in South Africa

Successful companies and sectors are evident in South Africa. Thawte, Billiton, De Beers, South African Breweries, Anglo American, Harmony, Liberty, Afrox, Investec and the motor, wine and food industries stand out. The essence of their success is explained by the mineral base, innovation, entrepreneurial spirit, financial infrastructure, and export advantages.

Sector focus

This chapter focuses on the opportunities in the manufacturing industry (steel in particular), the restructuring of South African state assets and the technology sector which combine the ingredients for success indicated above.

The robustness of a young democracy

The uninformed investor may read in the international press quite a number of unsettling stories about South Africa. Its neighbour Zimbabwe, the incomprehensible Aids attitude of its Government, crime and violence must give many potential investors food for thought. These aspects are best understood in the perspective of a young democracy.

South Africa’s **strengths** are its banking and legal systems, (communications) infrastructure, mineral resources, business community, strategic position on the globe, climate and, not least, its track record in negotiating practical political decisions. South Africa’s **weaknesses** are its high real interest rates, uneven income distribution, high unemployment, commodity based economy, poor but improving competitiveness, and inadequate education system. **Risks** exist (in its high crime rate, fractious labour relations, weakening exchange rate, Aids epidemic, and worrying levels of corruption) but are manageable.

The robustness of the young democracy is evidenced by South Africa’s consistent pursuit of strategic policies (e.g. financial discipline, restructuring of state assets) and the fact that it continues to find pragmatic solutions for controversial policy issues (e.g. mineral law, labour law) by engaging all vested interests. Its free press, its political opposition, the independent judicial system where civilians sue their Government in order to receive anti-retroviral HIV/Aids drugs, are vital cornerstones for its democratic future. The recently announced roll-out plan for the Aids drug nevirapine proves that democratic pressures do ultimately have effect[5].

An effective black economic empowerment strategy

A successful investment in South Africa requires the implementation of an effective strategy for black economic empowerment. This government policy endeavours to bring the black majority of the population into the mainstream economy over time, without damaging the economy in the process. For that purpose the lessons from the last ten years have to be learned (Do's) and the mistakes made have to be avoided (Don'ts).

Do's

Black economic empowerment needs to add real economic value to the venture. This needs to be added not only in the corporate structure but even more so in its day to day operations. The most effective drive for black economic empowerment is led by young black professionals who believe that empowerment should take place at all levels of the economy, from shareholding, through management and operations, to customers and other stakeholders as a comprehensive approach to building a new corporate culture in South Africa, driven by commercial imperatives and skill rather than hurdles imposed from the outside.

Involving this young generation of black professionals is considered a key success factor for an effective long term black economic empowerment strategy. New creative structures should be used that allow black shareholders and employees to use their skills and influence to create and own additional value within existing corporate environments.

Don'ts

Artificial shareholding structures have to be avoided. They were cornerstones in the mid-1990's, since black economic empowerment policy emphasised the level of shareholding by blacks. However, they proved to have considerable shortcomings. Many transactions were highly leveraged with institutional money (e.g. pension and provident funds) and relied on a rising market to repay the borrowed funds. They resulted in relatively little transfer of equity value to the black investors but encouraged deal-making rather than capacity-building.

Government policy[6]

The pressure from the Government in response to empowerment is both increasing and maturing although initially its position has been varied, multi-faceted and at times confusing. The focus now is on sectors were a leverage to influence the business process directly exists (e.g. combining the allocation of fishing quotas and the access to new mineral rights with checks and balances). Target setting charters (e.g. the Petroleum and Liquid Fuels Charter for the energy sector) are agreed where the influence is more limited. Private sector response has been notable and resulting deals are summarised in Figure 2.

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[5] Business Day April 18, 2002.
[6] Business Map, Empowerment 2002 – The State Steps In, April 2002, pages 1-3 and 30-33.

The President's State-of-the-Nation address in February suggests a flexible response to the ambitious list of targets for an integrated national black economic empowerment strategy (including a legislative framework, participation in public sector restructuring , National Empowerment Fund, strategies for human resources and rural development) [7], proposed by the Black Economic Empowerment Commission[8]. Also awaited from the Government is a clear but hopefully flexible definition what constitutes empowerment. Issues of definition have emerged in both the fuel industry (Shell and Tepco deal) and in the media sector (rejected Kagiso-Nail Transaction). Also the successful black economic empowerment procurement drive (Telkom spending in its financial year 2001 was 3.9 R bn) based on granting preferential access to state contracts for qualifying black economic empowerment bidders, will benefit from an improved definition.

State enterprises have also made dramatic moves in changing the racial make-up of their employee base, while so-called "affirmative action" is progressing well in the private sector, albeit understandably more slowly. It is here that the young black professionals are being developed. Given the Government vested interest in a successful black economic empowerment, the risk continues that new black corporate empire builders will be allowed to benefit from their political power.

Figure 2: Top 10 empowerment deals in 2001[9]

Sector	Buyer	Seller	Stake	Value(Rm)
Mining	African Rainbow Minerals	Anglo Gold Free State	50.0%	1,100
Mining	African Rainbow Minerals	Anglo Platinum's Maandaghoeks mine	50.0%	675
Financial Services	Brimstone Consortium and Progressive African Investment Consortium	Peoples Bank	30.0%	557
Mining	IDC[10] and Simane Investments	Harmony Gold Mining	7.5%	450
Energy	Thebe Investment Corporation	Shell SA	25.0%	300
Mining	Mvelaphandha Diamonds	Trans Hex	20.5%	200
Mining	Royal Bafokeng Nation	SA Chrome	22.0%	100
Defence	Kgorong Investment Holdings	Reunert Defence Logisitcs	20.0%	80
Financial Services	Pamodzi Investments Holdings	Alacrity Financial Services	34.6%	80
Financial Services	Wipcapital	Future Growth	40.0%	40

The minerals and manufacturing sector

South Africa has got a wealth of mineral base. It has 88% of the world's platinum reserves, 83% of its manganese, 72% of its chromium reserves, 45% of its vanadium,

[7] Business Map, Empowerment 2001 – Better Outcomes, March 2001, page 36.
[8] A lobby group conceived in late 1997 at a conference of the Black Management Forum and chaired by Cyril Ramaphosa under auspices of the Black Business Council in its report early last year.
[9] Business Map, Empowerment 2002 – The State Steps In, April 2002, page 9.
[10] Industrial Development Corporation.

39% of its gold and a large portion of its gem diamonds. A key dimension of its economic strategy since 1990 has been to add value to this mineral base by middle and end product manufacturing. Various manufacturing plants have been created, e.g. Saldanha Steel, Columbus Stainless Steel, Billiton Aluminium smelters at Richards Bay, Hulett Aluminium. The stainless steel industry alone consists of over 400 mainly small or medium seized companies employing 28 000 people. Stainless steel production rose between 1991 and 1999 from 100 000 to 400 000 tons and is growing at twice the world average rate. Service industries exploit their opportunities too. A foreign example is Hencon (Dutch aluminium mobile equipment manufacturer) investing in 2001 2.2 Rm and planning an expansion of an estimated 1.8 Rm, while its sister company Caesar (ground work equipment) expects also to invest 2.5 Rm.

The motor car industry in South Africa stands out, but has also faced in August a union strike for substantial wage increases. BMW exports its 3-series from South Africa. It announced last December that it was to expand its investment in its Rossalyn plant near Pretoria from 1.1 Rbn with a further 2.2 Rbn to 3.3 Rbn for export to Japan, the United States, Taiwan, Singapore, New Zealand, Hong Kong and Australia. Volkswagen exports the Golf 4 to Europe and DaimlerChrysler assembles the C-class Mercedes-Benz both for export and the local market. South Africa is very well positioned to benefit from the international trend towards more flexibility in car manufacturing [11].

The poor global steel market conditions emphasise the need for the Integrated Manufacturing Strategy (IMS), developed by the Department of Trade and Industry and presented mid April for immediate discussion in Parliament and presentation to cabinet in June. Ahead of this strategy the steel industry in South Africa underwent a considerable consolidation during 2001. During this process international steel concerns showed specific interest in the investment opportunities arising, e.g. WPSC, Ferrostaal (Columbus), and Ispat/LNM (10% Iscor which split its mining and steel activities in Iscor Steel and Kumba Resources and exchanged the IDC 50% share in the troubled Saldanha project for shares). The competitive position of South Africa has strengthened as a result of recent devaluation of the Rand and its exclusion from the 30% tariffs the United States imposed on European and other international manufacturers.

Figure 3: Opportunities in the manuafacturing sector

Opportunity	**Sector**	**Transaction (Rm)**
Coega, BHP-Billiton	Aluminium	18 375
Newcastle	Steel, slab caster	315
Ferrostaal	Stainless steel	
Rossalyn Pretoria	Motor Car industry	3 300
Hencon expansion	Aluminium mobile equipment	1.8
Caesar	Mobile service equipment	2.5

Black empowerment in the mining sector has been enhanced by the Government's leverage to grant new mineral rights. The draft minerals development bill agreed on by the Department of Minerals and the Chamber of Mines in July 2001 is another example

[11] The Economist February 23, 2002.

of South Africa's ability to find practical solutions for seemingly irreconcilable differences. Compromises were reached on security of tenure, need to attract foreign investors, objective criteria for allowing or refusing licences, the right to appeal and transitional arrangements to phase in the legislation. It was also agreed to set up a US$ 100 m fund to support small mining companies. Hence, a slew of empowerment deals emerged within the sector (e.g. African Rainbow Minerals twice, Mvelaphandha Diamonds, Royal Bafokeng Nation) some of which showed the special purpose finance vehicles used in the first generation empowerment deals[12].

Coherent black empowerment policies for the manufacturing sector are central to the IMS of the Department of Trade and Industry. Major players (e.g. Anglo American, Iscor, IDC) have already shifted the racial make-up of their employees and is on occasions supported with employee equity schemes. Through their financial strength long term strategies can be embarked upon. The potential the manufacturing sector offers for small and medium sized companies is matched by IDC's focus to fund starting black businesses through bridging finance, wholesale financing and merger and acquisition support.

The process of restructuring of state assets

The investment opportunities in this process were fully analysed in the 2001/2002 Euromoney Yearbook on Venture Capital & Private Equity[13]. The process has worked its way confidently through a very tough year. It survived in August 2001 the confrontation with a strike targeted against privatisation, organised by the Congress of South African Trade Unions. A number of setbacks occurred and lessons from foreign privatisation failures (e.g. electricity California, railways in the United Kingdom and The Netherlands) are being taken on board. The South African democracy appears to be strong enough to weather these storms and although many issues have not been finalised the programme is more firmly established than ever before.

Telkom was scheduled to get in 2001 its primary listing in Johannesburg and its secondary in New York. The listing is now planned once market conditions permit. The May 7, 2002 expiry of Telkom's 5 year exclusive licence has initiated a sector restructuring. The number of fixed licences is finally restricted to two. A second fixed licence is to be issued during 2002. Transtel and Eskom Enterprises will hold a 30% stake leaving the balance to be issued to black empowerment (19%) and a foreign or local equity partner (51%).
South African Airways dealt with the controversial contractual arrangements of its CEO Coleman Andrews and recently repurchased for half the selling price (1.4 Rbn) the 20% shareholding from the financially troubled Swiss Air.
Spoornet received approval from the Government and endorsement by the unions for its restructuring model. In response to internal resistance and international experience with privatisation it was decided to maintain a larger participation of the State than initially anticipated.

[12] Business Map, Empowerment 2002 – The State Steps In, April 2002, pages 70-73.
[13] Venture Capital & Private Equity Yearbook 2001/2002, pages 51-53.

Portnet is in an advanced state of developing appropriate concession models for port operation and the selection of facilities and services to be concessioned.
The electricity sector incorporated the Distribution Holding Company and six Regional Electricity Distributors are being established. The National Electricity Regulatory Board commissioned a study to compare an ‘electricity pooling model’ with the ‘multi-market model’. Once the selected business model is turned into a clear regulatory framework the restructuring of distribution will start.
Forestry made progress by the sales of 22 000 ha in KwaZulu Natal for 100 Rm to the SiyaQhubekha consortium, consisting of Mondi Ltd and Imbokodvo Lemabalabala KZN[14] and by short listing two bidders, the AFC Zama consortium and the foreign Paharpur Consortium for the combined Mpumalanga and Northern Province forestry package.

Figure 4: Opportunities arising from the programme to restructure state assets

State Assets	Opportunity	Value[1]	Status[2]	Share[3]	Planning
1. Telkom	IPO additional 45%	18.0	6	75%	4
	Fixed line licence	4	3	70%	2002
2. Denel	Shares in Denel	0.5	5	<50%	2002
3. Transnet					
SA Airways	100% of shares	10.0	6	100%	2002
Airport	Additional 45%	3.0	5	75%	2003-4
Spoornet	Coallink	4	3	100%	2003-4
	Luxrail	4	3	100%	2003-4
	Orex	4	3	100%	2003-4
Portnet	Port Services	4	4	4	4
4. Eskom	Generation	4	2	80%	2003+
	Transmission	4	2	4	4
	Distribution	4	2	4	4
	Local distributors	4	1	4	4

1. Rbn
2. 1: Strategy, 2: Regulatory Framework, 3: Business Model, 4: Restructuring, 5: Trnasaction, 6: Iteration
3. In Private hands after completion of restructuring process
4. Not yet determined

The emerging integrated approach to black economic empowerment is also evident in the programme of restructuring of state assets[15]. The restructuring schemes target a black ownership of between 10 and 20%. To avoid any artificial structures the National Empowerment Fund is scheduled to receive part of the shares from the entities undergoing restructuring. In addition, successful collective investment programmes at deeply discounted prices for low income groups in Malaysia[16] and Korea[17] are being investigated. The operational empowerment focuses on more meaningful access to state-regulated activities, training and skills development, affirmative action in management,

[14] Business Map, Empowerment 2002 – The State Steps In, April 2002, page 8.
[15] An Accelerated Agenda Towards the Restructuring of State Owned Enterprises, Policy Framework, Ministry of Public Enterprises, August 2000.
[16] Bumiputra Unit Trust Scheme as part of Malaysia’s New Economic Policy of 1971.
[17] People’s Share Programme in Korea 1987.

entrepreneurial opportunities through outsourcing, partnerships, procurement and easier access to financing. To enlarge the share employees can earn to own in the companies they work for, successful schemes in a variety of countries (United States, Venezuela, Russia, Spain) are being investigated. Community trusts are considered to be an effective tool to transfer the benefit of combined purchasing power to individual consumers.

The technology, media and telecom sector

The imminent listing of Telkom and further deregulation of the telecommunications market is expected to have an accelerating effect on the already strong technology sector in South Africa. The proven potential of this sector is supported by the launch of five venture capital funds over the last year, four of which were initiated by the Industrial Development Corporation with co-investors and fund managers from the private sector (Vantage, Horizon Tech Ventures). The overall funds of these new initiatives are in excess of 1.0 Rbn.

Although the technology sector suffers from the worldwide cool-down there are few casualties amongst listed firms. South Africa has a definite competitive advantage in security developments in the technology sector as a result of its proven R&D track record in this respect. Experts claim creativity and innovation is on a par with Israel and India. The existence of incubators and technology hubs (e.g. Pretoria, the Bandwidth Barnyard in Cape Town and 4 incubators sponsored by the Department of Trade and Industry) allows South Africa to continue to develop its knowledge and development base.

Established (e.g. Didata) and new (e.g. Wizcor) South African technology companies are very aggressive in keeping abreast of world-class technologies. Manufacturing costs are relatively low given the depreciation of the Rand, making South Africa a leading destination for IT development and innovation, which create easily exportable intellectual property for the exploitation in larger more mature markets.

Figure 5: Investment opportunities in the technology sector

Opportunity	Sector	Transaction(Rm)	Investment(Rm)
Eskom Enterprise	Telecommunication	1 000	100
E-com Institute	IT-Integration	30	3
B2B Africa	E-procurement	500	100
Kwikpay	IT-digital distribution	50	5
Wizcor	IT Accelerator Fund	100	5
Intellivest	Portfolio Management	20	2
20Twenty		150	50
Second National Operator	Telecommunication	3 000	1 000
Afrimark	E-procurement	30	6
Consology	E-billing	30	5

The technology sector offers black economic empowerment a number of opportunities. The sector meets the relatively young age of the new generation of black professionals. The focus on development and new generation products creates low entry barriers. The sector offers opportunities for black entrepreneurial talent with an innovative garage based outlook. Once success is proven growth strategies need to be managed. The sector is surrounded by a financial and consultancy infrastructure offering young black professionals the chance to develop their individual knowledge and expertise. The sector is therefore considered to be a natural breeding ground for a strong development of black economic empowerment.

Conclusion

Investment opportunities presented in this chapter must be judged against the background of the solid economic policies South Africa has put in place and against the background of the dynamics of a young democracy. Part of these dynamics is a conscious drive for black economic empowerment. This type of transformation is complex, controversial and politically sensitive.

Given South Africa's complexity and continuing evolution as a democratic nation, investors are best advised to enter the South African market through joint ventures or a local partner once firm decisions to invest have been taken. Such local partners need to have an integrated view on the interdependent issues of black economic empowerment. Unlike India and China, South Africa does not have restrictive laws about local partnerships, directorships or shareholding. Nevertheless black economic empowerment is an aspect of the South African economy that cannot be ignored. As the black consumer base grows in South Africa, black economic empowerment is expected to progress until eventually there will no longer be any need to differentiate. South Africans have a proven reputation for innovation and adaptability. A new generation of young South Africans is determined to complete the economic transformation of the country.

Authors:

Adriaan Brouwers (Managing Director)

Leverage

Beurs van Berlage

Damrak 273 – 275

Amsterdam

The Netherlands

Tel: +31 20 622 8768

Fax: +31 20 622 8427

Mob : +31 62 256 5979

E-mail : a.brouwers@leverage.nl

Isaac Shongwe (CEO)

Letsema Consulting

Bryanston drive 159

Bryanston – Johannesburg

South Africa

Tel: +27 11 540 9700

Fax: +27 11 706 3161

Mob:+27 82 453 2440

E-mail: isaacs@letsema.co.za