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Free Market Foundation submission on BEE

To: Committee 1
High Level Panel on the Assessment of Key Legislation
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Job creation and economic development implications of financing empowerment transactions

Executive Summary

Black Economic Empowerment (BEE) and by extension Broad-Based Black Economic Empowerment (B-BBEE) are initiatives by the Government of South Africa to realise the country's full economic potential by incorporating the marginalised majority (historically disadvantaged black South Africans) into the economic mainstream. To date the emphasis has been on transformation of shareholding ownership rather than the creation of new and sustainable jobs or increased business activity.

Funding provided by banks for these purposes have not contributed materially to the job creation in general or specifically for the previously disadvantaged. The introduction of BEE Codes of Good Practice and the relevant Sector Charters turned the focus on employment equity, management control, skills development, enterprise development and preferential procurement for black-owned businesses.

Funding advanced to BEE special purpose vehicles (SPVs) which acquired shares in "white-owned" companies were used to transfer of ownership from existing shareholders to black shareholders. Empowerment transactions did not require the injection of direct equity by empowerment shareholders to fund expansion and acquisitions that would enhance shareholder returns and create employment. In most instances the position of BEE shareholders and/or beneficiary groups was passive with limited to no operational involvement. It is thus difficult to conclude that to date there has been a meaningful contribution to job creation for previously disadvantaged South Africans or the fulfilment of the country's potential. Funds have generally been used to compensate existing shareholders. Most BEE transactions have resulted in shareholders, including a growing number of direct and indirect black shareholders, incurring significant economic costs and dilution of assets in order to facilitate empowerment transactions.

The creation of black-controlled entities such as Exxaro and ARM created black industrialists who became wealthy individuals by global standards. This has to some extent delivered on the government's objective of redressing economic imbalances. It should be acknowledged that BEE

was set up to create a black middle class and not sustainable jobs for South Africa's working class where black unemployment has increased substantially and where economic imbalances between white and black people persist.

There have been BEE holding company structures such as RBH and Wiphold where shareholdings in operating entities resulted in material cash flows through dividends and investment disposals. These cash flows were effectively channelled to communities for skills development and BEE entrepreneurial seed capital thus indirectly contributing to future job creation. The Sishen Iron Ore Scheme and the FirstRand Foundation have also invested into job creating ventures. However, these are exceptions as the cash flows from investments are in most instances not significant. The need for distributions to beneficiaries for general consumption typically outweighs the investment and skills development rationale.

If, on the other hand, debt funding is advanced by banks and financial institutions to empowerment structures who in turn deploy that capital to re-invest directly in an underlying operating entity for growth, there is a stronger likelihood of meaningful job creation. There are companies that have successfully raised new capital for growth as part of a BEE shareholding transaction. The government's new approach of supporting black industrialism targeted at investment of growth capital in a specified labour-intensive sector can, if successfully implemented, contribute more directly to sustainable job creation.

A separate point is that the fall in commodity prices, the general global and domestic economic slowdown, and uncertainties have been conducive to neither capital investment growth nor job creation. This following appendices explore these and related issues and recommendations which, we humbly submit, merit dispassionate analysis and discussion with a view to positive legislative reform.

Attachment

1. Does the financing of empowerment transaction result in job creation?

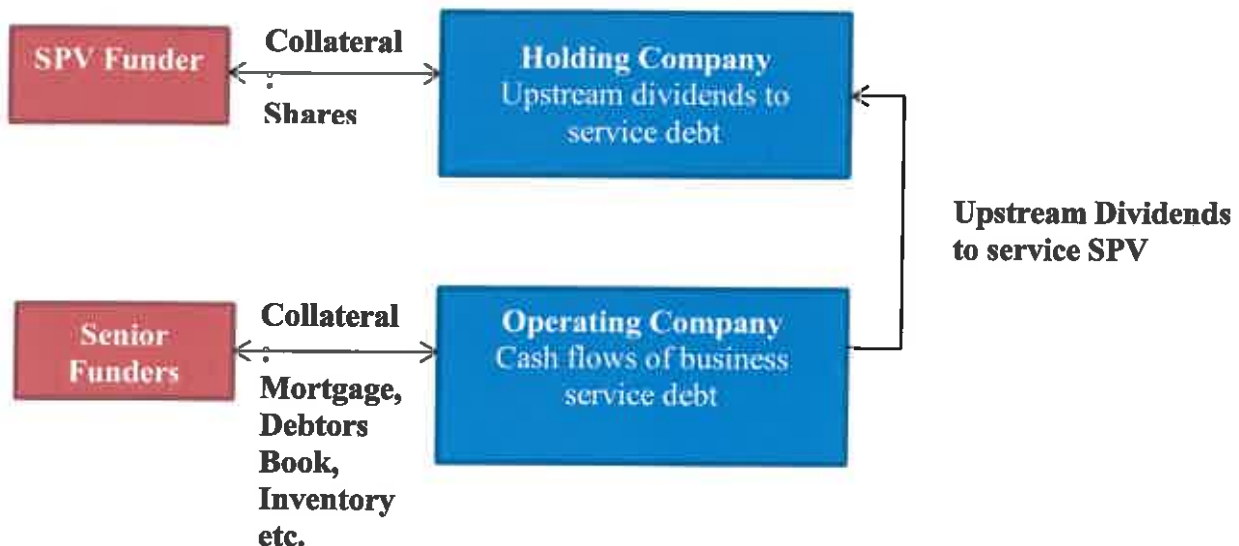
Does the financing of empowerment transaction result in job creation?

1. Credit risk assessment of BEE share based lending

A majority of BEE share based transactions have been structured on the back of shares in operating companies where profits and cash flows are produced. Debt funding have been placed in intermediary or holding companies known as BEE Special Purpose Vehicles or SPVs. That debt has been serviced from up-streamed dividends from the operating company. Debt in BEE SPVs is thus structurally subordinated to bank debt and creditors in the operating company from a cash flow perspective.

Exposure to BEE SPVs present higher funding risk to banks and financial institutions than traditional funding (lending products) to operating entities. Thus demands higher pricing and/or a reduced appetite for funding. The graphics below illustrate a typical group structure illustrating the subordination of funding into a BEE SPV and the cash flow "waterfall":

Structural subordination



Cash flow Waterfall Example

Cash Flow Waterfall	Year End (R'm)	
EBITDA	10 500	
CHG in Working Capital	-3 950	
Maintenance Capex	-525	
Tax Paid	-1 000	
Interest Received	500	
Free Cash Flow	5 525	
Interest Paid	-750	← Senior Debt Funding
Capital Repayments	-1 500	
Free Cash Flow before discretionary	3 275	
Expansion Capex	-1 500	← Subordinated SPV Funding
Dividends	-1 000	
Free Cash Flow post discretionary	775	

The table above illustrates that funders in the SPV would be paid after senior debt providers, which increases the risk profile for these providers of capital. This necessitates higher pricing and reduced appetite. Additionally, SPV debt is repaid out of dividends, which are a discretionary item (i.e. payment of dividends is at the discretion of a company).

The following additional factors should be considered:

- 1.1. The ability of an operating entity to borrow and attract debt capital from banks and other financial institutions is determined by the sustainability and track record of its operating model, and financial and business risk considerations. An operating entity's credit quality reflected in its rating is derived from an assessment of, inter alia, these drivers.
- 1.2. A better credit rating implies lower debt cost (i.e. more affordable cost of capital) and/or a greater lending appetite from banks and financial institutions. A company's credit quality thus directly impacts its ability to attract favourable terms on debt capital to enable expansion into new projects, products or markets required for growth and ultimately job creation.
- 1.3. In addition, operating entities as borrowers can also typically offer acceptable collateral in the form of fixed or working capital assets which qualify for lenders' risk mitigation and thus improved pricing from lenders.
- 1.4. In contrast thereto, the following applies to traditional SPV structures which acquire shareholding for BEE parties:
 - 1.4.1. Since taxable profits are generated by operating capacity not SPVs they pay less tax.
 - 1.4.2. APVs are non-operational and merely own shares in operating entities.
 - 1.4.3. The only assets of SPVs are shareholdings which constitute collateral to lenders. SPV shares are more subject to above average market risk volatility (specifically in the resources sector) i.e. they provide less sustainable value to lenders than an operating entity's assets and cash flow generation.

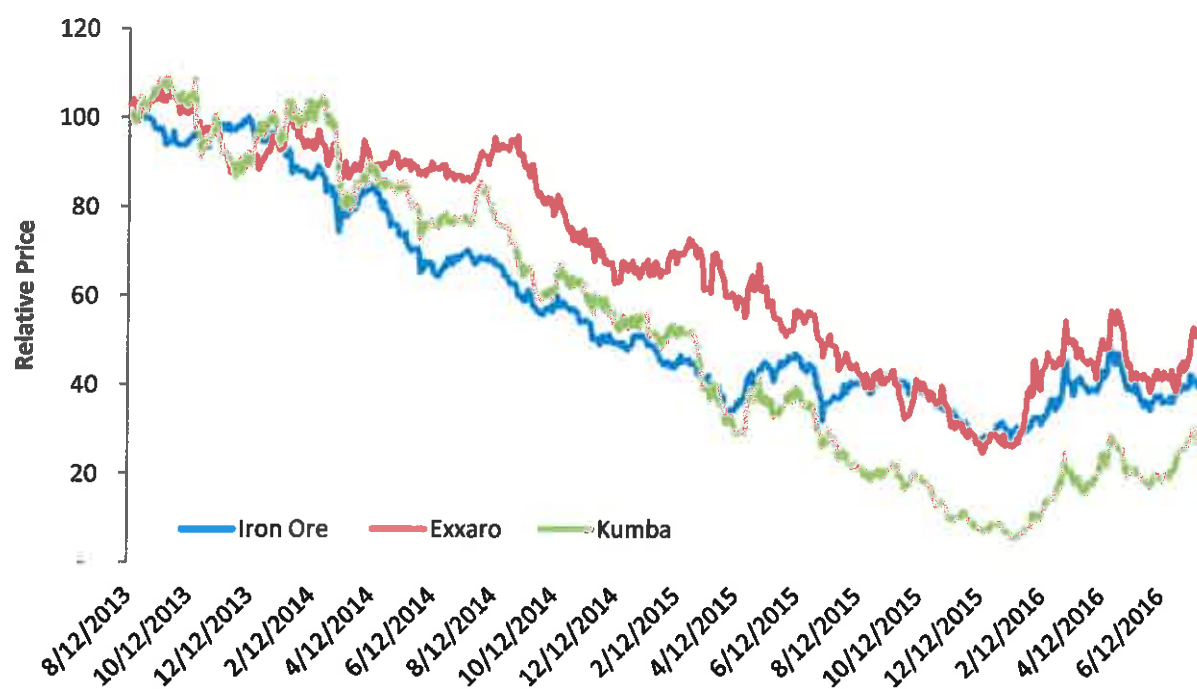
- 1.4.4. Cash flow for debt service relies on discretionary dividends and other shareholder distributions i.e. subordinated cash flows.
- 1.1. Banks and financial institutions which finance SPV companies typically have to create capacity to invest in SPV preference share issuance (as opposed to advancing a loan) so as to match the cost of financing with the SPV dividend income. Not all financial institutions have sufficient preference share capacity to participate meaningfully in these SPV structures.
- 1.2. Banks and financial institutions lending to these special purpose companies typically require increased pricing to compensate for the increased risks identified above compared with loans to operating companies.
- 1.5. Typically, these transactions are funded as share cover deals where the financial institutions provide unlisted or listed shares and a corporate guarantee from the operating company as collateral to facilitate funding. This reduces the debt capacity in the operating company, which prevents further debt capital being available for production purposes.

2. The correlation between market fluctuations (especially commodity and share prices) and value creation for BEE ownership

BEE deals that are funded against listed shares are, in addition to credit and financial risk, susceptible to market risk as the fluctuation in share prices impacts the cover level relative to debt funding. In addition to the extent that the underlying operating business is impacted by commodity prices, this further increases the volatility of the share prices. Due to this fluctuation in the share price the beneficiaries of the empowerment transaction tend to see their net worth fluctuate with the underlying share price. This is specifically evident in commodity related companies where a majority of the BEE transactions are observed.

The graph below compares the share prices for Exxaro and Kumba over the past three years:

Exxaro-Kumba-Iron Ore Prices Comparison



The graphics above illustrate the high correlation between share prices and underlying commodity prices. It is evident that in a commodity downturn significant shareholder value is lost. This could also trigger a default by the funding institution with the shares being sold to repay the debt or with a call on a corporate guarantee from the operating company. This undermines empowerment and materially impacts the financial health of operating companies. These BEE transactions do not create jobs. They do facilitate wealth creation or loss depending on share price volatility.

3. More comprehensive notes on the Black Industrialist Programme (BIP)

The current BEE approach has been geared less towards job creation than the creation and redistribution of wealth in the hands of black people. This is why BEE policy has not yielded meaningful job creation. The policy was intended to address imbalances of the past by promoting equitable corporate ownership. To promote job creation without compromising wealth redistribution, the government established the Black Industrialist Programme (BIP) which is aligned to the Industrial Policy Action Plan (IPAP). The key elements for this programme are summarised below:

- 3.1. The primary objective of the BIP is to ensure global competitiveness in specified areas and to have sustainable economic growth consistent with job creation.
- 3.2. Targeting specific labour-intensive industries aligned to IPAP including but not limited to:
 - 3.2.1. Blue/Ocean Economy, including Vessel Building and Repair,
 - 3.2.2. Mineral Beneficiation,
 - 3.2.3. Industrial Infrastructure,
 - 3.2.4. ICT,
 - 3.2.5. Agro Processing,
 - 3.2.6. Clothing, Textiles/Leather and Footwear, and
 - 3.2.7. Chemicals, Pharmaceuticals and Plastics etc.
- 3.3. Government's plan is to promote black industrialists in these sectors by providing easier access to funding on preferential terms via DFIs which include DBSA, IDC, ECIC, Land Bank, NEF and the PIC.
- 3.4. Access to markets provided through the use of public procurement to leveraged expenditure aimed at developing new industrial and technological capabilities facilitated through State Owned Enterprises (SOEs);
- 3.5. Support through training, matchmaking and information sharing, research and innovation support etc.
- 3.6. Support of active as opposed to passive black shareholders who drive the direction of underlying businesses. Passive black shareholding characterises current BEE transactions.
- 3.7. Examples of passive investment include Growthpoint, a PIC deal where the focus is black ownership rather than direct job creation.
- 3.8. Potential hindrances to successful implementation of the Black Industrialist Programme include:

- 3.8.1. Governance and financial health of SOEs. SOE procurement and contracts are typically sources of company growth.
- 3.8.2. Politically appointed people who may not have needed experience or expertise.
- 3.8.3. Debt capital as opposed to seed or equity capital.
- 3.8.4. Lack of proven financial performance historically, which influences bank and other funding negatively.

4. A stronger likelihood of sustainable jobs creation

- 4.1. Operating companies typically generate value by devoting capital (debt and equity capital) to the production of goods and services. This typically includes long-term fixed investment in an operating platform such as a mine, plant and equipment, machinery and tools, infrastructure, and short-term investment in working capital assets such as inventory and accounts receivable.
- 4.2. Companies which employ this capital efficiently create sustainable profits and positive cash flows. This creates wealth which benefits diverse stakeholders. These beneficiaries include employees through increased employment, higher incomes and better working conditions. This value creation is captured by listed companies in value added statements in annual financial statements. These statements depict wealth created by companies and distributed to stakeholders, including employees (salaries, jobs, working conditions), government (taxes and services), the wider community and the providers of capital. The provision of capital is a precondition for all other benefits.
- 4.3. The current form of empowerment transactions tends to take does not address job creation directly which is a policy objective. Policy reform encourages market forces to create value in ways that are commensurate with job creation.
- 4.4. The majority of the empowerment transactions entailed wealth redistribution (ARM, Afrisam, MTN, Exxaro etc) and community development (WIPHOLD, RBH and MIC) without prioritising job creation.
- 4.5. The BIP does seek to address job creation without compromising the key objective of BEE policy. What transformation needs job creation while at the same time encouraging black managers and business owners to make active decisions on the strategic and operational direction of businesses. This will advance rather than compromise the attainment of empowerment objectives. It will promote a pool of skilled black business owners while simultaneously creating sustainable job opportunities.

5. Ideas for further discussion

- 5.1. There are transactions where the development of BEE entrepreneurs funded by banks and development finance institutions delivered on job creation and job preservation. MIC, RBH and Wiphold and many others created new and sustainable jobs by creating value in underlying investments.
- 5.2. With the advent of the new Black Industrialist Programme (BIP), the government is taking a more proactive stance towards sustainable entrepreneurial development. As a result, DFIs such as the IDC fund only empowerment transactions where capital is injected into the operating companies. Transactions are evaluated on whether they increase operational and productive capacity with incremental job creation. DFIs have as part of their lending criteria the number of new jobs created and/or preserved relative to funding. The emphasis is on labour-intensive methods of production in IPAP.

6. Recommendations:

- 6.1. Programmes should promote small business empowerment. For example, a retail programme sponsored by retailers and general service suppliers (Shoprite, Pick 'n Pay, Spar, Makro, KFC, McDonalds, Chicken Licken, Spur, Cashbuild, Builders Warehouse etc) creates a limited range of franchises in less developed and lower income areas through which small black retail businesses can leverage off a sponsor's infrastructure and ability to raise working capital. This promotes small business and creates jobs.
- 6.2. Financial Institutions restrained from creating limited franchises because of capital and fiduciary considerations could develop training schemes for a select range of skills for emerging entrepreneurs servicing specific needs of communities.
- 6.3. House building schemes could include a requirement to train people from the area where the houses are being built. They could learn building processes on site in skills such as bricklaying, basic foundations, painting, roofing, plumbing etc. They can provide these services in their community after housing schemes are completed.
- 6.4. An abundance of opportunities exists for small supply operations supplying eggs, chicken, vegetables and the like locally supported by contracts to supply larger outlets.
- 6.5. Broad based schemes aimed at developing rural communities should have a skills development overlay with a short, medium and long term focus and should promote local entrepreneurship. That would fast track rural development.
- 6.6. Developmental schemes should start at ground level for the benefit of local communities and the development of skills and opportunity and focus on all levels of individual skills and ability.
- 6.7. These are mere examples. A myriad different schemes could be developed along similar lines which will provide income and employment while developing an entrepreneurial culture which will lead to further development and wealth creation in the long run.