CCRED POLICY BRIEF

Industrial Development Research Programme: JSE Top 50 firms[1]

July 2017

Introduction

South Africa's low economic growth has meant sustained high levels of unemployment, compounding the unequal and exclusionary economic structure. The country's economy is still heavily reliant on minerals-based activities, especially for exports. Diversified manufacturing sectors, capable of absorbing relatively low-skilled labour, have performed poorly, reflecting what has been termed premature deindustrialisation. In this context, it is critical to understand the strategies of large firms in terms of investment, expansion and internationalisation. This is central to the process of formulating policies for industrial development that address the key challenges of growth and economic structure.

This study assessed the investments of the largest 50 firms by market capitalisation listed on the Johannesburg Stock Exchange (JSE). The focus of the underlying research was to understand the investments, decision-making and strategies of large and lead firms *as they relate to industrial development in South Africa*. As such, it is important to distinguish between dual-listed companies which do not have significant operations in South Africa, and those firms listed and operating primarily in South Africa.

Composition of the top 50

While there has apparently been considerable changes in the composition of the top 50 the very large firms (in the top 20) have largely retained their positions at the commanding heights. In addition, the entries into the top 50 reflect the growing importance of services. Companies such as Discovery and the private hospital groups reflect the importance, as well as concentration, of private healthcare.

Several firms have risen significantly, such as in the case of Steinhoff and Discovery, when compared to rankings in 2000. In addition, there has been significant entry and growth of property management and health care companies. The rise of property companies is notable as it includes large companies that do not have significant domestic operations, essentially raising finance in South African capital markets to finance investment internationally including in Europe.

Investment incentive

Firms in the top 50 of the JSE experienced aggregate real increases in revenues and profitability measured in terms of returns on assets and equity over the period considered (2011-2016). However, the aggregate data on the top 50 does not reflect developments in South Africa given the significance in terms of market capitalisation of large, internationalised companies[2] that in some cases derive less than 10% of their revenues from South

[1] This policy brief draws from an underlying working paper forming part of the Industrial Development Research Programme (IDRP) funded by the DTI. See Bosiu et al. (2017), 'Growth and Strategies of large and lead firms - Top 50 firms on the Johannesburg Stock Exchange', CCRED Working Paper No. 17/2017.

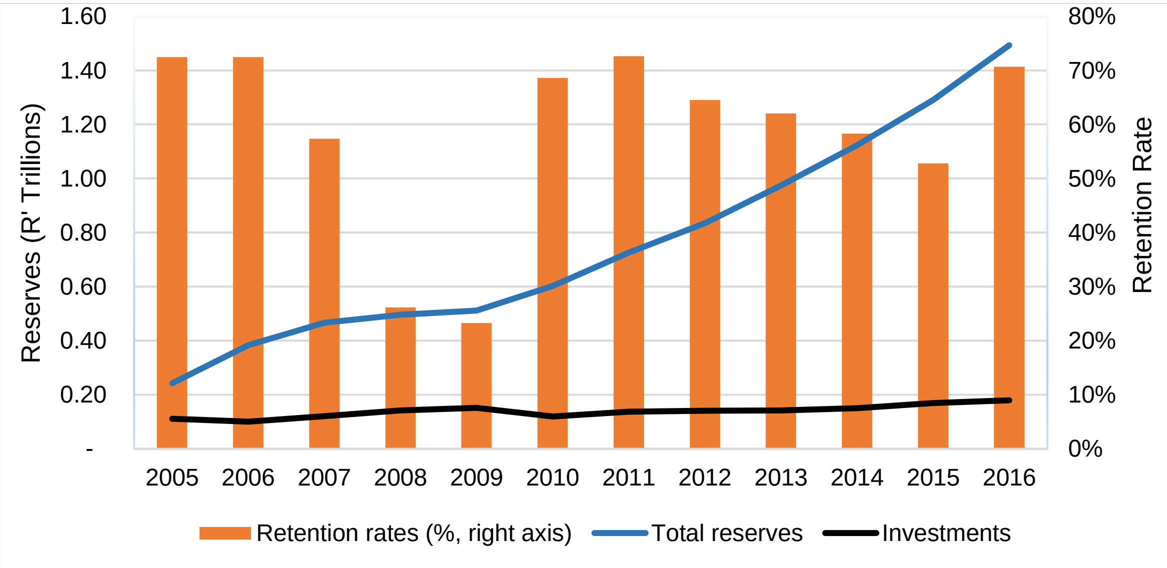
[2] The eight firms identified are British American Tobacco, SAB Miller, Anglo American, Glencore, BHP Billiton, Richemont, Naspers and South32.

African operations. When assessing firms with activities predominantly in South Africa, it is evident that investment is low, but profitability has been high. Firms have retaining cash, and reserves have built up significantly. Available funds have also been used for mergers and acquisitions rather than investment in new capacity, and many expansion investments have instead been outside South Africa, although there are important differences by sector. This underpins low private investment levels in the economy as a whole, noting that investment is also influenced by low growth and demand in the economy.

A comparison of movement or changes in reserves over time relative to annual investment (measured in terms of gross fixed capital formation) shows that firms have on aggregate diverted more funds to reserves as opposed to investment between 2010 and 2016. In contrast, in the period from the early-2000s up to 2010, on average firms where investing more than they were contributing to reserves. The trends are also mirrored in the reported company data which formed the basis of the analysis. The increase in investment during this period is largely explained by expansive projects in anticipation of the World Cup in 2010, government infrastructure projects, as well as favourable commodity prices around the early-2000s. However, there are important nuances at the sector and company level explored in the research.

Total reserves of the 50 firms considered stood at R1.4 trillion in 2016, which excludes those of eight large cross-listed companies (Figure 1). When all firms are included, reserves in 2016 amount to R3.1 billion. There are of course legitimate reasons for reserving funds, including to hedge against future uncertainty or risk, and planning for future projects. However, the rate at which the total stock of reserves has increased over time is notable, when considering recent debates regarding South Africa's low investment and growth cycle. Profits which could be invested, other things equal, are being withheld. To some extent, this could be explained by other factors such as low domestic demand or political economy uncertainty although it was not possible to ascertain this reliably across firms.

Figure 1: Reserves and investment (capital expenditure) 2005 - 2016



Source: InetBFA

Investment trends

Generally capital expenditure by the top 50, controlling for the eight large cross-listed companies, has been increasing slowly over the period although this has also slowed most recently. A disaggregation of these outlays shows that the majority has been spent on replacement capital expenditure (note: a limitation in the analysis was the lack of disaggregated capital expenditure data for most firms, which do not report in this way). Although replacement capital expenditure is necessary for the purposes of maintaining existing operations, and can enhance efficiencies, of concern in terms of South Africa's current low growth cycle is a lack of investment on additional, expansionary investments. Firms have, however, undertaken extensive, large value mergers and acquisitions.

Mergers and acquisitions

Significant mergers and acquisitions activity was observed across all sectors. However, in terms of value, the majority of value spent on merger transactions by firms in the top 50 was for acquisitions outside of South Africa. On average over the years 2011 to 2016, 61% of the value of mergers (which could be identified from company reports and business combination notes) involved deals outside Africa. Merger activity outside the country reflects ongoing and extensive internationalisation. However, this internationalisation has not been part of growing South African operations, but largely instead of investment locally.

A key challenge raised by the trend in merger activity is that mergers are part of ongoing concentration. Mergers can create future synergies and efficiencies that can result in increased productivity, however, there are significant risks of anti-competitive outcomes given growing concentration in South Africa and, indeed, globally. The concerns about anti-competitive conduct (particularly cartels) are particularly acute given the recent history of such conduct in many key sectors.

At the same time, there have been major acquisitions and investments by the top 50 firms in other African countries. These have included various green field projects as part of investing in improved capabilities and contributing to African growth. For example, in the case of the listed food producing firms and supermarket groups these investments reflect stronger regional value chains and growing regional trade.

Concluding remarks

The profile and size of the top 50 listed firms reflects the concentration of the economy and lack of structural change, notwithstanding the rise in importance of services and the ongoing internationalisation of big businesses. These firms have broadly maintained profit levels while not investing in expanded productive capacity in South Africa.

The assessment shows that firms have retained substantial earnings. This is consistent with large businesses being in positions of entrenched market power, where barriers to entry are high, and where their position is not likely to be challenged by new emerging companies. High levels of concentration and barriers to entry are a well-established feature of South African economic sectors. The challenge for policy makers is to determine the appropriate set of measures to stimulate investment in new capacity by incumbents and by smaller rivals.

Further work in this area is being undertaken by the Industrial Development Think Tank, housed at CCRED. This will consider in more detail the key challenges arising from a policy perspective in terms of structural transformation in South Africa, including through policy options to change the tightly concentrated nature of economic sectors and patterns of ownership and control. This builds on and complements CCRED's studies on Barriers to Entry in the South African economy which provided important policy proposals for the creation of a more inclusive economy, particularly in terms of enabling the entry of black owned companies to challenge established lead firms.