

Corporate restructuring and competition policy

The three essential questions

Will policy help improve the future incomes and job prospects of the great majority of South Africans? Will it help reduce what they pay in real, terms for goods and services and improve their variety and quality. Will it improve the returns from their savings and so the benefits paid out by pension funds, banks and other financial institutions?

Some facts about the distinction between ownership and control

The complaint has often been made that it is wrong that a few (whites) should own so much of the SA economy. The complainants, to be accurate, should substitute *JSE* for *economy* and for *own* they should say *control*. Controlling companies does not necessarily mean owning them and the companies listed on the JSE (Johannesburg Stock Exchange) do not represent the SA economy. Moreover, it should be recognised that a concentration of shareholder control may well be consistent with intense competition in the markets JSE listed companies sell to or buy from.

Ownership and control of the six large groups of companies that dominate the JSE by market value is separated by a minority of shareholders who control and a majority who own. Four of the six groups are family controlled, that is Anglo-American (Anglo), Rembrandt, Liberty Life and Anglo-Vaal. Tight control of some of the companies that make up the groups can be achieved with an ownership stake in the parent company of less than 5%. This controlling share will represent a very large proportion of the wealth of the controlling families. The mutual life insurers Sanlam and the Mutual will typically own a much larger stake, about 30% or more in their group companies.

In either case the non-controlling shareholders have by far the larger ownership stake in these companies linked to the various leading groups. These owners are widely spread through a very large number of pension and other forms of retirement funds. Thus the beneficiaries of the dividends, and more importantly, growth in dividends and increase in the value of the shares owned, are millions of South African employees and their retired predecessors. Increasingly they are black. They make up the majority of the pensionable work force in the formal sector and in time they will enjoy the majority of the benefits paid out. Union leaders have the power, with other trustees, to influence the investment policies of these funds.

Much of the accumulated wealth of South Africans, outside of the equity stake in their homes, is therefore being watched over by the self same controllers. About 60% of retirement funds are in equities, and of these the great proportion must be in the shares of companies that belong to the major groups.

The managers of the pension funds act as the agents of their beneficiaries. The share of the big three (Old Mutual, Sanlam and Liberty Life) in the total of funds under management is perhaps 70% of the total. But they compete very actively with each other and with at least 15 other serious rivals. They do so on the basis of the performance of the funds under management.

The links between size on the JSE and the economy at large

The companies and groups listed on the JSE play a very important role in the economy but their importance can be exaggerated. Companies controlled by Anglo, the largest of the groups, account for between 30 and 40 per cent of the value of the JSE. Anglo has calculated that their operations produce about 7% of SA's total output or GDP. If companies controlled by the other groups that make up another 50% of the JSE contribute to GDP in roughly the same ratio to market value, then JSE large group- controlled companies are responsible for perhaps 20% of all value added in SA.

Clearly the groups play a key role in managing economic resources but not the overwhelming one suggested by their share of the JSE. Government itself is responsible for about 25% of economic value with transfer and interest payments by government equivalent to about another 7% of GDP. The state

owned enterprises, Eskom, Telkom and Transnet and many of the important foreign owned companies that operate in SA, Shell, BP and Caltex, Total, Nestle, Unilever, Volkswagen, BMW and Mercedes Benz etc, are not represented on the JSE. Nor is every large private business. And a good proportion of GDP and a very much larger proportion of employment is contributed by small businesses.

The role in the economy, as well as the structure of ownership and control of a stock exchange, varies from country to country. For example Brazil, an economy about 6 times the size of ours, has a Stock Exchange with only two thirds of the market value of the JSE. Malaysia, economy about two thirds the size of South Africa's, has a share market nearly as large (all measured in US Dollars). Nor is it unusual for a few companies to dominate Stock Exchanges measured by share of market value. The Amsterdam Bourse is dominated, more than is the JSE by Anglo, by Royal-Dutch Shell and Unilever.

There is no obvious linkage between importance on a Stock Exchange and the power of a company or group to dominate, to the disadvantage of rivals, customers or suppliers in the particular markets in which they engage. For example Anglo's 7% of the GDP is generated to an important extent, perhaps more than half, from export sales of minerals, gold and other goods. Export markets are likely to be highly competitive.

The Anglo interests outside of mining are well spread though some of the companies may well have a dominant share of a particular market. SA Breweries comes most obviously to mind. But it is an exception and what might or might not be relevant in the beer market would not necessarily apply to any other market in which Anglo-controlled companies operate. Competition policy is necessarily concerned with the possible abuse of power in a well defined market and each case would have to be considered separately. The market in question might conceivably be the national market for labour or capital. To my knowledge it has not been seriously suggested that Anglo, either on its own or in combination with the other groups that dominate the JSE, have exercised some kind of monopoly power over the supply of capital or labour in South Africa.

The different groups and the companies under their control compete intensely for capital raised on the domestic and increasingly on foreign capital markets. The group system in SA goes back more than 100 years and was a feature of the early development of the diamond fields and gold mines. Over time, different groups waxed and waned and acquired or lost relative importance on the JSE and in the economy, precisely because of their ability or want of it to find additional sources of capital. If the group companies are profitable then most of the extra capital for expansion for either their own purposes or to finance other group companies will be provided by their own cash flows. If they are not profitable it will be difficult to attract outside capital.

The market for labour is also obviously made up of very many hirers and many more suppliers. None of the hirers, including Anglo-controlled companies, could be said to have the power to determine wages and conditions to their advantage. Rather than any excess demand for workers at prevailing wage rates, the formal sector is strongly characterised by excess supplies of potential workers. To the economist, wages must be regarded as too high rather than too low to absorb the available supplies. This does not suggest abuse by the monopsony powers of employers.

The meaning of shareholder control

The power to control means essentially the power to appoint the board and through them the senior managers and so the policies of the companies. Legally Old Mutual and Sanlam are controlled by their policy holders. In practice they are controlled by their senior managers. It is they who select the Board rather than the other way round. Other important management-controlled companies on the JSE, include Sasol and Iscor, which emerged from privatisations.

There are basically only two kinds of companies: management-controlled companies and shareholder-controlled companies. Managers too, unless politicians take over, also control State owned companies. Almost all the very large, New York Stock Exchange companies are management-controlled. Most of their shareholders own a minute fraction of the shares issued and none, even in

consortia, have the power to control managers. Managers are only vulnerable when poor performance leads to a hostile take-over. The US hostile take-over is not without its own problems and regulations often protect established managers from a take-over. The same is largely true of companies in the UK. But there, unlike the US, a group of important institutional shareholders may well be inclined to act together to replace unsatisfactory senior managers. In most other countries, as in SA, strong shareholders are to be found in control, and as in SA effective shareholder control is exercised with often very much less than 50% of the shares in issue.

Non-controlling shareholders are vulnerable to abuse and disappointment by controlling managers or controlling shareholders when the controllers act in their own and against the interest of the majority of shareholders. In the case of management-controlled companies there is the possibility of a hostile take-over. Such possibilities improve when disappointments with poor performance of managers brings with it a much lower share price. The cost of a hostile bid will be reduced. But in companies with controlling shareholders no take-over bid can succeed without their consent however unsatisfactory the performance. In such cases when the share price weakens as a result of poor performance the encouragement to give up control is the premium some outsider would be prepared to pay over and above the prevailing market price in order to control the company and reorganise it. The controlling shareholders would be denying themselves as well as their majority partners were this control premium to be refused. Nevertheless there will be cases where such incentives may not prevail over a strong and expensive taste for control.

There are in fact no fail-safe methods for securing the success of any firm, whether manager or shareholder-controlled. Firms of both types have been brilliant successes. Many more are mediocre performers and some of these remain impervious to the discipline of the market for control or the market for managers. Non-controlling shareholders in either type presumably make their investments with their eyes open, being aware of the possibilities of success and failure and of the controllers resisting a change in control. The successful firms will be encouraged by their majority partners to expand and be supplied with additional outside capital for such purposes. Failures, even if managers are not forced or encouraged to give up control, will be denied additional capital on anything like favourable terms. At best such firms will stagnate. This is the way the capital market works.

Ownership separated from control and everyone a winner

Almost all companies begin as owner-managed. Successful ventures expand by reinvesting profits and by attracting outside capital from banks and more rarely from minority partners. Minority partners have to trust their controlling partners who, among other powers, control the salaries they pay to managers and themselves. They therefore have little protection once the controllers have acquired a strong position. This is why these trusting partners are so hard to find. Outsiders have to rely on the controlling shareholders wishing to maintain their reputations as custodians of other people's wealth. Maintaining a reputation for fair play and good management on behalf of minority partners is essential if capital for further expansion is to be raised on favourable terms.

There are few limits to the expansion of successful firms other than ability to raise capital. For the few firms with controlling shareholders of great achievement, prospects and with good reputations, raising additional share capital need not prejudice their control. Control will become less secure as outsiders come to more own than 50% of the shares. But this barrier may be easily circumvented by the issue of low-voting or no-voting shares where regulations permit.

Where regulation inhibits this, a holding company could be formed to hold the 51% controlling stake in the operating company. The original controllers would keep 51% of the holding company and sell 49% to outsiders. Outsiders would then own 49% of the operating company directly and half of the remaining 49% or 25% indirectly. They would therefore own and receive 74% of the dividends from the operating company without being in any way able to control its management.

This process could be repeated *ad infinitum*. In recent years the JSE has turned its face against

listing super pyramids. There is however nothing to stop the establishment of unlisted companies to hold the ultimate controlling stake. Often the unlisted family-owned holding companies, especially in the early hopeful phases of growth, will take on debt, secured by the value of the holdings in listed companies, to follow their rights in share issues made by the key operating companies under their control.

In the US, UK and in South Africa, unlike for example continental Europe, issuing non-voting or low-voting shares was made difficult by laws and stock exchange regulation. But South African entrepreneurs were able to avoid the obstacle and to achieve exactly the same results with the consent of majority partners by forming holding companies, cross holdings and voting trusts. This they did to maintain control while raising extra capital for expansion. At times the expansion would be to take the key operating company beyond the original core activity. This would be done to diversify the family's wealth that may have been highly dependent on a single line of business activity. The controllers thus become the controllers of a conglomerate, without giving up control.

Nobody is forced to invest in tightly controlled companies. Any purchase or sale is at a market determined price. As with all share investments, such transactions come without guarantees. Only time can tell whether the trust placed in the controlling shareholder and in their abilities as controllers of managers and as managers of assets had been justified. That a few South African family-controlled groups have been trusted in the way they have and have been able to expand without giving up control, represent exceptional business success stories. Many originally small owner -manager enterprises make the attempt to become something more than a small business. Only a few succeed and ever fewer maintain their strength over a few generations.

Structure and market capitalisation

The South African system of listing holding companies and cross holdings exaggerates market capitalisation by comparison with exchanges where non-voting or low voting shares are employed to retain control or where one-share-one-vote rules. For example the large, Anglo stake in De Beers is included in any valuation of Anglo and vice versa. Clearly the same assets that help produce gold or diamonds are being counted more than once. This applies even more strongly to holding companies. Thus the same gold mines are included in market values as listed gold mines, as part of Amgold and as part of Anglo and so on for every JSE listed holding company with holdings of other listed assets. The market values of the underlying operating assets are doubled, trebled or quadrupled as they are counted amongst the assets of legally separate companies, each with different though sometimes overlapping shareholders.

Low-voting shares, serving the same purpose of concentrating control, are counted only once as part of the capital of the listed companies. Very often these so-called "B" shares trade at the same price as the "A" shares that come with voting rights. This may mean that either voting rights are not valuable or that in the event of any sale of control, it is expected that the offer to buy control will be extended to all shareholders. A number of logical consequences follow. Where holding companies prevail, market capitalisation will be much higher for the same stock of operating assets. By the same token the ratio of shares traded to market capitalisation will be much lower because the controllers' shares will never be traded. SA has a high ratio of market capitalisation to operating assets. But the ratio of shares traded per annum to that market cap is exceptionally low compared to most other exchanges. But clearly one cannot have it both ways – an artificially high market cap and high turnover to market cap ratios.

Some serendipity

The extraordinarily high market cap of the JSE has provided South Africa with a major advantage. South Africa was long excluded from the World Bank Index of Emerging Markets. These, defined largely by reference to per capita incomes, count for about 11 per cent of the market cap of all stock exchanges world wide. Indexes are important because they are used as a bench mark by fund managers

and their clients to evaluate performance. Returns are compared to the returns generated by the relevant index.

In April 1995, South Africa was included in the Emerging Market Indices. Based largely upon market cap and the ability to trade in the shares listed, the JSE received a huge weight of 23%, more than that of all Latin America, including Mexico combined, in the IFC Investable Index. This means that any fund manager holding less than 23% by market value of South African companies in any Emerging market portfolio is in danger of under performing. There are few if any Emerging Market Funds with anything like a 23% exposure to South Africa and perhaps few will ever wish to go that far. However since the SA weightings are currently so far below 23% a built-in demand for South African securities has been established. This is clearly good for South Africa's balance of payments and helps reduce the cost of capital for South African companies.

The foreign viewpoint

Foreign bankers and potential investors make two related criticisms of the SA structure. Firstly they criticise the conglomerate nature of the large SA corporation. Secondly they argue that the system of tight control makes it harder to buy into South Africa. Foreign bankers have a particular interest in changing the SA structure. Change means deals which means fee income. Furthermore the more change that can be forced by government the lower will tend to be the prices at which the shares and companies change hands. This clearly will not be helpful to the South African saver. But getting a bargain from a seller with a large direct and well informed interest in the asset may prove difficult. Is this what the bankers are complaining about? This concern of the controlling shareholder to buy low and sell high is exactly what their SA partner shareholders would demand of them. As indicated, the great majority of them have small stakes, the benefits of which mostly accrue through rights to pension and provident funds. The small savers who hold the great majority of the shares in the major SA corporations, look to the controller shareholder to watch over the managers who look after their operating assets. They surely do not want their controllers to be put under pressure to sell? Nor would such forced sales at lower than otherwise prices be in the broad national interest.

There is of course a national interest in foreign investment and improving the opportunities for foreign investors to buy South African. The way to encourage foreign investment in South Africa and to assist the restructuring of the corporate structure would be further to reform exchange control. That is to allow South Africans the same freedom to buy and sell foreign assets that foreigners now have to buy and sell South African. If so, more South African owned SA based assets will be sold at a market determined price to foreign investors as South African firms and portfolio managers diversify internationally.

In the past, in some measure because of exchange controls, the cash that could not be profitably employed by successful SA businesses in their core activities was used to buy stakes in unrelated activities. Other managers were employed to look after the surplus cash. This they did more or less successfully, under the supervision of the controlling shareholder twice or three times removed. If the investments worked the managers would be left alone. If they failed, new managers would be found to make the best of a bad job. This form of diversification by the controllers away from the core activity has worked very well for some of the groups, some of the time.

Bundling, unbundling and foreign exchange

The portfolio investor in JSE listed companies typically has the choice of investing either in the group parent or in the listed subsidiaries they control. They will constantly compare the risk adjusted returns of the whole, the diversified group parent company and the sum of its listed parts. But it should be appreciated that the group parent company is typically not a pure investment trust holding only listed assets. The SA group controlling companies typically also undertake investments in unlisted ventures. These they may start up and hope to reduce their stake in later. The difference in the performance of the

group and the listed subsidiaries will depend on the success or otherwise the group has with its start-ups. Studies show that the group parent can add wealth for shareholders through the development of new ventures and the returns from unlisted assets and fee income. Such a conclusion is not surprising. If the group companies had consistently failed to produce, the group would not have been able to access additional capital from either inside or outside.

The portfolio investor will pay a premium, for rapid growth in the dollar incomes they can expect from SA companies. They will appreciate good shareholder control over managers to this end. What they do not need is for the controlling shareholders to diversify on their behalf. This they can do well enough on their own. But this does not mean the end of the conglomerate. GE in the US is but one example of a highly successful conglomerate. But the onus is on the managers and controlling shareholders of a conglomerate, especially in a world of mobile capital, to prove that they can add wealth for all through a proven specialised ability to control and monitor diverse activities. They will have to demonstrate that being a conglomerate is not simply a device for diversifying the risks of the controlling shareholders and/or their managers. Shareholders will demand a discount to hold shares in a conglomerate if they are required to accept a very mixed bag of assets simply for the sake of retaining the involvement of the controlling shareholder or existing managers trying to reduce their own risks. It is the opportunity to reverse this discount and achieve the huge price to earnings premiums that come with being a world class company that will be incentive enough for controlling shareholders of SA corporations. Incentives to make the deals that mean more foreign investment and which will be of benefit to themselves and their majority partners have never been more pronounced. Freedom from exchange control is bound to encourage a more specialised, focused character for the typical SA conglomerate.

The role of the black entrepreneur in restructuring corporate South Africa

The individual black South African businessman has an obvious interest in forcing the pace of corporate restructuring. The faster the pace is forced the better the terms upon which black South Africans are likely to be involved. Clearly it is highly desirable that black South Africans come to participate fully as controllers of South African business in the interest of a majority of non-controlling shareholders. However it is not at all obvious that the price of entry into the system for black entrepreneurs should be an artificially low one. As with entry by foreigners it is not in the interest of the great majority of savers that their assets should be sold off at bargain basement prices. This would benefit a very few at the expense of the many.

It is also very much in the interest of the workers and consumers, the great majority of whom are also black, that the firms that supply them with jobs and goods and services should be as well managed as free competition could determine. They have no economic interest in the promotion of managers or their controllers except on their merits. As has been indicated many South Africans have done well, mainly through their pension and other contractual savings schemes, out of the Oppenheims, the Ruperts, the Gordons and a number of other part owners, but full time controller/managers. The controllers may have been white, but the beneficiaries have been the usual rainbow of colours represented on the pension schemes and the provident funds.

It is the early identification of the next generation of business superstars that savers in South Africa are anxiously looking to. They and the new savers they will serve, deserve as much encouragement from a system that concentrates powerful control and disperses the benefits, as their predecessors have had. Hostility to the SA system of corporate governance among influential black South Africans was generated because it appeared quite falsely, as has been indicated, to have benefited only a small number of whites. This hostility will hopefully evaporate as black entrepreneurs now use the system to raise capital to expand their businesses. They have been able to do so without having to concede control and without having to rely on their own, naturally limited savings, as others before them have done.

New Africa Investments Limited (NAIL) provides a very good example of how the system can be used to advantage by black entrepreneurs. NAIL had a market value of some R347m in March 1995. Its major asset is a 30% shareholding in life insurer Metlife. Corpaf, a listed pyramid company, worth R92m owns a controlling 51% of NAIL. According to the pre-listing prospectus, Corpaf is 63% held by an unlisted company CAI which is in turn 79% owned by another unlisted company, CAH. CAH is 40% owned by N H Motlana & Sons (Pty) Ltd in which Dr Ntatho Motlana is reported as having a 60% interest. Thus Dr Motlana has achieved effective control over the management of NAIL and with a 12% ownership stake in Corpaf worth some R11m and so a 6% stake in NAIL worth some R22m.

The most important point about all this is not how much money Dr Motlana may have or will make. How much will be the difference between what was paid for his share of the operating companies and what they are worth over time. As is usual in all such pyramided arrangements that SA families make to maintain control, we are unaware of how much debt has been incurred at the upper levels of the Motlana pyramid structure. And if there is debt it will be debt secured by the value of the underlying assets. There is everything still to play for.

Thus the important issue is how well will NAIL do in the future under Motlana control. For every extra Rand NAIL returns to the Motlanas it will be returning R94/6 ie R15,66 to other shareholders. It is the quality of control, as with all the other tightly controlled, widely owned companies quoted on the JSE, that will be decisive. NAIL will be judged by its results. The better it does, the more assets Dr Motlana will be able to control.

Clearly, black entrepreneurs have a special contribution to make to the SA economy. By taking advantage of the wealth creating opportunities available to them they legitimise what is a highly productive process. They also can bring special skills in managing business relations with government. Managing governments well is often an essential ingredient in business success and a successful economy. By so doing they can create wealth for their controllers and more important, for their many shareholders who will be of all races. Running business well means better satisfied consumers and more productive and so better paid workers. That is the ultimate aim of good corporate governance.

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