The good and the bad in empowerment deals:
A shareholder’s perspective”

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What makes a “good” black economic empowerment (BEE) deal? This is a question shareholders are asking themselves. Some have been badly stung. For instance, investors who backed Gold Fields’ deal to introduce new BEE investors into its South Deep mine are now ruing the day. That deal is now being probed by US investigators who suspect it may have included corrupt payments to politically connected individuals. If found guilty, the company could face big fines.

The Gold Fields deal was not unique. In 2012, ArcelorMittal SA made a similarly cynical attempt to buy out Imperial Crown Trading (ICT). At the time, ICT was alleged to have hijacked part of Kumba Iron Ore’s mining rights to the Sishen Mine. The Constitutional Court later ruled that the rights were Kumba’s alone. ArcelorMittal quietly dropped the proposed transaction with ICT.

Off the record, mining executives will tell you they come under significant pressure from politicians to do deals with specific people. And as of April this year, mining companies will be required to confirm that over 26 percent of their operations are owned by black investors or face losing their mineral rights. Because that minimum has to be maintained, when one black group sells, the company has to ensure other black groups buy in. There is thus a constant flow of deals and plenty of scope for individuals to use whatever power they have to ensure that the spoils go to favoured people.

Investors have a direct interest in such deals. For one thing, they come at a cost. However they are structured, newly introduced black investors are effectively receiving a discount on their shares, which has to come at the expense of existing shareholders. Gold Fields’ notorious deal, for example, cost over R2 billion, which was a direct hit to the income statement of the company and therefore a real cost to shareholders.

There is obviously a serious problem when a R2 billion deal ends up getting the company into hot water with US regulators. The US Foreign Corrupt

Practices Act is a draconian piece of legislation that is now being rigorously enforced. Any sign of a company with any US presence triggers an investigation. Gold Fields was swept up because it has a secondary listing in New York. Unsurprisingly, foreign investors are now asking whether BEE deals are by definition corrupt and whether they should simply vote against them or disinvest from companies that do them.

The answer, of course, is no. But shareholders do have work to do to ensure that companies make the right empowerment deals that deliver on the objectives of empowerment. There are three key questions to ask:

- Is the deal structured to minimise the cost to shareholders?
- Are the deal partners going to bring genuine value to the company through their abilities to advance the interests of the company?
- Does the deal advance the project of transforming South Africa’s economy?

These three objectives will sometimes clash, but in the best deals they do not.

SHAREHOLDER COSTS

On the first objective, empowerment deals come at a cost, but there are various ways to minimise this. One way is to only accept black investors who have some capital to contribute to the deal. Certain big names in empowerment circles – such as Mvelaphanda, Gold Fields' first empowerment partner, or Shanduka, which was until recently Cyril Ramaphosa's firm – have now built substantial balance sheets and can afford to put cash into businesses they invest in. But this approach concentrates deals in the hands of a few already wealthy individuals, which appears to be in tension with the third objective. To transform the economy, deals should uplift large numbers of people, rather than the few.

If cash contributions by the newly introduced investors are not feasible, then two other factors can effectively lower the cost to shareholders: the way the deal is structured and the sustainability of it. Logically, deals that have the largest implied discount to the market price are also the most sustainable because they are the most likely to generate sufficient return to cover the cost of capital. These deals are structured like options, but are technically different because they ensure beneficiaries have voting rights from the start. An option gives the right, but not obligation, to the holder to buy an asset at a future date at a locked-in "strike price". If the price of the asset appreciates, it then becomes sensible to exercise the option. For example, a R5 strike price for a share worth R10 at expiry would be exercised, giving the holder a R5 profit.

For the option to reach the end of its life with a positive value in an empowerment deal, the returns from the shares also need to be higher than the cost of finance. So the key issues that affect the sustainability of the deal are the cost of finance and the strike price. The bigger the discount between the share price now and the strike price, and the lower the cost of finance, the more likely the deal will end up with a positive value.

Options are common in many areas of corporate finance and are usually used to incentivise the holders to drive up the value of the company. They have been a popular way to motivate managers of companies. But do they create the right incentives for empowerment shareholders? In part, empowerment deals are done to ensure the company complies with requirements in order to tender for projects and other business. But, like any shareholder, empowerment shareholders can do more than simply open doors through their presence. They are able to play a strategic role in a business and contribute in many ways. Options do stimulate this – empowerment shareholders have an important economic reason to make sure their contribution is substantive because it is in their interests to improve the value of the company. This can be done through the strategic input that empowerment shareholders can bring, including helping a company to better cater to a diverse and transformed marketplace. Such strategic involvement of black shareholders also goes a long way to achieving the third objective of making black empowerment far deeper than the colour of corporate shareholders' skin.

When empowerment partners do contribute value in this way, all shareholders are better off and the cost of the deal is a price worth paying. For this to happen, shareholders must ensure that the empowerment investors are able to add genuine strategic input that improves the earnings power of the company. It is too easy to see this value cynically, as obtaining the right cover by having politically powerful people exposed to your company so that they protect your interests. From the look of it, this is how Gold Fields must have thought its empowerment partners would add value. That deal was also structured, not as an option, but as a donation of shares, so the incentives couldn't have driven a return to shareholders in the long run. All that was achieved was the short-term political cover for the mining group to obtain mining rights for South Deep. But cover of this sort can become a liability as the political fortunes of the partners change. Today's powerful political figure can tomorrow be a voice in the wilderness. Shareholders, though, can stay around for a long time.

In short, then, it is wise for shareholders to avoid deals with politically exposed people whose value is not in the form of real strategic input, but only short-term political cover. They should favour those who can genuinely add long-term value that will compensate for the cost of the deal to shareholders.

VALUED PARTNERS

Who could such people be? One obvious answer is a company's own black employees, who are well positioned to add value, loyalty and commitment to the company through the incentives of an option structure. Some of the most successful deals done to date – if not all – have used this approach, including those of Kumba Iron Ore and Standard Bank.

Kumba's empowerment scheme stands out as exemplary. Its 6 209 employee shareholders received over half a million rand each from it in 2011 and have since received R100 000 in dividends. They are due to receive a further lump sum this month [March]. This has had direct benefits for the company. It has relatively calm labour relations – although the employee scheme was both a help and a hindrance in this. Some employees are not members of the scheme, as they were not employed at the time it began. As a result, the large 2011 payout led to resentment and fractious relations among employees, which contributed to a 2012 illegal strike. On the whole, though, Kumba has lower labour militancy than other mines and lower staff turnover.

Kumba's scheme has other important elements. It benefits a trust that contributes to the communities around its operations, funding development and social services including healthcare and education. Such support helps the company maintain good community relations, which can be very important to ensure an effective operating environment. Fractious community relations can inflame labour relations as well as posing a threat to the security of the business. The Marikana tragedy is the worst example of how wrong things can go when a company doesn't maintain good staff and community relations.

The third important element of the Kumba empowerment structure is the participation of Exxaro as a strategic partner. Exxaro is the largest black-owned mining company in South Africa, with significant operations of its own in the coal industry. Its participation in Kumba has allowed it to also make significant payouts to its own employees, while senior management provide direct strategic input to Kumba.

The key factor behind the success of the Kumba scheme has been the growth in the Kumba share price and the company's large dividends (technically, the empowerment scheme is at the level of its mining operation, Sishen Iron Ore, but it is Kumba's largest asset and the main driver of its performance). The share price has more than doubled over the past five years and has paid out a further 30 percent of the share price in dividends over the same period. This performance was both a function of strong global demand for iron ore and also the fruit of an efficiently run operation that has managed to meet its production targets. The returns have allowed all of the elements of its scheme to benefit handsomely.

It doesn't always work that way. Schemes can end up with depressed share prices, no dividends, and no money in the hands of beneficiaries. When that happens, things can go badly wrong – employee expectations are dashed, along with morale and labour relations. Companies have little choice in such a scenario but to start again and create a new scheme with reset prices that will have better prospects of delivering real value. While this amounts to another cost to shareholders, it can be worth incurring when the deal has the potential to provide good value to the company.

To some extent, share prices are set by forces beyond the control of a company or its shareholders. Resource prices, for instance, are determined by international markets and reflect demand by global consumers as well as the supply that reaches the markets from other sources. But three things are within its control: the strike price, the cost of finance and the strategic value the empowerment partners can deliver to the business. Shareholders need to focus on all three in order to satisfy the first two issues that matter.

UNDOING APARTHEID'S LEGACY

The third of my three questions is also important to consider. Companies should engage in undoing the legacy of apartheid by helping to change the racial makeup of the economy. This is both for independent moral reasons, in that empowerment plays a part in redress for past wrongs, and also for reasons of enlightened self-interest: a transformed economy would be more stable and offer a much larger market. Shareholders care about these things too. While foreign investors are often painted as disinterested profit seekers, many institutional investors have mandates from pension funds that instruct them to consider moral issues in their investing. Empowerment is an issue of both redress and sustainability and many international investors are willing to back it.

When does a deal not advance the project of transformation? When it is narrowly focused on a handful of already well-off black shareholders, it seems less empowering of black South Africans than a very broad deal that includes a vast number of people. However, there is an argument on the opposite side: concentrating wealth in a few black hands creates large and powerful black investment trusts that can drive black interests more effectively. It depends on who in particular would benefit from the narrow deal and whether this concentration of resources would be useful. For instance, a black investment firm with a strong record of driving change within companies and using its resources to wield a wider impact on the economy could be a strong contender. A narrow group of beneficiaries interested only in short-term wealth accumulation and no further transformative impact clearly would not be.

To my mind, a single good deal can achieve multiple effects. It can empower staff, ensure their loyalty and motivate them to contribute to the value of the company. It can ensure a good relationship with the communities within which the company operates. And it can also help black capital gain traction in the South African economy. All three of these effects are good for companies and good for the overall transformation project.

So it is remarkable that the Gold Fields deal and others like it can even be done. Whatever pressure Gold Fields was under to take the route it did, it did not serve its shareholders' interests. Shareholders have made their views clear, and will serve as a backstop against such pressure from unrelated parties. Politically connected individuals are likely to be rejected, even if they have the power to make a company's life very uncomfortable. That is as it should be.