SELLING OFF THE SILVER

THE IMPERATIVE FOR PRODUCTIVE AND JOBS-RICH INVESTMENT

By **Nimrod Zalk**

The author is an industrial development policy and strategy advisor in the department of trade and industry and a PhD candidate at the School of Oriental and African Studies, University of London. He writes in his personal capacity.

Nimrod Zalk

South Africa's failure to mobilise higher levels of investment in productive sectors of the economy has materially contributed to the conditions amenable to clientelism, patronage and corruption.

Capitalist development since the Second World War ushered in unprecedented rates of capital accumulation and structural change in the world economy in the form of rapid industrialisation. Fast and sustained industrialisation has been associated with large increases in wage employment, labour productivity, and health and educational welfare. Countries that have been able to mobilise rapid and sustained late industrialisation, such as South Korea, Taiwan and India, have displayed three characteristics in particular: a high and sustained share of manufacturing in gross domestic product (GDP); a high rate of fixed investment in GDP, and rapid growth in the value and sophistication of manufactured exports.

Over the last two decades of apartheid, South Africa performed increasingly poorly against all three of these benchmarks. While the development of mining and heavy industry had previously driven growth, investment in megaprojects and the electricity and transport infrastructure to support them increasingly dried up. The need to shore up profits in a stagnant economy accelerated a longstanding pattern of conglomerate growth predicated on acquiring existing companies rather than the development of new products and markets (particularly export markets). Thus South Africa saw a profound

The rising influence of institutional investors demanded intensive corporate restructuring in order to unlock larger and more rapid flows of cash to shareholders.

economic and political crisis escalate over the 1980s.The large private conglomerates, recognising the need for a political settlement to restore prospects for accumulation, began strategic engagements with the African National Congress (ANC). Large public business groups like Iscor and the Industrial Development Corporation (IDC) also positioned themselves for a post-apartheid future, developing much closer relations with their private counterparts even as they secured increasing autonomy from their formal principal, the state.

After a decade of social crisis and declining per capita incomes, South

Africa's transition to democracy in 1994 came with high hopes for economic revival. There was a broad consensus that revitalising the economy required industry to shift from its historical reliance on mining and mineral processing to more diversified and labour-intensive manufacturing sectors.

In the post-apartheid period, growth, fixed investment and export performance have fallen far short of middle-income developing country comparators, along with exceptionally high rates of unemployment. Given this mediocre performance, which has worsened since the global crisis, many influential commentators argue that South Africa's political economy has descended into extremely damaging relationships of patronage and clientelism.

How did we get here? What went wrong? And what can be salvaged? I address these questions based on my own research on the post-apartheid development of the steel and engineering sectors.

THE FREE MARKET NARRATIVE

A beguilingly simple narrative rapidly solidified over the early 1990s: introduce macroeconomic stability through inflation and public expenditure controls and de-emphasise the need for public investment. Remove market distortions such as tariffs, capital controls, excessive labour market protection and requirements to lend to particular sectors. These reforms, it was argued, would result in an autonomous and virtuous restructuring of the economy through disembodied market signals. New entrants,including foreign investors and emerging black businesses, would step in to rapidly raise levels of investment and employment. Particular faith was placed in the unalloyed benefits of foreign direct investment to bring not only net positive capital inflows but also the transfer of the latest technologies and managerial efficiencies.

In sector after sector, conglomerates unbundled and then consolidated in sectors where market power could be shored up.

Critics of this view argued that public investment marshalled rather than displaced private investment, that the predicted benefit of lowering tariffs in the absence of more comprehensive strategies for industry restructuring was not supported by international evidence, that capital account stability was required, and that South Africa should foster a stable and motivated, rather than lowly paid, workforce. The conglomerate structure that had emerged under apartheid, it was argued, required active reorientation.

As is well known, the former narrative won the day, not least due to relentless individual and collective advocacy by the largest business groups. The set of policy reforms ultimately adopted by government reflected virtually all those demanded by the conglomerates. The major exception was a strengthening of worker rights in the labour relations regime. The argument that government needed to play a strong role in steering a process to reorient the massive financial muscle and substantial (although deeply skewed and uneven) industrial capabilities built up by the conglomerate groups was dismissed variously as distortive of market forces, likely to frighten off foreign investors, and more likely to make things worse than better.

The conglomerates alsorecognised very clearly that the implementation of policies that would allow them the freedom to restructure domestically and shift capital abroad required a legitimation mechanismwith the incoming democratically elected government and influential parts of its constituency. Thus they initiated the practice of black economic empowerment (BEE), with its emphasis on ownership transfers to influential individuals, to secure buy-in for orthodox reforms, particularly capital account liberalisation.

In parallel, the deregulation of the financial sector that had been underway since the mid-1980s was rapidly taking form asa shareholder-value movement that emerged in the United States and the United Kingdom and spread to developed and developing economies alike. This movement saw the rising influence of institutional investors demanding intensive corporate restructuring in order to unlock larger and more rapid flows of cash to shareholders.It was within this context –and an uneasy and unstable political settlement – that fundamental corporate and industrial restructuring took place in South Africa.

SELLING OFF THE SILVER

How has this process played itself out both in broad-brush terms across the economy and specifically in the steel and engineering sectors?

South Africa's post-apartheid economic restructuring has seen intense corporate activity in the harvesting of historical investments and the distribution of their proceeds, rather than in raising investment in new products and markets, particularly export markets. Two recent pieces of research are revealing. A 2015 PhD »

study by University of Stellenbosch academic Nicolene Wesson enumerates the magnitude of funds transferred from JSE-listed firms to shareholders from 1999 to 2009. Over this period, R384 billion was paid out to shareholders: R247 billion in dividends and R137 billion in share buybacks. Note that this does not include transfers from South African firms listed offshore, such as Anglo American and British American Tobacco (BAT), as well as returns from unlisted investments including rapidly growing private-equity activity. A 2015 Intellidex report on the value of BEE deals estimates that the unencumbered financial value transferred through BEE deals by the 100 largest JSE-listed firms between 2000 and 2014 amounted to R317 billion. Again, this is an underestimate of the value transferred as it excludes unlisted transactions, not to mention surpluses accruing from massive public-sector procurement spend.

Relate these (underestimated) sums to the levels of fixed investment in the economy. The R384 billion in transfers to shareholders is equivalent to 17 percent of total gross fixed investment in the economy over the same period. The R317 billion in surplus transfers through BEE from 2000 to 2014 is equivalent to 8 percent of total gross fixed investment. If even a proportion of these flows had gone into fixed investment, investment rates would have been considerably higher.

The magnitude becomes even starker when compared to fixed investment in the manufacturing sector. Over the respective periods, transfers to shareholders represent 61 percent and BEE transfers 29 percentof manufacturing fixed investment. This is not to naively suggest that shareholders should not receive a healthy return on their investments, nor that there should not be BEE transfers, but that productive fixed investment has not been a primary objective of corporate activity.

Developing country plants, such as South Africa's operations, were used to generate as much cash as possible to repatriate to the global parent.

With tepid overall fixed investment, the largest increase in South Africa's fixed capital stock has been overwhelmingly in finance and related services, despite mediocre private savings and investment rates. It has also been in services sectors linked to large increases in credit-fuelled and import-intensive consumption. In sector after sector, conglomerates unbundled and then consolidated in sectors where market power could be shored up, and exited sectors where it could not. These ranged from banking to heavy industries like petrochemicals and steel, construction, wheat and maize milling, bread, poultry, sugar and telecommunications.

RESTRUCTURING IN STEEL

The negative feedback effects of policy choices adopted or accelerated over the early 1990s rapidly began to appear. The de-emphasis of public investment meant that the surge in demand for light engineering anticipated in the Reconstruction and Development Programme in areas such as housing, public transport and water reticulation did not materialise. Simultaneously, rapid reductions in import tariffs introduced intense competition. Iscor's privatisation as an unregulated monopoly (with Highveld as a second monopoly) allowed domestic steel pricing to be pushed to full import-parity levels. Even as policy rhetoric emphasised the greater play of market forces for downstream industries, extensive public support was given to one final set of megaproject expansions in carbon and stainless steel and a range of other mineral-processing projects.

Faith that a virtuous process of industrial restructuring would be driven by shifts in relative prices introduced through liberalisation saw little, if any, need for serious co-ordinated strategy to reorient the engineering sector. Consequently, no such strategy was mobilised until 2007, when South Africa began to mount its first meaningful post-apartheid industrial policy. Far from restructuring being driven by the envisaged disembodied market forces, it was in practice driven by the same conglomerates that had been unable to render their engineering subsidiaries fully competitive in conjunction with the rising influence of institutional investors.

Iscor had already been privatised in 1989. Its primary strategy for restructuring was a massive slashing of jobs, but whatever costs were cut in the process did not translate into greater efficiencies. In fact, financial performance deteriorated under privatised management, despite Iscor increasingly exercising its market power to price steel domestically at import parity levels. Notwithstanding this, Iscor – as did its other large private counterparts, Anglo and Gencor – embarked on a massive expansion, in the form of an entirely new integrated steel plant at Saldanha predicated almost entirely on exports, despite depressed global steel prices. These expansions were generously supported by cheap Eskom electricity, IDC finance and tax incentives. Simultaneously, China was beginning to suck in increasing amounts of iron ore for its own steel production, which began to

drive up global iron ore prices. Iscor management, in conjunction with the IDC, promoted an unbundling as a way out of the morass.

Iscor's increasingly attractive iron ore assets were acquired by Anglo and a foreign investor, LNM, was brought in to salvage the steel business, underpinned by a concessional iron ore supply arrangement with Kumba. LNM was a leading player in a consolidation of the global steel industry that was based initially on the leveraged acquisition of recently privatised steel plants in developing countries and then extended to the acquisition of plants in the United States and Europe. Mittal Steel, LNM's successor, emerged as the largest steel group in the world after a hostile takeover of Arcelor to create ArcelorMittal. This process of growth through leveraged acquisition left ArcelorMittal with high levels of debt to service, which in turn informed a bifurcated strategy. Developing and transition country plants, such as South Africa's operations, were used to generate as much cash as possible to repatriate to the global parent. By contrast, investment and research-and-development expenditure was concentrated in US and European plants to ensure they didn't fall behind technologically, not least because this could result in losing out to aluminium in the valuable automotive market.

Rapidly rising steel prices from 2001 – part of a broader global commodity boom –and a valuable cost-plus iron-ore pricing arrangement with Kumba masked a combination of underinvestment in the maintenance of ArcelorMittal South Africa (AMSA)'s plants and rapidly rising inefficiencies as net investment flowed outwards to AMSA's global parent. However, the subsequent collapse in steel prices following the global financial crisis,in conjunction with the collapse of its concessional arrangement with Kumba, starkly exposed these inefficiencies. The circumstances surrounding the loss of the Kumba supply arrangement, and the three-way contest to secure the valuable rents associated with it, reflected deeper ruptures in the political economy. »

> **As one former Anglo director has put it, "The move to London was a disastrous mistake for the company and for the country."**

Steel Wool Spinning
Credit: Wikicommons

Anglo American's shift in domicile and offshore listing on the London Stock Exchange was largely motivated to escape the strictures that might be imposed by a post-apartheid government. However, it rapidly became subject to a different set of strictures: aggressive institutional investors insisted that, in order to unlock shareholder value, Anglo should become an increasingly focussed mining company and shed its non-mining businesses to erode the discount it traded at relative to its peers Rio Tinto and BHP Billiton. This would raise both its share price and payouts to shareholders.

Anglo shed three major steel and engineering assets. Highveld Steel, the country's second largest steel producer was sold to Evraz in 2007. Evraz had also been engaged in the debt-based acquisition race to become a major global steel player, culminating in even higher debt levels than ArcelorMittal. Similarly to Iscor, Highveld – already suffering an investment backlog –was placed within the ownership of a group whose primary imperative was to return cash to the centre to service a massive debt load. The failure to invest was thus even more brutally exposed with the downturn.

While the glut of Chinese steel and associated cheap imports has been the proximate cause of the industry's distress, commodity markets are always subject to periodic downturns and high cost plants are the most vulnerable to large losses (as experienced by AMSA) or closure (as with Highveld). This is not to suggest that foreign ownership is automatically problematic. Columbus Stainless Steel under the Spanish Acerinox group has been a far more sustainable and responsible investor. The point is rather that unconditional transfers to foreign ownership subordinate national industries to the global strategies of the transnational parent, in this case with disastrous consequences for Iscor and Highveld.

Anglo also owned two of the most important engineering companies to emerge out of the apartheid period: Scaw Metals and Boart Longyear. Boart was a unique product of the Anglo group, having developed international competitiveness soon after its establishment in the 1930s. By the 1990s, it was among the largest global manufacturers of mining rockdrills, exploratory drilling and services and abrasion tools. However, these successes masked longstanding managerial weaknesses and technological backlogs, especially the failure to keep pace with the global shift from hand-held pneumatic rock drills to hydraulic drilling rigs. This failure particularly impacted Boart's

This investment-holding company model has become the favoured structure of emerging large BEE groups.

South African operations due to its longstanding reliance on supplying hand-held drills to a rapidly declining mining industry.

Anglo split Boart's lagging South African components from the international businesses. It was careful to pre-empt government concerns by ensuring that the two domestic businesses were sold off to empowered consortia and to claim that no South African jobs were lost in the processes. While one of these has survived, the other rapidly went under. In preparation for this sale, Anglo also bought and then closed down Huddy, a smaller but capable rock drill

Credit: spilldoctor.co.za

manufacturer. Anglo then sold off Boart's international businesses to a consortium of two large international private equity players who rapidly realised their return by listing Boart Longyear (excised of its South African operations) on the Australian Stock Exchange.

Anglo's disposal of Scaw followed a similar pattern. Scaw's operation straddled primary steel production and value-added engineering. The demise of public investment in rail seriously undermined its rail-related business, pushing it back onto its traditional reliance on mining, in areas such as grinding media and rope and chain. From the early 1990s, Scaw rapidly internationalised in the grinding media sector, acquiring North and South American businesses. By the early 2000s, it was a leading global player, producing around 42 percent of world output.

While Scaw was not fully competitive in all its engineering operations, it was financially sustainable and virtually debt free. Anglo began to indebt Scaw, to the tune of around R6 billion, partly to facilitate the entry of a BEE partner but primarily to extract cash. The economic and commodity downturn flowing from the global economic crisis rendered it increasingly difficult for Scaw to service this debt load. In a gun-to-the-head transaction, the IDC purchased Scaw to avoid the loss of 6 000 jobs and to preserve the industrial capabilities linked to South Africa's

large-scale public rail programme. Even on its own narrow financial terms, Anglo's shift to London has been an abject failure, leaving it far smaller than when it listed. As one former Anglo director has put it, "The move to London was a disastrous mistake for the company and for the country".

RESTRUCTURING IN ENGINEERING

A similar pattern unfolded in relation to Rembrandt's engineering interests. By the mid-1980s, Rembrandt had taken over Iscor's investments in the engineering sector. The most significant of these was Dorbyl, the largest engineering group in South Africa's history, which at its height employed around 25 000 people. More than any other engineering firm, Dorbyl supplied the engineering capabilities required by Iscor, Anglo's mines, and other mining and heavy industries to install and maintain plant and equipment, as well as for associated electricity and rail infrastructure. Dorbyl's activity also spanned the rail and automotive sectors. As mining, heavy industry and associated infrastructure megaprojects dried up over the 1980s and public investment faltered, Dorbyl's failure to develop competitive capabilities for export became increasingly evident. For a brief period, management and shareholders tried to make it commercially sustainable but neither was up to the task. Not only was Dorbyl unable to competitively restructure its manufacturing operations, it also failed to run its import-oriented businesses viably when conditions for importation had never been more favourable.

A slew of disposals and acquisitions followed. In the name of "releasing value to shareholders", a "management participation scheme" was established to reward Dorbyl's senior management for *disposing* of its businesses. It subsequently transpired that the former CEO was part of a private equity consortium to purchase one of Dorbyl's major acquisitions: a US roof sheeting business called Alpine. Sold by Dorbyl for $159 million, it was resold within seven months for $250 million.

Our priorities as a country need to be recalibrated: productive and jobs-rich investment must sit at the apex of our economic objectives.

Over this period,Remgro – Rembrandt's successor – was extensively restructured as an investment holding company, consolidating itself in banking, insurance and related services, and restricting its manufacturing and agricultural footprint to areas where it could consolidate or otherwise retain strong control of the relevant market. Rembrandt has engaged strategically with the BEE process, actively identifying and cementing relationships and investing one of the leading BEE firms, Kagiso–Tiso Holdings, which in turn has modelled itself on Remgro's company model.

This investment-holding company model has become the favoured structure of emerging large BEE groups, with a preference for engaging in sequential minority BEE deals across multiple sectors, rather than deepening ownership, control and additional net new fixed investment. It has been far less risky and far more lucrative to sequentially secure stakes in existing businesses than engage in net new investment.

Notwithstanding the designation of rail for local production, state-owned companies (SOCs)have placed limited orders with domestic manufacturers. This follows a broader pattern of SOC and mining sector preference for purchasing from "empowered importers", which has reflected a preference for ownership over domestic production and jobs. Furthermore, even as capable manufacturers with significant empowerment credentials, including majority black ownership, have emerged, SOCs have not been giving them meaningful levels of orders.

South Africa's recent turn towards clientelism and patronage is often popularly characterised as a *cause* of low growth and investment, but there are good reasons to consider that the relationship has run in the opposite direction at least as much. South Africa's failure to mobilise higher levels of investment in productive sectors of the economy has materially contributed to the conditions amenable to clientelism, patronage and corruption.

CONCLUSION

What are the implications of this analysis of the restructuring of South Africa's post-apartheid economy? First, it is not intended to be used as a stick with which to beat one or other corporate actor. Nor, to repeat, is it to suggest that shareholders should not receive reasonable returns or that black economic empowerment should not be pursued.

It does, however, argue that our priorities as a country need to be recalibrated: productive and jobs-rich investment must sit at the apex of our economic objectives. South Africa finds itself in a position not dissimilar to that leading up to our first democratic elections. This requires a new and realistic set of bargains between large established corporates, emerging black business, labour and the stateto restore the conditions for patterns of accumulation that prioritise productive and jobs-rich investment. NA