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PRIVATE SECTOR INVESTMENT - THE LIFEBLOOD OF THE ECONOMY

By Mike Schüssler, Brenthurst Wealth Consulting Economist, and Elize Kruger

WHY FIRMS INVEST

For most countries, growth and employment are linked to the level of fixed investment and the effectiveness of that investment. Most fixed investment or fixed capital formation often comes from the private sector. This is the case for South Africa too.

The main reason for investment by the private sector is to make a decent return. A private company invests in order to make a return, as it will cease to exist if it makes losses. Often it is not losses, per se, but not producing enough of a return to justify more investments in the firm. For example, a firm makes a net profit, but the rate of return on the capital employed is less than inflation, which destroys capital and thus the firm has no reason for further investment.

Think about your own investment in education. When you go to university you expect a return on your hard work for giving up, say, three years of potential earnings to study. You do this with an expectation of a higher income for the rest of your life (or perhaps just more prestige, but an easier life is the general expectation!).

The same applies to shareholders who have given up some of their savings with the expectation of making a return, and companies have to compete for the attention of shareholders for their rands. They need to create attractive returns.

Moreover, companies must make a profit to exist. People do not invest when losses are foreseen, or the returns are lower than the actual risks, such as inflation or business failure. Profits are the major reason why companies are established.

IN THIS ISSUE

"If South Africa does not make this radical shift, then I am afraid we will end up in the poorest 20 countries on earth where our neighbour, Zimbabwe, now finds itself. Ask Rwanda, it takes decades to crawl out of that hole, even with very high growth."

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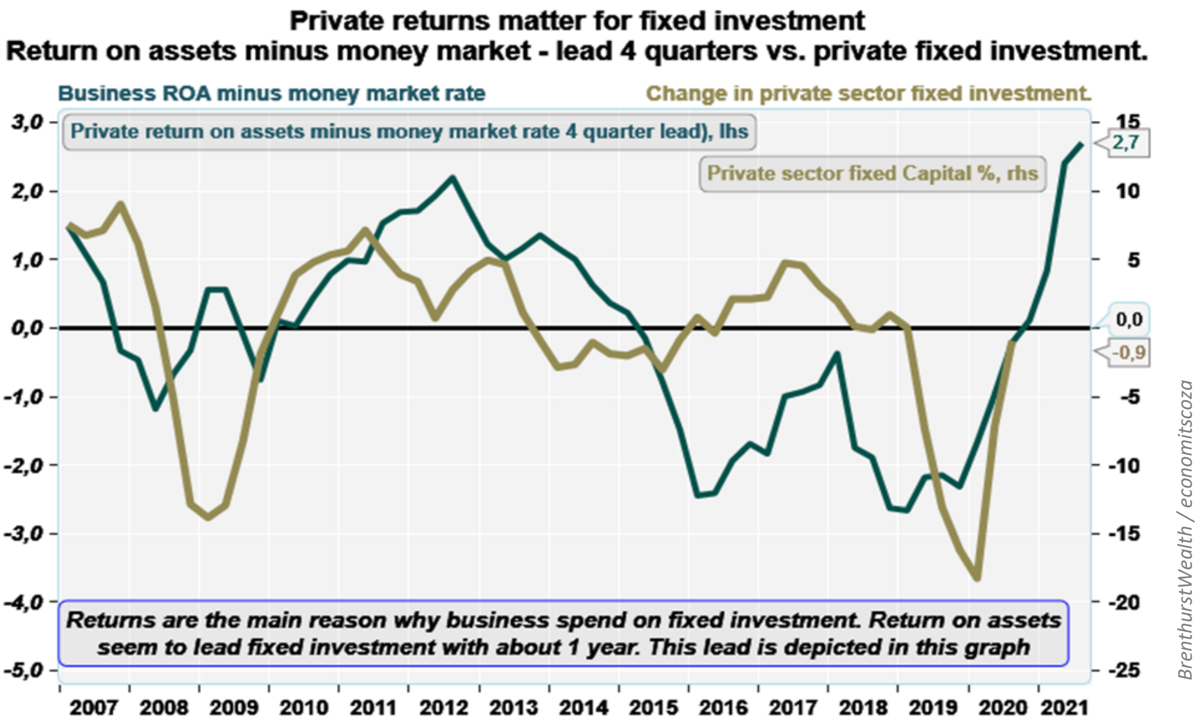
Companies, when expanding or looking for opportunities, will look at profit potential, market size, ease of doing business, etc. The most important factor is potential profit, probably followed by market size and knowledge of that market.

As can be seen in the graph below, profits lead to investments. Here we compare the return of assets employed by the private sector and deduct the short-term interest rate that a firm could get with the bank. The reason is that a firm should be making a higher return than the bank rate or else it could just keep the money in the bank.

CHART 1: REAL RETURN ON ASSETS MATTER FOR PRIVATE SECTOR FIXED INVESTMENTS AND LEAD WITH ABOUT 1 YEAR.



SO HOW CAN WE COMPARE PROFITS ACROSS ECONOMIES?

Comparing profit margins or returns on investments across the world.

This being a macroeconomic report, we are going to look at two major methods for measuring returns across economies. The data here gives great insight and helps one understand why certain economies can attract fixed investment to grow, while others struggle.

FIRST METHOD:
NET OPERATING SURPLUS

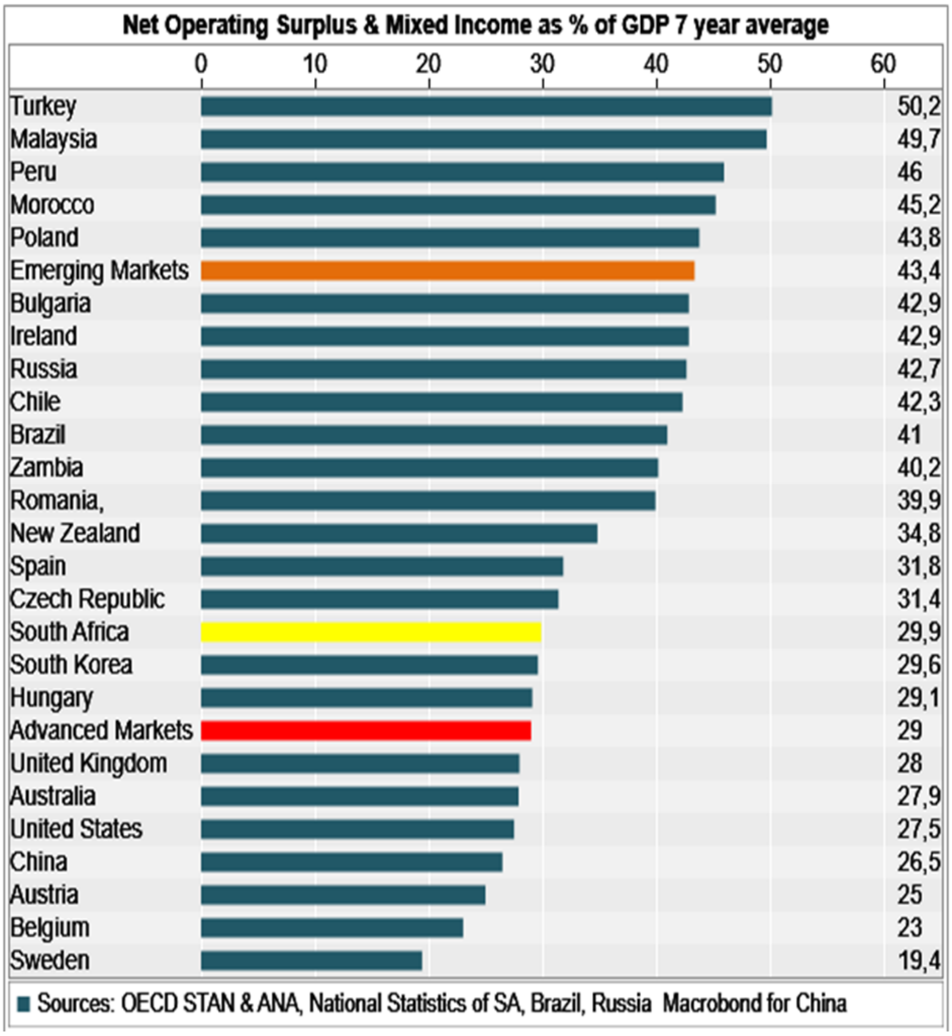
This is normally determined by looking at what has contributed to the value-add of an economy. Compensation of employees is normally one large part, while the gross operating surplus forms the other half. But when comparing countries it is better to use the net operating surplus for comparing profits across economies.

This method involves measuring the net operating surplus and mixed income as a share of value added. Mixed income is basically the earnings that a small business owner gets in both salary and profits where the difference between the two is difficult to distinguish.

When looking at the inputs that produce the value in an economy, there are rewards that are allocated either to capital (gross operation surplus) or to compensation of employees. There is also a small third segment called mixed income which is normally the portion that smaller business owners pay themselves.

Gross operation surplus is the total amount of money allocated to capital. However, the surplus is not profit, as one must account for depreciation of capital. (i.e., a truck gets old and after a few years has no value to the firm).

CHART 2: NET OPERATING SURPLUS AS A SHARE OF NOMINAL GDP FOR SELECTED COUNTRIES.



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THE NET OPERATION SURPLUS IS THE GROSS OPERATING SURPLUS GENERATED IN AN ECONOMY AFTER ACCOUNTING FOR THE DEPRECIATION OF ASSETS.

In CHART 2 we have compared the net operating surplus and mixed income to GDP ratio for a few selected countries over a seven year period.

This gives a longer term view of profits that are either allocated to shareholders in the form of dividends or interest paid for loans. Some of the net operating surplus is also utilised for taxation. Important to note, however, is that the firm can also use the net operating surplus to invest in new projects it believes will increase profits in the medium term. (Remember that the net operating surplus excludes depreciation of capital, so replacing the equipment to continue normal operating of the business is not included in this number, but in gross operating surplus).

The mixed income segment is generally a small portion of around 4% to 8% for most economies, although some economies with more smaller businesses have a higher mixed income share. But as the net operating surplus is the dominant factor here, it is the reason why one compares the profitability amongst different economies with this component.

What is, however, clear is that emerging markets generate, on average, nearly 50% more net surplus than developed countries. This is one of the biggest drivers of foreign direct investment flows out of developed countries into emerging markets. Almost all emerging markets have inflows of foreign direct investment and advanced countries typically have outflows.

Yes, in this picture there are exceptions such as China , but China has now been the fastest growing large economy for four decades and they are considered too big for companies not to invest there. Hungary and the Czech Republic are close neighbours in Europe and, due to the Eurozone, the Czech Republic also has lower interest rates which also lowers the net surplus a little.

Emerging markets close to major developed countries, such as those in Europe or Mexico in North America, do get some benefits from being a “poor family” in the vicinity of a “rich neighbourhood”.

The Net Operating Surplus as a measure of profitability, however, is not always ideal when comparing economies with vastly different structural compositions. For example, oil producers and big commodity exporters can have very high operating surpluses during a commodity boom. Then it is not always possible to separate the mixed income from the net operating surplus.

There are also other problems, so researchers at the Penn World Tables from the University of California (Davis) and the University of Groningen have developed the real internal rate of return for economies.

SECOND METHOD: INTERNAL RATE OF RETURN

The second method in comparing profitability in different economies is by measuring the internal rate of return (IRR). This method takes capital structure and differing deflators into account. It also accounts for resource rents. (The estimates of natural resource rents are calculated as the difference between the price of a commodity and the average cost of producing it.) This makes it easier to include commodity economies in the IRR.

Basically, it measures the return on capital above inflation after labour income, as well as resource rents, are subtracted. The actual internal rate of return also classifies capital into long-term capital, short-term capital, as well as capital services. So, the different time periods for the use of capital are also considered. (For example, laptops may depreciate after, say, 4 years while a large shopping mall will depreciate over 25 years.)

Measuring profitability in this way is similar to how fundamental investment analysts analyse and compare companies, but the country IRR is more on an economy-wide scale.

It adds another tool to the box for economists to measure returns across economies. The average developing market has an IRR of 12,4%, well above that of South Africa, which has an average IRR of 9,72% over the last five years. **Refer to Chart 3.**

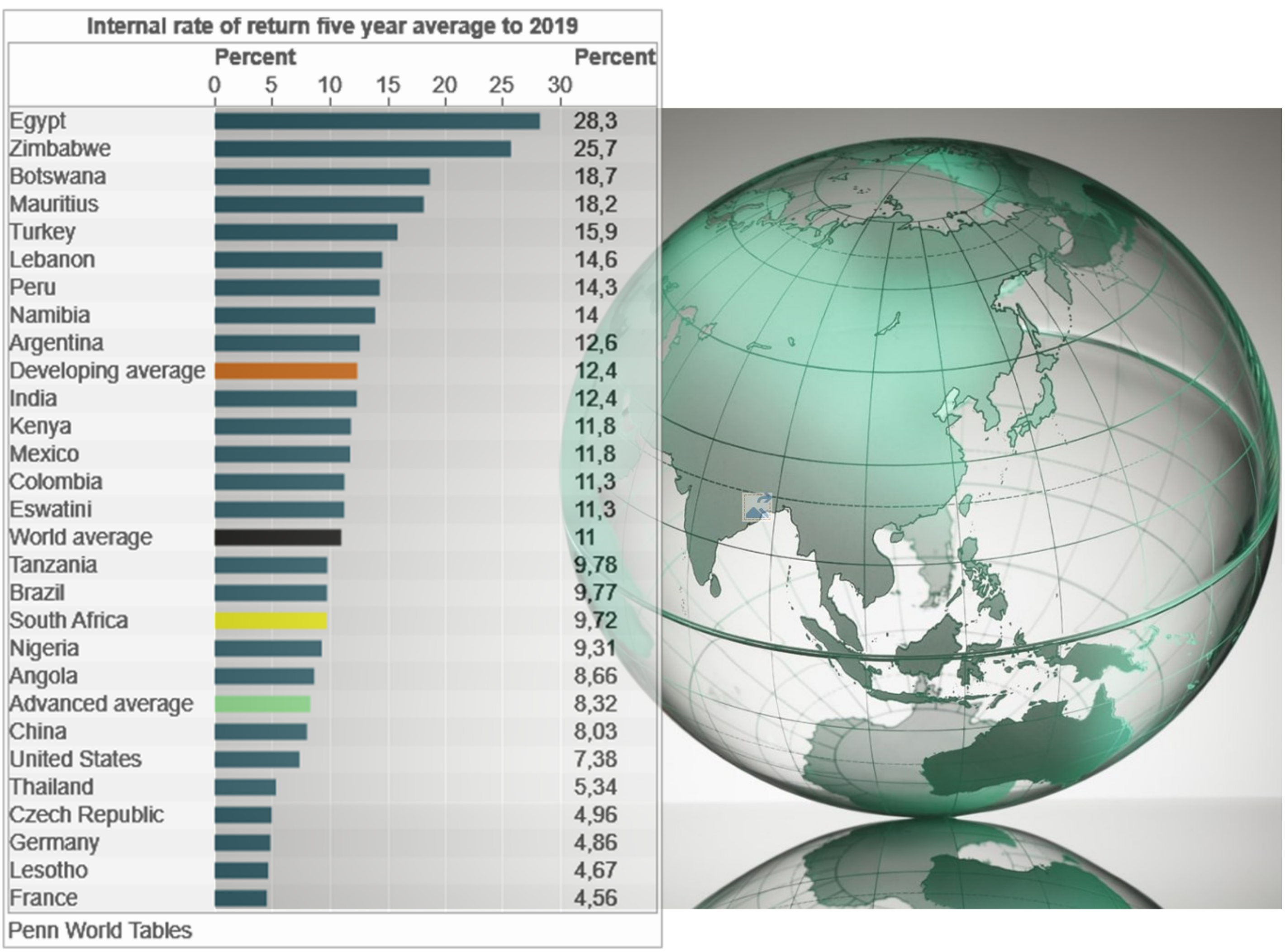
South Africa did, however, outperform the advanced country average which had a return of 8,32% over the last five years.

Again, there are many more choices for a direct investor which would present higher returns and, as the inflation risk is already discounted, it makes the comparison easier. There are other risks such as socio-economic and political stability, taxation, regulations and future economic growth, but they too can be given a risk rating allowing the IRR tool to be used to compare countries.

While this may sound complicated, the fact is that there are over 100 other emerging markets for which this data is available for a time, allowing local and international investors to compare returns across countries. Bigger firms and investors would typically have researchers that do a lot of research into these basic factors, on both an industry and country basis.

SA offers an IRR that is 16% higher than the advanced country average before factors like taxation and regulations are included, which sounds like a reasonable bet. However, the fact that the average developing country has a 28% higher rate of return takes South Africa off the radar when compared to other emerging markets.

CHART 3: THE FIVE-YEAR AVERAGE FOR THE INTERNAL RATE OF RETURN FOR SELECTED COUNTRIES AND GROUPINGS.



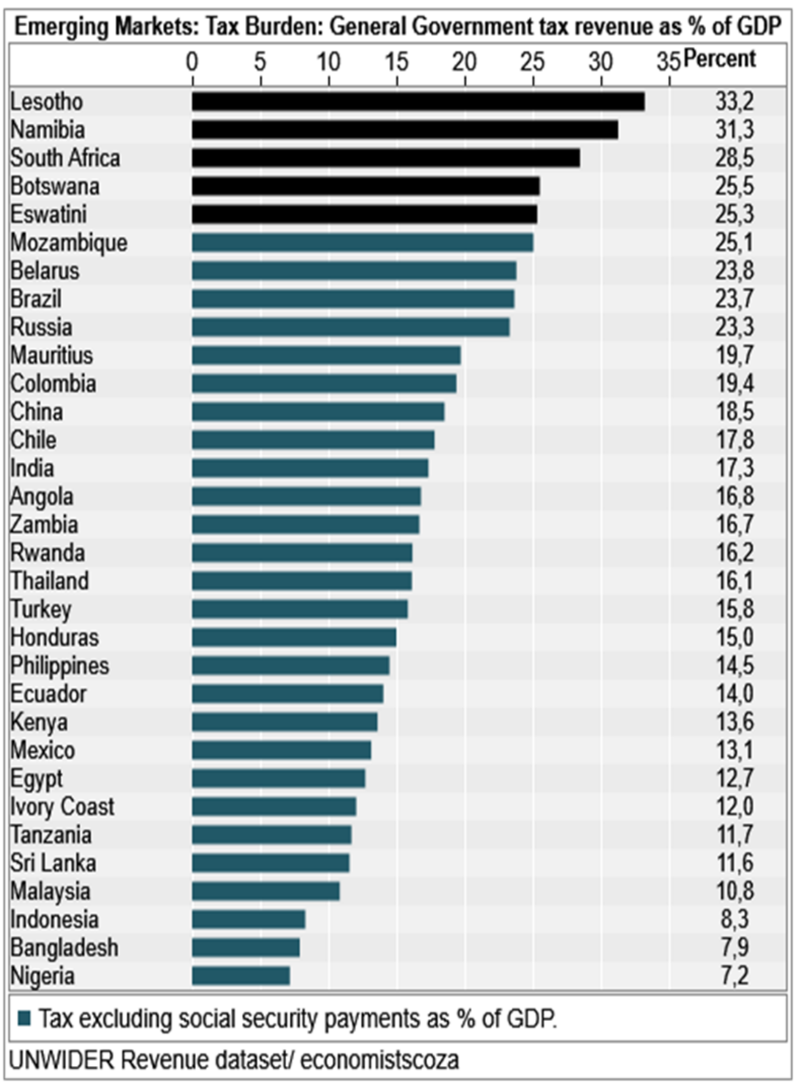
These measures, the net operating surplus and internal rate of return, are important for direct investors like a car company that opens a factory in a country. This is not a stock market investor that can speculate and enter and exit the market easily, but a long-term direct investor and, as they cannot pack up and leave in three minutes, they have to take time to study various aspects of an economy.

One of the first would be the expected returns the company would be able to realise, and this is where the net operating surplus and the real internal rate of return come into play.

OTHER FACTORS THAT IMPACT FIXED INVESTMENT FORMATION IN SOUTH AFRICA

THE FACT THAT SOUTH AFRICA FARES BELOW AVERAGE IN BOTH THE RETURN MEASURES DISCUSSED ABOVE IS NOT THE ONLY FACTOR THAT PLAYS A ROLE IN CREATING FIXED INVESTMENT.

CHART 4: THE OVERALL TAX BURDEN IN SELECTED EMERGING MARKETS



SOUTH AFRICA HAS THE FIFTH HIGHEST COMPANY TAX BURDEN IN THE WORLD, ACCORDING TO UNWIDER TAX DATA.

SOUTH AFRICA FURTHER HAS THE HIGHEST OVERALL TAX BURDEN IN THE EMERGING MARKET UNIVERSE, AFTER LESOTHO AND NAMIBIA.

This subtracts from the profits in an economy, making South Africa an even poorer choice.

Personal income tax is also steep and for foreigners managing their company subsidiaries here, it is also a problem.

Even South African businesses have noticed the high tax burden and those that have not noticed have probably never made a decent profit in South Africa. While South Africa does not have the highest company tax rate (however, still in the top 20), it has fewer exemptions as well as high dividend taxes.

Add to this burden the compliance that companies must adhere to in the Black Economic Empowerment (BEE) codes. It's like an extra tax, many a director has told me. Moreover, foreigners are confused by the BEE sector rules. Foreigners ask questions such as "do you want us here", "why must we have a requirement as to the colour of our suppliers" and "why do we have to buy from people who are just rent-seekers and increase our costs"?

This is in addition to a high crime rate, broad-scale corruption and social activists launching court cases against new developments.

It's almost as if South Africa wants to remain in poverty and inequality. Yes, inequality is mainly due to only 35% to 45% of the adult population having work over the last two decades. Only a quarter of the population are in the formal sector and they would, de facto, all be in the top third of income earners.

That investment creates jobs is often talked about, but that lack of profits and reasonable returns and high taxes which are inhibiting job creation, is not often mentioned.

South Africa has so many sites discussing employment and unemployment and the price of labour, but this researcher has yet to see any of these well-paid researchers take the bull by the horns and discussing returns on capital, hassle factors such as BEE requirements and visits by inspectors just searching for "mistakes" so that they can be bribed. The results of narrow politically correct research with no regard to returns can be seen below.

FOREIGN DIRECT INVESTMENT. "WAS IST DAS?"

The impact is clear as fixed capital formation declined for the first time in 10 years (previous negative in 2010/11 in GFC) as portrayed earlier in Part 1 of this research. Worse still, South Africa has not attracted much direct investment at all.

The SA government has invested less, as a percentage of GDP, than at any other time since World War 2. Clearly, even government and its enterprises are instrumental in the disinvestment of South Africa. Moreover, much of that which was recorded as fixed investment by the public sector is dead investment, with negative returns such as football stadiums and overpricing of investment in electricity, trains, harbours, manufacturing, etc., due to corruption.

With little insight into the actual facts, the government wants to not only be a developmental state, but also lead the country's fixed investment spending drive. The irony is that broad government investment is likely at an all-time low since the Union was formed.

The media repeats government statements – as they must – without sharing the knowledge that government is not actually investing. Worse, the depreciation of government infrastructure, such as roads, has for years been faster than government investment into repairing/replacing it. Even worse, government is aware of the large-scale destruction over and above the depreciation of infrastructure, but cannot get itself to rectify that situation.

As a result of poor returns and weak government investment in infrastructure, and a host of other issues, the private sector investment was the lowest as a share of GDP in 58 years. The private sector talks a good deal, but they resist committing their money in South Africa.

More than one business leader, has stated in private, that money is silent. It may occasionally shout for joy for creating 2000 jobs, but when the other section of the business is closed, not a word, on the 10 000 jobs that have been terminated.

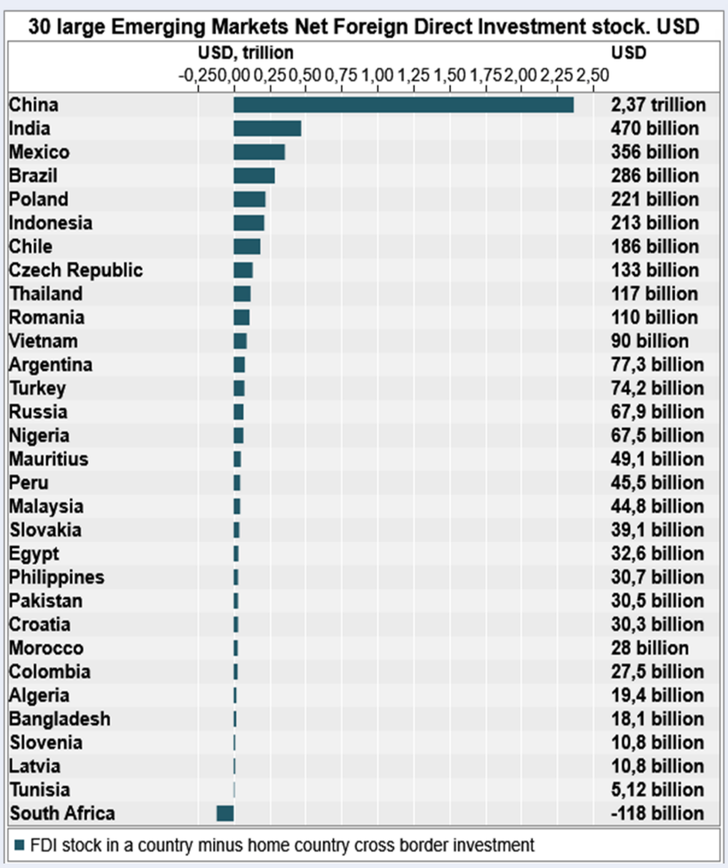
Without any worries I can state that there is a contradiction when South African businesses talk of investing locally, when actually, bar very few exceptions, they are all just busy with a political public relations exercise. Most of the JSE listed companies earn more outside South Africa than in SA and its neighbours. This was pointed out by Morgan Stanley in 2011 already, but the government remains blind to this.

South Africa is the ONLY emerging market that attracts less foreign direct investment than its own direct investment into other countries.

Let that sink in for a minute… South Africa, with the world's highest unemployment rate, invests more in other countries than locally. The ONLY emerging market to do so. Outside of the motor industry (which gets big subsidies), security industry and the primary industries, SA is getting zero foreign direct investment.

Chart 5 shows the Cross Border Fixed Investment Stock for most important emerging markets as collected by both the IMF and UNCTAD over the years. Clearly, foreign investors stay away from South Africa, while our local businesses prefer to invest elsewhere.

CHART 5: NET FOREIGN DIRECT INVESTMENT STOCK FOR LARGER EMERGING MARKETS.



The situation is actually worse than the chart reflects, as many of the now foreign investors were domestic investors that moved their domicile to foreign shores and then, over time, disinvested even more.

SO WHY DO WE CARE? WHAT IS THE BOTTOM LINE?

South African businesses know that the risk return ratio in South Africa is not worthwhile. It has often been pointed out by foreign investors that South Africans want to invest elsewhere.

As an equity investor in SA you may get that foreign exposure, but with an added layer of costs in many cases. Excluding those companies with their primary listing outside of South Africa, it has become clear that too many companies grew faster outside South Africa than locally.

The higher turnover growth is another reason and the money follows the path of least resistance and, of course, of profits. While we shout at our business leaders and their companies, they have noticed that they are not really wanted, and the profits are low. Political accountability is nowhere to be found.

Others have pointed out the lack of investment, even in opposition metros, and they do not see much of a turnaround when hard decisions are not made. Coalitions cannot, by their nature, make these decisions.

**Politics aside, what we have here, in short, is poor returns on capital with high tax and regulatory burdens (not common in other countries) and a population that would rather save a gravesite than earn a living.
We know some of these statements are harsh, but this is the cold hard reality.**

But it would be cruel to be nice by saying that the future is bright when clearly the returns on investment and the investment levels themselves point to a long period of low, if not negative, growth.

THIS INVESTMENT DATA REVEALS THE MEDIUM-TERM FUTURE OF SA

- Growth is, at best, going to be below South Africa's average – which already was below the world average. No economy can grow without fixed capital formation. The fact that SA, at present, has fixed capital formation below 20% signals that South Africa's growth rate will be far below the world average.
- With the South African population still growing faster than the world average of about 1%, in per capita GDP terms, South Africa will continue to fall in the rankings. The current 110th place in the World Income rankings will most probably decline further. SA may only decline a few places in the coming decade as many very poor countries are far behind, but after 2030 the decline will become more noticeable.
- **Many fast-growing poorer countries such as Bangladesh, Vietnam and India are growing and attracting much fixed investment. So too are some African countries such as Ethiopia, Rwanda and Ivory Coast.**
- Between 2035 and 2040 India – based on current trends – will surpass SA's per capita GDP. In the decade to 2050, SA's per capita income will be surpassed by Vietnam and Bangladesh and it is very likely that a few African countries such as Kenya and Ivory Coast could also surpass SA. South Africans are likely to be in the bottom third of the world population by then.
- Our current lack of fixed investment may even speed up this decline to where South Africans find themselves inside the bottom third of the world population just before 2040. It is then likely that SA citizens will be in the bottom 20% of the world population, in terms of per capita income, before 2060.
- If SA continues investing at the rate of the last decade, then unemployment too will continue to grow.
- South African radicals continually shouting about monopoly capital is clearly wrong. SA just does not attract capital and slandering it is chasing the very last of it away.

WHAT CAN BE DONE?

Economically we need to lower the costs and the risks in the economy. At the same time, we must increase the returns that direct fixed investment investors can expect.

The first part of that will require radical deregulation and items which are current holy cows, such as BEE, sector charters, etc. will have to go.

All state monopolies must be transformed to where the state can manage the infrastructure, but the private sector runs the services. Or split Eskom up into three parts: generation and distribution, as well as transmission. Keep transmission in state hands. Split them up into at least two parts for distribution and generation, but also sell the parts to cover most current Eskom debts. But create competition.

Allow state firms to fail. While it is happening, there are others that continue in with the old ways.

Give up the network frequencies so that the private sector can buy them and run services in a modern and effective way. But even before that, criminal charges and convictions will have to be forthcoming. Many businesses have felt the impact of corruption and state capture and are apprehensive make further investments.

The civil service wage bill will have to be cut by at least one third, as a percentage of GDP. Most of the savings from the wage bill will have to go toward infrastructure.

The hardest change will be to be honest with South Africans. Share with them that the world is growing because most of the world is in private hands and that SA needs that capital. We need to accept that an open competitive economy needs private enterprise and a functioning state – not a developmental state. However, this may cost political capital and, while not directly costing money, the fifty years of investment in radical socialist thinking will be difficult to turn around.

But I believe that most South Africans know this and that is why they no longer vote. Most small business owners know what they want. They may have to change plans now and again to adjust to the market, but they want a stable supply of water, power and less costs from the state.

If South Africa does not make this radical shift, then I am afraid we will end up in the poorest 20 countries on earth where our neighbour, Zimbabwe, now finds itself. Ask Rwanda, it takes decades to crawl out of that hole, even with very high growth.

It also costs lives in the form of hunger and not being able to afford medicine and it severely limits the population's choices. Sorry sloganeers, South Africa needs profits, choices and certainty, not radical rent-seekers clothed in kind-hearted words while driving the knife into the entrepreneur. Only then we will be a country I would want to invest in.

Mike Schüssler
BRENTHURST CONSULTING ECONOMIST

Provides expert economic insight and analysis to the company's clients and advisory team.

President Cyril Ramaphosa included many economic issues in the State of the Nation Address presented on 10 February, which included the extension of the Covid-19 relief grant. The extension is estimated to cost the fiscus R50bn, expenditure made possible by the mineral resources boom that is expected to raise the 2021/2022 tax revenue target by R200bn. Details will be provided by Enoch Godongwana, the Finance Minister, when he tables the 2022/2023 budget on February 23. This is but one issue the Minister must address. Speakers MAGNUS HEYSTEK and independent economist ELIZE KRUGER, along with auditor and tax expert, GERHARD VAN GRAAN, will review the budget and share insight into the impact on investors.

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