SOUTH AFRICA

Our Nation Delivers

THE BRENTHURST INITIATIVE

5th August 2003

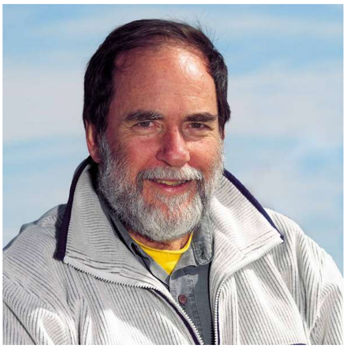
THE PRESIDENT REPUBLIC OF SOUTH AFRICA

One of the great challenges that faces our nation is to ensure that the economic fruits of our political transformation can be shared by everyone in our society. How best to achieve this is an issue we all need to address.

I therefore welcome this Brenthurst Initiative to stimulate wider discussion and debate on a subject so crucial to our future as a nation. I hope that the ideas presented here will provide fertile ground for thought and debate and so help to shape a winning future for all of us.

TM MBEKI

17 July 2003



INTRODUCTION

By

NICKY OPPENHEIMER

Ever since my grandfather first arrived in this country in 1902 the Oppenheimer family has been deeply committed to South Africa and its future.

Unlike many of his contemporaries who flocked to the gold and diamond fields to make their fortunes and then leave, my grandfather saw himself as a South African from the day he arrived. Both as Mayor of Kimberley and as that city's representative in parliament he set a theme of public service to our country which established a family tradition.

Nearly 50 years ago my father, when he was still a Member of Parliament, prepared a memorandum on constitutional reform in South Africa. Although couched in the language of the day, his proposals called for direct African representation in the Senate and were nothing short of revolutionary at a time when the apartheid government was busily disenfranchising all people of colour. Nevertheless, the proposals embodied his passionate, life-long belief in a common South African nationhood shared by all its people. In a speech in 1954, he said that "the safety, stature and moral progress of our country depend on building up a sense of common loyalty, of common patriotism; of a willingness, if necessary to make common sacrifices: of a conviction of common nationhood in which <u>all</u> South Africans can share."

It gave him great joy when forty years later that sense of common nationhood finally found expression in South Africa's re-birth as a free, self-confident, vibrant, multi-racial democracy.

Every true South African who puts the future of the country above his or her own interests accepts, however, that while the country's political landscape has been transformed, the transformation of the economic landscape is far from complete. Much more needs to be done to ensure that the majority population sees and feels that it has a prominent share in the country's economic life and wealth and the benefits which a common nationhood should bring.

Initiatives have helped to kick-start that process and I am sure that in a few years the face of South Africa's business and industrial landscape will indeed look very different to today. The question that now faces us is not who the main figures in that landscape will be, but how big will be the landscape itself and how many people will feel the benefit of that transformation?

South Africa's economic advancement depends critically on investment, both direct and indirect, and on the sentiment that drives it. As proud South Africans, my son Jonathan and I have, like many people, been troubled by the nervousness over South Africa's risk and reward ratios which seems to inhibit investment decisions – both local and from abroad. It set us thinking as to how Government initiatives to accelerate black economic empowerment could, instead of further inhibiting investment, become a tool to strengthen investor confidence and so expand the South African economy for the benefit of all its people.

This concept excited us sufficiently to approach Robin Buchanan, Cyrus Jilla and Alan Bird of Bain & Company in London and ask them to join us in exploring the idea further. The answers produced by this informal think-tank were sufficiently interesting and promising to present to President Mbeki. He in turn was so engaged by our argument that he agreed the time was now right to launch a broader debate on this issue.

On the cricket field I know there have to be winners and losers, but in business I am excited by win-win scenarios. Recent Government initiatives have begun the process of transformation. They are the foundations of the new South African building. How many rooms that building will have, whether it will be large enough for all, or too small for many, will depend on how we proceed beyond this first step to change the composition of South Africa's boardrooms and the employment profile of its companies. Without vigorous growth powered by enthusiastic investment, there is a risk that the advantages could be limited to a newly privileged few, rather than spreading the benefits across society, alleviating poverty and eliminating the historic disadvantages of the many.

If instead transformation were combined with a package of other measures designed to attract and encourage investors to commit themselves and their funds wholeheartedly to the future of this country, the outcome could be very different. But – and this is critical – all incentives must be tied inextricably to each company's commitment to transformation and this commitment must be measured not by goals, but by achievement through the application of simple, precise and transparent standards.

This is what I mean by a win-win scenario: South Africa will, if it follows this path, be seen as committed to expanding and supporting investment. Investors will be seen as committed to and supporting transformation. Expanding investment will ensure that transformation will empower not just a privileged few, but an ever-expanding element of South Africa's formerly disadvantaged majority. And an energised and vigorous economy, with business and political leaders sharing a real enthusiasm and commitment to transformation, could become an example to the world.

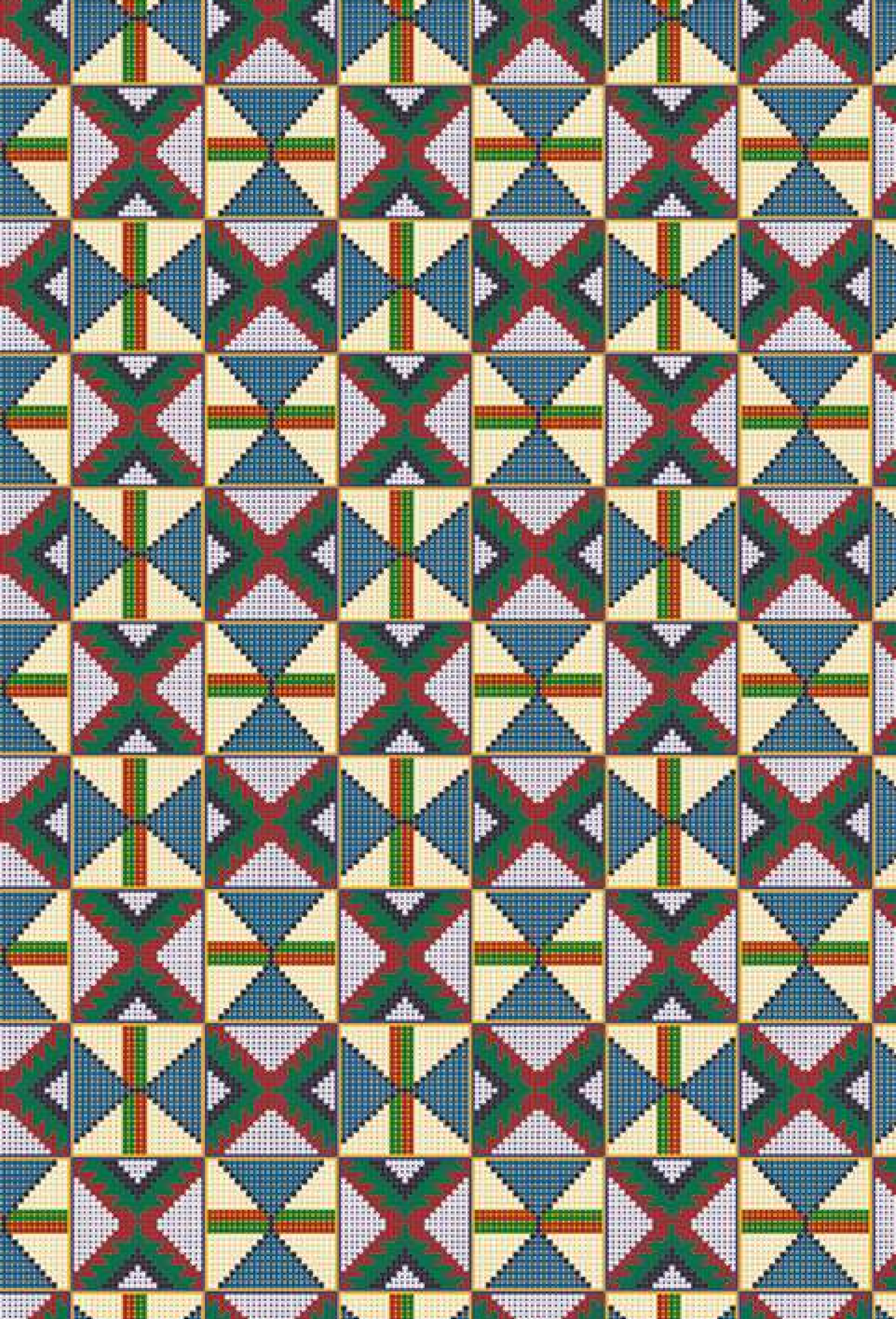
In 1994 South Africa's political transformation was just such an example. Over the last decade South Africans have shown that they have the imagination, the will and the leadership to rise above the world's more dismal expectations and to devise new solutions to old problems. I believe we can do it again and provide – as we had the courage to do in 1994 – unique solutions to unique problems.

Although I am excited by the proposals in this document, I am not so naïve as to believe that they will or can resolve all South Africa's problems. There is no magic bullet. But I remain convinced that they could begin to tilt investment decisions away from an exaggerated risk awareness and towards a real interest in the rewards South Africa has to offer.

I accept and indeed hope that the ideas we have put forward will stimulate many questions and improvements on the answers we have suggested. We will not find the answers, however, if we do not debate them.

It was my father's belief that South Africa would only realise its true destiny when everyone could engage fully and irrespective of race in every strand and level of its economic life. In putting forward these ideas for your consideration, Jonathan and I hope we are taking his legacy forward and closer to the day when his hopes are fulfilled; when everyone will enjoy his or her fair share not only of the existing cake, but in an ever-expanding and vigorous economy with more than enough for all.

Nicky Oppenheimer



OUR UNIQUE CHALLENGE

Effective transformation requires our economy to grow

South Africa achieved a miraculous political transformation in 1994. Our challenge now is to repeat the miracle with a similar feat of economic transformation.

Transformation of our economy is critical and real progress is being made. Our Government has created a much more stable macroeconomic environment. The economy has grown by 3.1% per annum since 1999. Real GDP per capita has grown by at least 1.3% over the period,[1] reversing a long-standing negative trend.

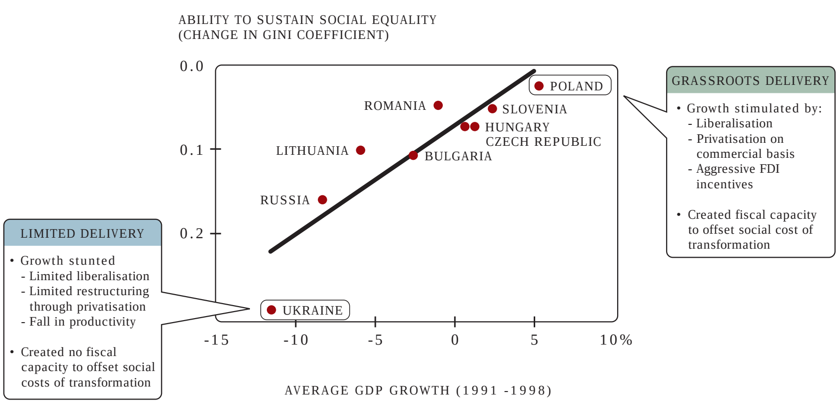
Government is also making progress in driving the process of transformation. We now have a Strategy for Broad-Based Black Economic Empowerment, supported by industry specific charters (e.g. Mining). Already a company's transformation credentials are being used as a key criterion for awarding Government contracts.

However, our economy's growth rate must increase if we are to achieve the target set at the recent Growth and Development Summit to halve unemployment from 30% to 15% by 2014. This will require economic growth of 5% per annum,[2] bringing South Africa up to the level of prosperity of the Czech Republic today, by 2014.[3]

Successful transformation requires growth. In the absence of growth, true grassroots delivery is difficult, if not impossible, to achieve. Eastern Europe, which also had to effect a major shift in economic ownership, provides a case in point. After the “fall of communism”, countries took diverse approaches to liberalising the economy, resulting in different rates of growth.

The rate of growth, and its relationship to a country’s ability to sustain its level of social equality, is shown in Figure 1. Social equality is measured by the Gini coefficient, a measure of how evenly income is distributed across a population. Countries that achieved the highest growth rates, such as Poland, were better able to distribute the benefits on a more equitable basis.

Fig. 1. Transformation without growth constrains grassroots delivery [4]



And this is the nub of the challenge we face. South Africa must both grow AND transform. Growth OR transformation is untenable. A failure to transform is clearly unacceptable, but slow growth will reduce severely our capacity to transform. Our unique challenge, different to that faced by Eastern Europe, is that businesses must transform and, at the same time, must invest further in our country. This is essential to increase our rate of growth and expand our capacity to transform.

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Achieving higher growth requires investor perceptions of risk to be overcome

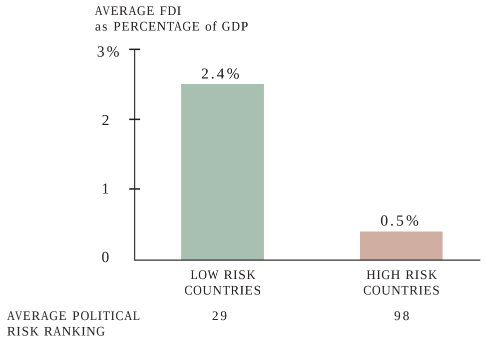
South Africa must compete globally for investment, both from domestic and foreign firms. Many factors are important to businesses when evaluating an investment opportunity. These include domestic market size, workforce productivity and skills, and quality of infrastructure. However, the perceived country risk is a major “threshold” factor. Perceptions of risk are not always entirely valid or well informed, but nevertheless they have a real impact on our ability to attract investment and therefore on our growth prospects.

Whether we like it or not, South Africa is perceived to be a relatively high-risk destination for investment

Whether we like it or not, South Africa is perceived to be a relatively high-risk destination for investment. Out of 140 countries, the International Country Risk Guide (ICRG) ranks South Africa 70 (that is, 69 countries are lower risk investment destinations), rubbing shoulders with Syria, El Salvador, Israel, Peru, Azerbaijan and Ukraine.

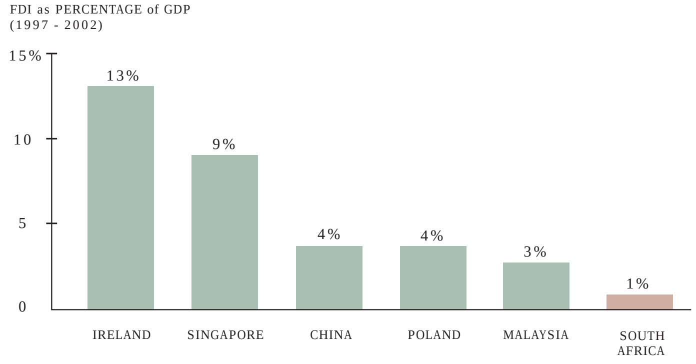
This constrains our ability to attract the level of investment we require to grow our economy at the rate our goals demand. Lower risk countries attract more Foreign Direct Investment (FDI) [5] (see Figure 2).

Fig. 2. Perceptions of risk constrain a country's ability to attract investment



South Africa lags far behind countries such as Ireland, Singapore and China in our ability to attract FDI. The issue is not just with FDI; our overall investment rate is also lower than for these countries.

Fig. 3. South Africa lags other countries in attracting investment [6]



The way we approach transformation should increase, and certainly not reduce, investor confidence. The wrong approach to transformation can increase perceptions of risk in three key ways:

- Lack of certainty and clarity in the operating environment
- Limited sense of partnership with business
- Lack of confidence in the future sustained value of investments (e.g. equity deals transacted at less than "fair value"; need to "underwrite" BEE equity funding arrangements, etc.)

Although risks can be exaggerated, the potential impact of these risk perceptions is anything but theoretical. Following the leak last year of the "draft" Mining Charter, we experienced net foreign capital outflows of R11 Billion during the following six months. This contrasts to average foreign capital inflows of R19 Billion over the previous seven years.(7) Thankfully, due in part to investors becoming somewhat reassured by the agreed Mining Charter, we have now returned to net capital inflows. We have not, however, recovered the inflows lost in the intervening period.

The way we approach transformation should increase, and certainly not reduce, investor confidence

Investors were reacting to what they perceived to be an environment becoming hostile to investors. They saw a high degree of uncertainty over what businesses would be asked to achieve, and were concerned over the future value of their investments.

> The choice facing South Africa does not have to be either transformation or growth; it can be transformation AND growth

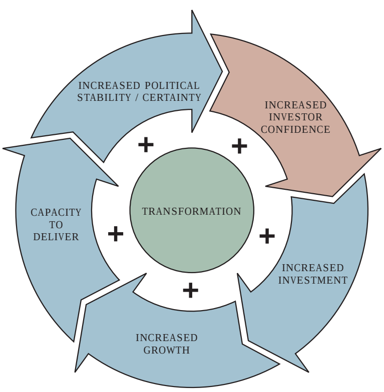
While many factors clearly influence growth, if our approach to transformation reduces perceptions of risk, it will help drive growth. Growth in turn will accelerate and expand our capacity to transform. The choice facing South Africa does not have to be either transformation or growth; it can be both transformation AND growth. In fact we believe it should be both greater growth AND greater transformation.

Willing partners in transformation

As a country, we need a bold set of measures to ensure that investors become willing partners in our growth and transformation.

We need to increase investor confidence to stimulate higher investment and growth. This will increase our capacity to deliver, increasing political and social stability that in turn will further increase investor confidence – creating a virtuous circle of transformation and growth (see Figure 4).

Fig. 4. Transformation AND Investment-led Growth



While stimulating growth requires action on many policy fronts (such as promoting direct investment, addressing workforce skills and productivity, and reducing crime), we propose a package of three measures. These measures aim to ensure that our approach to transformation increases investor confidence. They aim also to reinforce progress against established transformation goals. These three measures target directly the three perceptions of risk that can arise from the wrong approach to transformation:

Lack of certainty and clarity in the operating environment	➡	Agree a National Transformation Scorecard (and stick to it)
Limited sense of partnership with business	➡	Create investment incentives, linked to transformation performance
Lack of confidence in the future sustained value of investments	➡	Communicate and adopt a comprehensive plan to close the perceived “BEE funding gap”

1. Agree a National Transformation Scorecard (and stick to it)

Investors require the certainty that clear and realistic targets for transformation can provide. Once set, investors must also have the confidence that these targets will not be changed.

The Strategy for Broad-Based Black Economic Empowerment, together with the individual sector charters that are being developed, represents real progress. At the national level, our Government has adopted an approach based on guidelines rather than legislation. Terms are now better defined. A balanced scorecard with four elements has been developed:

- Direct empowerment (30% weighting):
  Equity Ownership and proportion of Black executive and Board level management
- Human resource development (30% weighting):
  Employment equity and skills development
- Indirect empowerment (30% weighting):
  Preferential procurement to Black firms and enterprise development
- Tailored by enterprise or sector (10% weighting)

Most importantly, the scorecard recognises that black ownership is just one element of transformation. Progress in other areas (e.g. human resource development, indirect empowerment) is equally, if not more, important in delivering transformation at the grassroots level. Greater flexibility on targets for black ownership will ease the pressure on available funds (although more still needs to be done) and reduce the risk of BEE deal failures down the line.

> A National scorecard's power lies in providing a basis to create a competitive advantage for those firms that transform

The balanced scorecard, defined in the Strategy for Broad-Based Black Economic Empowerment, provides an ideal mechanism to define national standards for transformation, applicable across all sectors. Any differences across sectors should be the exception, not the rule. This is essential to create the certainty that investors demand. In order for this balanced scorecard approach to be effective, we need to:

- Ensure unambiguous definitions for each scorecard element
- Set targets that are stretching but realistic (with timeframes appropriate to each element of the scorecard, e.g. employment equity vs. housing / living conditions)
- Design a simple approach to report and audit progress
  - Self-reporting by companies as part of the annual report?
  - Tax style audits with penalties for false submissions?
- Commit not to change the rules of the game

A nationally applied scorecard has value in its own right in defining transformation requirements, quantifying progress made and providing certainty. Its real power, however, lies in providing a basis to create a competitive advantage for those firms that transform.

Companies that meet transformation targets set within the context of the scorecard must be able to reap the reward. This could be through, for example, achieving preferred supplier status when submitting tenders for public sector contracts. More importantly, it could be through qualifying for investment incentives that are only available to those who have demonstrated progress towards transformation goals and targets.

2. Create investment incentives, linked to transformation performance

Financial incentives represent one of Government's most powerful instruments to encourage and direct private sector investment in South Africa. We propose these incentives should be linked to demonstrated progress against established transformation targets. This would provide companies that transform with a competitive advantage over those that fall behind the pace. Incentives would provide the "carrot" to balance the "stick" of required Charter and legislative compliance.

These incentives must stimulate the investor-led growth we require to achieve our goals for job creation and poverty alleviation, while also helping to accelerate transformation.

> We propose that the rate of corporate tax a company pays should depend on its transformation performance

Many approaches are available to create the required incentives. Our Government has, to date, primarily used direct investment grants and incentives as stimuli to growth. These include the Strategic Investment Programme (SIP), the Small and Medium Development Programme (SMEDP), and the Support Programme and Partnership for Industrial Innovation (SPII and PII).

Other countries have adopted similar approaches to stimulate investment.

China, for example, has used a mix of export tariff reductions, tax holidays and corporate tax relief in special export zones, resulting in a surge in Foreign Direct Investment. (From 1990 to 2000 annual FDI flows rose from $3 Billion to almost $40 Billion).[8]

Direct incentives are an essential part of the mix. However, by their very nature, it is difficult to make them relevant to all companies, and increasingly World Trade Organisation (WTO) requirements constrain what can be put in place. They are also costly to administer.

An opportunity exists to create a new incentive, based on differential rates of corporate tax. Hong Kong, for example, has used lower levels of corporate tax to attract investors. We propose that the rate of corporate tax a company pays should depend on its transformation performance.

Companies who transform (or are already transformed) would pay less tax and therefore have greater ability to invest in growth and new projects. Those who fail to transform may find themselves paying more tax. Such an approach would:

- Apply across all industry sectors
- Create an immediate competitive advantage for those businesses that meet set transformation targets
- Be simple to administer (assuming a robust National balanced scorecard is in place to measure transformation performance)

- Comply with current WTO requirements
- Work in tandem with other measures to stimulate growth, develop skills and target specific sectors (such as SMME)
- Represent the bold, high impact action South Africa requires, creating a unique South African solution to a unique South African challenge

Designing differential corporate tax incentives will require detailed work by DTI and Treasury experts and advisers. This work should ensure that these incentives will achieve what they set out to achieve and that they are readily enforceable. The key here is to ensure that scorecard definitions and targets are watertight. We propose a few design principles:

- Set the level of incentive sufficiently high to encourage investment AND transformation
- Represent a combination of "sticks and carrots". Use several tiers of corporate tax for different levels of transformation performance.
  - Such tiers could reflect the Good, Satisfactory, and Limited categories defined in the Strategy for Broad-Based BEE
  - Raise the hurdle for transformation performance over time, but set the standards from the outset
  - Penalise firms who do not transform sufficiently (but not from day one – perhaps after 5 years)
- Link incentives to transformation performance for a limited period (10-15 years) only – there must soon come a point where South

Africans no longer see value in making economic distinctions based on race.

Can we afford to do this? Perhaps the better question is: can we afford NOT to? Our aim must be to stimulate a level of growth that actually increases Government's absolute fiscal revenues (i.e. overall Rand receipts), notwithstanding a reduction in the overall percentage rate of corporate tax. Many countries, including China, Ireland, Hong Kong and Malaysia, have been able to achieve an increase in fiscal revenue and a reduction in tax rates, using both direct incentives and reduced corporate tax rates.

The worst-case fiscal cost is small, with substantial potential upside

The downside risk is small. If we assume that 10% of firms already have a Good level of transformation (as defined in the Strategy for Broad-Based BEE), and that an additional 6% of firms achieve this level each year for the next 15 years, and that they subsequently benefit from a 10% reduction in their corporate tax rate,[9] then:

- The average reduction in fiscal take would be 3.5% - 4% (equivalent to R9 Billion to R11 Billion per annum)
- The reduction in fiscal take would be lower in the first

years, allowing Government the scope to assess progress being made, and adjust the level of incentives as necessary to achieve the required impact

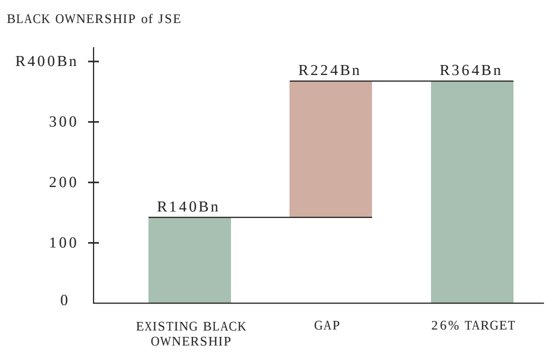
- The reduction in fiscal take would be offset by an additional growth rate in GDP of just 0.5% per annum
- Achieving fiscal neutrality would require investment as a percentage of GDP to increase by only 1.5% - 2.5% from the current level of 15%

3. Communicate and adopt a comprehensive plan to close the "BEE funding gap"

Lack of availability of finance has been a major obstacle to black economic empowerment. It also undermines investor confidence in the sustained value of their investments, as the ability to achieve ownership transfer on a "fair value" basis is called into question. Owners fear that transformation may result in the transfer of assets on a non-economic basis.

This fear is not entirely misplaced when simple numbers are considered. The required level of funding to achieve 26% black ownership (the target in the mining charter) of publicly quoted companies is over R220 Billion[10] at the current market capitalisation of the JSE (see Figure 5).

Fig. 5. Sizing the BEE funding requirement



Lack of finance remains a key problem, notwithstanding both our Government's more flexible approach to ownership targets, and many innovative approaches to financing BEE deals. These have included performance-linked funding and vendor loans. Unfortunately, while these approaches do represent transfer of ownership at fair value, they are risky. Many existing BEE deals have foundered, following the recent turmoil in the global economy.

The availability of funds should determine the level of black ownership we aim to create. This requires that we draw on all available sources of funds, and innovative and creative financing options, to sow the seeds now for future sustained black economic prosperity.

Conversely, we must avoid the risk of future failure. This could be the result if we push too hard now to create levels of black ownership that are economically unsustainable. If we create high levels of gearing for Black firms, we run the risk, in an economic downturn, of either requiring the debt provider to write down the debt (loss of fair value), or forcing the Black partner to dilute their stake (defeating the objective of ownership transfer).

Our Government must develop a comprehensive plan to promote all available sources of equity funding

Therefore our Government must develop a comprehensive plan to promote all available sources of equity funding, as well as debt funding, to close the “gap”. Greater access to funds should promote more financially prudent deals.

Sources of additional funding which we could access might include:

- Building grassroots black-owned equity, perhaps through enabling tax efficient Employee Share Option Programmes (ESOPs), or mandating compulsory levels of saving, as has been achieved in other countries such as Australia and Chile
- Targeting further investment in BEE firms from funds under management, perhaps through mandates for pension asset allocation or increasing the proportion of equities in the Public Investment Commissioners (PIC) pension fund

- Establishing incentives to create, and widen access to, special purpose financing instruments from institutions
- Creating incentives for individuals to invest in BEE firms and investment firms (for example the Canadian Junior mining model)
- Encouraging further private equity investment

In combination, these and other sources could create over the next 10 years a further R80 Billion to R100 Billion of black equity funding,[(11)] primarily at grassroots level. This would go a long way to closing the BEE funding gap, while also easing pressure on businesses to conclude BEE deals that are inherently high risk.

In addition, as we make progress in delivering our growth and transformation goals, we will increase our ability to secure loan finance on a commercial basis from international bodies. We will also be better placed to access international development funds and grants, such as the additional $5 Billion of US assistance committed at the 2002 Monterrey conference.

Delivering a plan that clearly demonstrates the full potential for funding will go a very long way to allay investors' perceptions of risk.

THE WAY FORWARD

Our country requires bold actions now to deliver both growth AND transformation. "Pain now, gain tomorrow" is not an option. Our economy must grow at least by 5% per annum now and into the future if we are to deliver as a nation and create the jobs required to reduce unemployment by half.

This requires that we gain broad-based and popular support for a set of measures that are in all our interests; that will allay investors' perceptions of risk; and stimulate the growth we require to deliver against our transformation goals.

Our purpose is to raise what we see as the primary issues around the approach to transformation, and stimulate debate. We recognise that what we have presented here is no silver bullet. However, perhaps it could be an important part of the answer. Of course, achieving 5% growth will require further actions to address other constraints, such as workforce productivity and skills, and current levels of crime.

These are our views and ideas. Tell us where you agree or disagree. Certainly, they need much further work before they can become a reality. Contribute your views and ideas, on what needs to be done. We need to hear from you, both in your personal capacity, and also as a spokesperson for the organisations you represent.

What is certain is that inaction is not an option. The ultimate goal of this Brenthurst Initiative is to ensure that we South Africans do not fail to grasp this opportunity to deliver. Thereby, we can begin to secure the future for our children and our children's children.

Your contribution would be most welcome. Why not tell us what you think?

You can e-mail us at thebrenthurstinitiative@eoson.co.za (or write to Nicky Oppenheimer at E. Oppenheimer & Son, 6 St. Andrew's Road, Parktown, 2193, or P.O. Box 61631, Marshalltown 2107).

Nicky Oppenheimer   Jonathan Oppenheimer

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Acknowledgement

We would like to thank Robin Buchanan, Cyrus Jilla and Alan Bird of Bain & Company for their input and advice in helping shape and develop the ideas that are core to this Brenthurst Initiative. Their ability to contribute the perspective of objective international and local investors, on the unique challenge we as South Africans must address, has been invaluable.

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