

The black industrialists programme in context: the real barriers to entry

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South Africa has one of the highest levels of income inequality in the world with a Gini coefficient that has remained around 0.65 over the past decade.¹ In addition, South Africa's unemployment rate, using the narrow definition, at 26.4% is very high.² Much of this has been attributed to the legacy of apartheid during which the majority of South Africans were economically marginalised with few economic opportunities.

Efforts have been made to try to reduce this gap in access to economic opportunities through regulation such as the Broad-Based Black Economic Empowerment Act. The New Growth Path and the National Development Plan also provide a framework for increasing investment in industrial activity and highlight key constraints to inclusive growth in the South African economy.³ In May 2015, South Africa's Minister of Economic Development Ebrahim Patel announced that R23 billion would be put aside over the next five years to support black industrialists in a strategy to increase investment and participation.⁴ While access to capital would be beneficial to increasing the participation of so-called black industrialists in the economy, a recent CCRED project on barriers to entry demonstrates that firms face more challenges than access to capital when attempting to enter an industry. By using case studies on the wholesale fuel sector and the entry of a new brand, Soweto Gold, into the beer industry, the studies show how structural and strategic barriers to entry could present an obstacle for entrant firms and 'black industrialists'. This article highlights some of these findings.

Concentration and market power in South Africa's economy

The South African economy is concentrated and comprises a small number of dominant firms in key sectors, a legacy of the industrial development strategies of the apartheid government, where the economy was structured principally to cater for the industrial policy of the apartheid state.⁵ Sectors such as telecommunications, agriculture, mining and energy were allowed to develop national champions in the form of state-owned firms that have since become vertically integrated, and in many cases owned by a handful of conglomerates and family groups.

Over time, the entrenched position of large firms and groups has persisted in key economic sectors resulting in the exclusion of a large proportion of the population from both ownership of assets and participation in the economy. From industrial organisation theory, we know that industries with a high concentration of firms and high barriers to entry are often characterized by limited competition, low incentives for innovation and few efficiency gains.⁶ Concentration in a sector, particularly in the production of homogenous goods, also creates strong incentives for firms to collude and jointly charge

monopoly prices for products and services.⁷ In order to protect supernormal profits, firms with market power may engage in anti-competitive conduct and strategic conduct to discourage entrants. They may for instance raise their rivals' costs and reduce rivals' revenues to encourage exit of new firms or deter entry,⁸ creating an environment which is not conducive for the successful entry of new (black-owned) firms.

In this context, recent studies on the liquid fuel wholesale sector⁹ and the beer industry¹⁰ in South Africa highlight the types of barriers to entry encountered by entrant firms in each sector, providing some insights into the real and often neglected challenges of firms that the black industrialists programme would need to consider and address in its design. These go beyond granting access to capital and the lack of skills and training for entrants. The research shows that there are also the challenges of gaining access to key inputs and customers (and not only through government procurement programmes which may not ensure sufficient offtake for firms to achieve scale), and the strategic reactions of incumbents to entry. These aspects speak to the actual contestability of markets in which new firms seek to enter.

Access to supply

In many sectors, large firms are vertically integrated at every level of the value chain i.e. input supply, production and distribution. New entrants often have to compete with their source of supply or enter at multiple levels of the value chain. This is certainly the case in both the liquid fuel wholesale (energy) and beer (agro-processing) sector. In the fuel industry for instance, the supply of fuel is in the hands of the seven major oil companies. These companies have the ability, infrastructure and capital to import and refine large volumes of fuel and also own infrastructure for the transportation and storage of the fuel. Wholesalers therefore have to access their fuel from the seven oil companies exacerbated by the fact that there is no viable alternative for sourcing or importing the product independently. This dependency usually means that the suppliers are able to dictate contractual terms to the wholesalers. Moreover, the independent wholesalers interviewed in the study found that it was not possible to play suppliers off against one another because they were often too small to significantly affect the majors. The nature of the relationship between wholesalers and suppliers also means that in situations where there are shortages of fuel supply, oil companies will tend to supply their own branded wholesalers ahead of independent wholesalers.

In the beer industry, this concern arises in the context of access to key ingredients. SABMiller is the dominant producer of beer with a market share of almost 90% and is present at every level of the value chain including the growing and sup-

ply of key ingredients such as hops and barley. This gives them the ability to raise prices of these ingredients for their rivals. However, beer production only constitutes around 15% of the total selling price of beer and the relative costs of barley and hops are a small percentage. The price therefore is not a primary concern. The quality of the ingredients supplied however is critical as it significantly affects the flavour profile and quality of the output. SABMiller has an incentive to provide rivals such as Soweto Gold with less than ideal quality of ingredients, and rivals such as Soweto Gold have no choice but to buy ingredients from their primary competitor.

Access to customers

For any new firm to enter and grow in a sector, they require access to customers. However, in industries with strong incumbents, dominant players can tie in customers to lock out rivals including through staggered, long term contracts. For example, in the fuel sector, most of the larger customers are tied into long term contracts with the majors which keeps entrants away from the more lucrative opportunities in major urban areas. The incumbents are also better able to provide customers with more favourable payment terms such as better credit terms and discounts which rival distributors are not able to match, in a low margin environment. While the customer is (rightfully) able to benefit from access to greater discounts, this practice can be a concern from a competition perspective if incumbent firms are shown to be offering deep discounts that may be below marginal costs, for instance. An entrant in fuel wholesaling is usually required to purchase fuel on a cash basis from the suppliers and therefore cannot afford to give favourable credit terms as this would affect the business' operational cash flow. Entrants therefore have to ensure that they compete in terms of reliability, quality of service and a good relationship with the customers, and can seldom compete on price.

In the beer industry access to customers comes down to a company's distribution network. Soweto Gold distributes its beer to 35 restaurants and bars through kegs. However, restaurants and bars represent only about 20% of the beer consumption market. Primary access to market is through shebeens and taverns, however it is difficult to get access to this customer base due to the incentives SABMiller provides to shebeen and tavern owners to place their beer products in the most strategic positions. Some of these incentives include provision of refrigerators to retailers on condition that they do not place other beer products in the same or in prominent positions in the fridge.

Furthermore, marketing is integral to accessing customers. Soweto Gold being a new entrant, does not have a sufficiently large budget to spend on the more effective advertising media. It thus limits its marketing to social media and viral marketing. SABMiller and other larger rivals such as Brandhouse can better afford to advertise on the more expensive platforms such as television, radio and billboards. SABMiller also has a very good distribution network and the infrastructure and systems to transport its beer from the

breweries to their customers seamlessly. Economies of scale also enable SABMiller to distribute their products at considerably less cost than entrants are able to, an issue discussed at length in the abuse of dominance case brought against the firm which was heard by the Competition Tribunal in 2014.¹¹

Incumbents' reaction to entry

A new firm needs to contend with the likely competitive reaction to their entry by incumbents. If an incumbent realises that an entrant is a potential threat they can leverage their position in the market to lower prices to levels close to or even below marginal or average variable costs to discourage or undermine entrants, or they could expand their capacity to signal to their rivals that they have the ability to flood the market.¹² In the fuel industry, because of the vertical integration and transparency in the sector, incumbents have insight into the capacity to grow and expand of downstream rivals. Since they also supply the rivals' key inputs, they have the ability to 'manage' the growth of rivals. In fact new entry into the liquid fuel sector benefits incumbent suppliers in that it indirectly provides additional customers for the oil majors given that the entrants still have to source fuel for new customers from the majors. However, in cases where entry is deemed to be threatening enough such as the proposed development of independent storage in Cape Town, the oil majors are likely to put up a fight.¹³

SABMiller has also for the most part appeared to accommodate entry with respect to small brewers. However, in 2014, the beer company launched its own craft beer called 'No. 3 Fransen Street', at a time when the specialty beer market was experiencing some growth. In promoting the beer, SABMiller offered incentives to retailers such as a premium draught tap, branded glassware and merchandise, management of aged stock and draught machine services which rival firms are not able to match.

Skills and training

An obvious issue that needs to be addressed in the context of the black industrialists programme is accessing the skills to operate businesses or the sector-specific knowledge to drive the business forward. Even as the Department of Energy is taking steps to have Historically Disadvantaged South Africans (HDSAs) enter the fuel sector, a 2011 Liquid Fuels Charter audit report showed that very few HDSAs were in ownership or management positions. Many of the HDSAs in these positions appeared as part of fronting to allow a company get a higher BBBEE score.¹⁴ The general lack of high-end skills in the country also means that new entrants to most sectors find it difficult to develop good operational and cash flow managers which are essential in a sector where operating margins are thin and success depends on having cash to purchase the primary input.

Conclusion

From the above discussion on the experiences of entrants in the liquid fuel and beer industries, it is clear that black indus-

trialists as envisaged need more than access to financing in order to successfully enter certain industries. They often have to contend with competitors who have been in the market for decades and have ownership of strategic infrastructure in the value chain. The decades of experience and vertical integration in the value chain give the incumbents competitive advantage that would be difficult for entrants to acquire.

The black industrialists programme should consider giving entrants access to public procurement opportunities such as those in municipalities, although depending on the sector these may not be sufficient to allow an entrant to achieve scale. The procurement guidelines advocate for preferential treatment of small and medium enterprises and HDSAs, however the actual implementation has been poor.

In terms of strategic barriers that are likely to be encountered, constraints in the competition law that make it difficult for the prosecution of abuses of dominance are a critical concern. It might be more viable for relevant government departments or private actors to facilitate direct partnerships with incumbent firms on agreeable terms which assist new industrialists to gain access, although it is important to caution against the creation of perpetual dependency. Entrants may thus over time gain their own customer base, develop their productive capabilities, and in the long term become effective rivals. This is akin to the concept of incubation of firms often cited in in-

dustrial policy strategies, which essentially acknowledges that entry dynamics encompass more than just access to finance, but a network of supportive policies as well, that both support firms to grow but also provide effective performance disciplines which entrench the principles of competition and rivalry.

Perhaps the end-game of developmental programmes of this nature should not be that every entrant needs to rise to become the same size as global giants such as SABMiller. The overarching principle may be to ensure that markets remain contestable, free from unilateral abuses of market power, and open to contestation even if only in smaller localised markets. The DTI will need to find the answer to the very difficult question of how big is big enough, and what size and type of entrant industrialist firms will be the markers of success for the programme?

Different industries may require sector-specific solutions to ease entry such as creating viable alternative sources of supply in the fuel sector. These sector-specific solutions would need to be sufficiently comprehensive to encourage entry and provide requisite support without interfering with the role of the entrepreneur in learning-by-doing, investing and innovating to retain their access to this support. In this context, R23 billion may be a drop in the ocean in terms of what is needed to enable effective entry in many key sectors.

Notes

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