Concentration, profits and investment: Let's focus on the structure of the economy, not "cash hoarding"

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Concentration

The extreme concentration of ownership and control within the South African economy, with a small number of large firms dominating most sectors remains one of the country's greatest economic challenges.[2] Debates about whether or not these companies are 'hoarding cash' or business is on an 'investment strike' miss the point. The bottom line is that companies have market power and are using it to earn good profit margins but investment remains weak. The opening-up of the economy to a diversity of participants has not happened and, if anything, concentration and vertical integration within sectors has increased since 1994, reinforced by high barriers to entry.

The claims by some that concentration reflects the efficiency of large firms is difficult to square with poor productivity performance and low investment in the economy as a whole. The prevalence of cartels in South Africa suggests that concentration and low levels of competition have gone together.[3] Large firms have also lobbied and strategised to undermine rivals, as would be expected, most recently exemplified by Multichoice. The reality that smaller participants are locked-out of markets further feeds the perception that the only way to gain access is by using state leverage to appropriate rents.

It should be no comfort to find that the world appears to be becoming more like us, as concerns about corporate concentration grow in many countries.[4] Nor does big business's defensive arguments that their investments have not been *that* low given the weak economy, or that their accumulation of reserves is not *so* much when various factors are taken into account, serve

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[2] See reviews by World Bank, OECD, IMF, as well as: Fedderke, J. W., Obikili, N. & Viegi, N., (2016) 'Markups and concentration in South African manufacturing sectors: An analysis with administrative data', *WIDER Working Paper No. 2016/40*; Mncube, L., Khumalo, L. & Ngobese, M., (2012) 'Do vertical mergers facilitate upstream collusion?' in K. Moodaliyar & S. Roberts, eds. *The development of competition law and economics in South Africa.* HRSC Press; Roberts, S. (2013) 'Review of Competition and Industrial Structure', for South African Presidency 20 Year Review.

[3] Muzata, T., Roberts, S. & Vilakazi, T. (2017), 'Penalties and settlements for South African cartels: An economic review' in J. Klaaren, S. Roberts & I. Valodia, eds. *Competition Law and Economic Regulation.* Johannesburg: WUP.

[4] Such as in the USA, see De Loecker, J. & Eeckhout, J., (2017), 'The Rise of Market Power and the Macroeconomic Implications'. *NBER Working Paper No. 23687*.

to take the debate forwards. Denial of the issues posed by concentration and the long-term structural challenges we face is just avoiding looking in the mirror. Big business has focused on state capture without drawing the links to high rents or applying the same scrutiny to large private businesses when they are found wanting.

The high levels of concentration have recently been highlighted once more by a Competition Commission study[5] of merger reports (which involve careful market definition). This study found that unilateral dominance (where a single firm has a market share in excess of 45%) existed in a large number of markets. In the merger reports reviewed from 2009 to 2016, dominant firms were identified in 294 distinct product markets. Using the Hirschmann-Herfindahl Index (HHI), the study found the following broad sectors to be highly concentrated:[6] Communication Technologies; Energy; Financial Services; Food and agro-processing; Infrastructure and construction; Intermediate industrial products; Mining; Pharmaceuticals; Transport. These sectors cover most of the economy and are central to economic growth and to consumers' pockets.

Moreover, market concentration, by at least some measures, is getting worse. Statistics South Africa data on concentration levels within manufacturing indicates that the proportion of sub-sectors in which the biggest five firms held 70%+ market share has increased from 16 sub-sectors in 2008 to 22 of the 80 sub-sectors in 2014.

While concentration levels remain high, there have been substantial changes in ownership. Assessment of JSE capitalisation by McGregors *Who Owns Whom* highlights the dramatic growth in the significance of domestic and foreign institutional investors. The companies controlled by these groupings each only accounted for an average of 4% of the JSE in the period 1995-2000. By 2016 companies controlled by domestic institutional investors accounted for 18% of the JSE, while those controlled by foreign institutional investors accounted for 42%. The rise of institutional investors tends to mean a focus on shorter-term returns as these investors trade shares more frequently and have aggressive demands for dividends and share buy-backs. The greater foreign ownership implies outflows of profits and greater vulnerability to tax avoidance.

By comparison, the significance of black owned and controlled companies (as assessed by McGregors having an empowerment holding exceeding 26% and no other dominant shareholder) declined from 7.1% of the JSE on average in the period 1995-2000 to just 0.5% of the JSE capitalisation in 2016. While it is trite to observe that black people are pension-holders and hence indirect owners through institutions, this misses the point about the need for a significant change in corporate control.

Large firms and investment

The orientation and strategies of the large firms is obviously very important given their significance in the South African economy. So, what have they been doing? In a series of studies, CCRED examined the top 50 listed firms in detail, and also examined developments in key sectors including metals and food.[7] These studies corrected for inflation and excluded

[5] Cited in Government Gazette No. 41294, 1 December 2017.
[6] This is calculated as the sum of the squares of the market shares. A score or more than 2500 is taken to indicate the sector is highly concentrated.
[7] Bosiu et al. (2017). Research Project on Large Firms and System for Regular Tracking of their Strategies and Decisions: Top 50 firms on the Johannesburg Stock Exchange (JSE). *CCRED Working Paper 17/2017*; Nhundu et

eight firms which had only a very small proportion of their activities in South Africa.[8] The studies' major findings included relatively strong profitability, significantly high reserves accumulated, and low dividends paid out. These results also hold if only non-financial corporations are measured, although there were important differences between sectors, with, for example, mining companies performing poorly.

Moreover, investments (using the accounting definition) by the top 50 firms on the JSE have been increasingly channeled towards mergers and acquisitions between 2011 and 2016, rather than expanding productive capacity. This suggests further concentration. It is misleading to talk about an 'investment strike', as such, which would imply a coordinated effort by corporates not to invest. This is to completely miss the larger point around the nature of the South African economy and its implications for fixed investment levels. Both the OECD[9] and IMF[10] have noted that South Africa has maintained among the highest levels of corporate profitability compared to other emerging market economies, while fixed investment levels have been poor. Of course, there are important differences by sector and between firms. Downstream firms subject to the exertion of market power from dominant market participants and cartels find their profit margins and ability to invest are undermined through high input prices.

The study of listed companies in food production and processing found that the firms have been growing their business by acquisitions rather than expansion of productive capacity. The 13 listed food processing firms, which account for a very large proportion of activity in the sector, are mainly controlled by institutional investors. The focus on growth through acquisition by these firms is concerning given the already high levels of concentration, significant barriers to entry and a range of competition issues which have been identified by the Competition Commission. In addition, concentration at the supermarkets level means that routes to market for producers are governed by three main chains who have a huge influence on the potential for smaller producers to reach consumers. There is a clear trend of expansion of operations and interests by South African firms to other sub-Saharan Africa countries.

In metals, machinery and engineering a substantial proportion of investment spend of the 25 listed companies has also gone on mergers and acquisitions, yielding consolidation in the sector. At the same time, some firms have effectively become distribution entities with a hollowing out of local manufacturing capacity in the face of low investment spending, weak demand (including a decline in government infrastructure investment), lack of implementation of local procurement policies, and a challenging cost environment made worse by energy and mining policies. In the last decade and a half there has been huge import penetration in the

al. (2017). Research Project on Large Firms and System for Regular Tracking of their Strategies and Decisions: Food Production and Processing Sector Assessment. *CCRED Working Paper 10/2017*; Bell et al. (2017). Research Project on Large Firms and System for Regular Tracking of their Strategies and Decisions: Metals, Machinery and Equipment Sector Assessment. *CCRED Working Paper 18/2017*; and das Nair, R. and Chisoro, S. (2017). Growth and strategies of large, lead firms - Supermarkets. *CCRED Working Paper 8/2017*.

[8] The Intellidex study (*The Myth of Corporate Cash Holding*) and accompanying op-ed suggested that conclusions cannot be drawn from 'trends in nominal cash holdings' and that 'a lot of their cash is held in hard currency', with reference to the largest three cash holders of BHP Billiton, Anglo American and Richemont. We note the CCRED study corrected for inflation and *excluded* eight firms because of their mainly foreign operations BAT, SAB Miller, Anglo American plc, Glencore plc, BHP Billiton, Richemont, Naspers and South32.

[9] OECD (2013) *OECD Economic Surveys: South Africa*

[10] International Monetary Fund (2017) *2017 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for South Africa*, Washington, D.C.: International Monetary Fund

machinery and equipment sector. However, there are some 'pockets of excellence' where firms are investing in developing capabilities and technologies that can drive industrialisation.

Competition, productivity and industrialization

At the heart of the discussion on whether firms are investing in the South African economy[11] is the relationship between competition and productivity. While large firms may claim to be better placed to innovate and upgrade capabilities, monopolists have incentives to focus on maintaining their position by lobbying and raising barriers to entry in order to continue to earn returns from exertion of their market power. High entry barriers and arrangements which weaken small and medium firms therefore undermine economy-wide investment. As financial market imperfections mean that retained earnings are important for firms' ability to make investments, smaller firms typically are more constrained in terms of the liquidity they can use in order to invest.

Competitive markets and policies which lower barriers to entry are therefore important to stimulate innovation and open-up opportunities to entrants with new business models and products. Competitive markets further incentivize firms to reduce costs and raise productivity within sectors, investing in expanded productive capabilities.[12] This is borne out by a range of sectoral studies conducted by CCRED on barriers to entry, which have found that investment levels are higher when there is greater rivalry due to effective challenger firms which push incumbents to up their game. If these firms are excluded then productivity and investment suffers.

The patterns of ownership, concentration, competition and orientation of large firms are thus critical to understanding the low levels of fixed investment and the failure to move towards more inclusive growth. Evidence from international studies shows that achieving growth and development requires structural transformation in moving within and across sectors to higher value activities. However, market concentration and, in fact, further consolidation through mergers and acquisitions in South Africa, has maintained returns in a stagnant economy rather than the higher levels of investment needed in new and upgraded productive capacity. Competition within the economy is thus crucial to investment, industrialization and development.

The proposed amendments to the Competition Act are an important step in the right direction. They need to be part of a package of measures including actions to address barriers to entry, access to development finance and improved regulation and targeted industrial policies to support rivalry and open-up markets.

[11] In the economic sense of domestic fixed investment, not mergers and acquisitions.

[12] Cohen, W. & Levin, R., (2010). 'Fifty Years of Empirical Studies of Innovative Activity and Performance', *Handbook of Economics,* Volume 1, pp. 129-213; Shapiro, C., (2012). 'Competition and Innovation: Did Arrow Hit the Bull's Eye?', in J. Lerner & S. Stern, eds. *The Rate & Direction of Inventive Activity Revisited*, National Bureau of Economic Research, University of Chicago Press; Nübler, I., (2014) 'A theory of capabilities for productive transformation: learning to catch up', in Salazar-Xirinachs, J.H., I. Nübler and R. Kozul-Wright, (eds.) *Transforming Economies: Making Industrial Policy Work for Growth, Jobs and Development,* Geneva: ILO.