Where is the uproar over corporate capture?

By Justin Rovian Naidoo

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Does the average South African understand why there are such hefty barriers for Small, Medium and Micro Enterprises (SMMEs) or such a paucity of cash to fund them?

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The economic and political landscape is often cited as the reason why capital can't get into the country, but the truth is that we have more than enough capital in SA or are willing to come into the country. The problem is that corporate capture is rampant. The cheap dollar and euro liquidity seeking decent emerging market yields is held captive and hoarded by a few major players in key industries.

Fiscal dumping

Let's start from the ground up with the most important sector: Enterprise Supplier Development (ESD). All companies with a revenue of more than R50m are required by the Broad-Based Black Economic Empowerment (BBBEE) Codes of Good Practice to invest a percentage of their Net Profits After Tax in ESD projects. When aggregated across the market, this would be a huge sum of money to offer much-needed liquidity to SMMEs, but why do 67% of all SMMEs fail within three years?

Simply put, corporate South Africa - as per human nature - chose the path of least resistance. Fund managers offer them points for their ESD needs, the deal is done and the relationship cemented in perpetuity. It's a practice known as fiscal dumping, which involves utilising capital to address corporate difficulties, in this case BBBEE and ESD scorecards, which includes preferential procurement -a major roadblock to doing business.

Preferential procurement was included in the BBBEE scorecard to ensure that companies spend a minimum Rand value (ratio of balance sheet) on suppliers within their own value chain to build them up by giving them preferential work over time.

However, if fiscal dumping occurs by placing capital with fund managers, then these companies obtain these points from the fund managers and no longer need to actually focus on firms in their supply chains. This is why SMMEs in really good supply chains still go under- they should have been given preferential contracts as per BBBEE regulations.

The concept of fund managers is not inherently a bad thing, since skilled people are required to manage capital. In South Africa, however, all ESD fund managers employ Private Equity (PE) methodologies to score deals for funding.

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So why is this an issue? Venture Capital (VC) is supposed to be aimed at SMMEs as soft friendly capital to aid startups in terms of going to market and creating a sustainable company. PE is for considerably more mature enterprises aiming to expand at scale. In South Africa, there is no distinction made between the two, with PE and VC converging to create a dire investment landscape for SMME entrepreneurs. In other words, when seeking VC-type startup funding, enterprises are scored utilising PE models, making the rate of approval dismal.

According to the research I conducted together with the South African Enterprise Development Council, 97% of SMMEs do not qualify for PE funding, meaning that the very capital that was disbursed to find its way to them is fenced off by procedures designed to keep them out. Why? This is to prevent funds from performing badly since they don't invest in any companies and incur losses.

In the meantime, the fund manager charges management fees and collects interest on idle capital. A common diversion, and one could perhaps say a gaslighting tactic, is to utilise the funds disbursed as grants for incubators and the like for the cosmetic appearance of success. SMMEs continue to fail as incubators do not guarantee corporate supply chain contracts or funding.

Individuals in ESD roles are frequently insufficiently skilled to make sound decisions or simply don't know any better, and the conversation at company board level tends to centre around getting BBBEE points for the year. I maintain that if a company is run correctly, it will automatically meet diversity needs and have a well-trained and diverse team without the need for points to be purchased. It should be the first step in the company's strategy, not an afterthought.

Section 12J

We find the same problem with Section 12J investments, a government-mandated tax programme that allows investors to put their tax money into a fund and gain a tax benefit as well as earn upside on the funds' investments. Fund managers had three years to deploy funds, so they waited out the period, looking for the best deals in the market. This obviously meant that somewhat better VC-type deals were passed up in favour of waiting for the best PE deal.

This would be okay if it was a private fund with investors putting in capital for maximum gain, but it is not, it is a government-mandated scheme to allow tax money to find its way into SMME investments.

Many large corporates are guilty of using 12J structures to manage their ESD and BBBEE programmes. These companies are thus implying that they're seeking for the most profitable way to deploy their cash rather than the greatest option for the SMME or even suppliers in their very own supply chains. This is why corporate South Africa's preferential procurement statistics are dismal, as they offer no real assistance to the SMMEs within their own supply chains.

2021 was the final year of the 12J scheme which was scrapped by the government due to the gross misappropriation of its intentions. One only has to look at the wave of 12J firms that were fairly silent for the last three years before suddenly announcing three to four new investments in short succession during the course of the first two quarters of this year. This is due to the fact that they either had to invest or return the capital, which is now an issue as the fund managers' fees have already been spent

DFI and foreign investment

Every year, Development Funding Institutions (DFIs) are required to invest a specified amount in specific locations and asset types. How is our JSE at record highs in the midst of chronic load shedding, high crime rates, and crippling unemployment, for example? It is inexpensive foreign capital seeking debt returns on par with those in South Africa (in developed countries this is between 0% to 2%, in SA you can get at least 10% to 15%).

DFIs and foreign capital must now deploy this capital, but only to particular institutions of a certain size, such as banks or mature funds. Fund managers apply for and receive capital on a drawdown basis, meaning they can claim to have received R500m from a DFI and have that amount under management, even if it's not on their books. This boosts their image, allowing them to market a large fund without incurring any cost of capital if it is never used. It also meets the DFI's requirement for capital placement.

Yet, once again, only the best deals are transacted on in the market and funds would rather wait years for a unicorn than risk a loss. This means that DFI capital is committed to the established fund, and cannot be transferred to another fund, such as a new entrant, with a better fit for purpose model for serving SMMEs.

South Africa has no shortage of capital; the problem is that those in charge of the purse strings are wilfully utilising models that do not match the characteristics of the average South African SMME, ensuring that the two will never meet. While the funder continues to grow, the SMMEs fail.

The average South African holds the government to the highest standards, and everyday talk is consumed by complaints about the status of our roads, public services and even our lives, as a result of state capture. I'll go one step further and say that corporate capture is equally to blame since billions of Rands lay idle and undeployed as a result of corporations avoiding their responsibilities and buying points.

This has nothing to do with the International Financial Reporting Standards (IFRS) or capital adequacy ratios, but rather capitalism at the expense of humanitarianism. This is true for all banks and institutions with large amounts of unspent cash that are not subject to capital adequacy ratios. Individuals are also to blame because they can clearly see how ineffective these allocations are but they don't want to upset the apple cart.

So, my fellow South Africans, where is the indignation now that we know we have more than enough resources to finance, grow and scale SMMEs to solve a major component of our economy? Where is the outrage?

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