What is the relationship between manufacturing firms and banks in South Africa?

Does it support industrial development?

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The banking system: broad approaches

Anglo-Saxon approach

- Strong emphasis on equity finance, products and markets
- Transactional / client relationship between finance institution and industrial firm
- Focus on security or guarantees for loan finance
- Banks not involved in the strategic direction of the firm and often do not have industry knowledge
- Efficient allocation of resources based on the Efficient Market Hypothesis
- The trend in recent years has been towards this approach
- Typical of UK & US

Continental approach

- Bank led approach
- Close relationship between financial institutions and the industrial sector
- Banks own shares in companies they finance; representation on company boards
- Banks taking a long term interest in the viability and growth of the firm & have a vested interest
- Financial institutions more engaged in industrial development
- Typical of Germany and Japan (especially in industrialisation phase)
- Approach also taken by Asian NICs (as well as US during its early industrialisation period)

What makes Germany and Japan different from USA / UK?

- From the 1930's but particularly after the post war period bank, bank finance is the major source of finance for industry; linked to efforts to rebuild industry after WW2 (vs equity finance)
- Banks play a major not only in providing long term finance to industry but are major shareholders and sit on the boards of companies
- Banks also provide support for German and Japanese firms that want to get equity finance from the market
- Low participation rates in stock exchange
- Banks close proximity to companies is a risk mitigation – not only for their finance but other financiers: they ensure good governance

Why is this important?

- Emerges as a response to the bank crises and depression of the late 1929/early 1930s.
- State sees banks as a resource for economic and social objectives.
- Strong bank regulation and emergence of a system that aligns industrial finance, banks, worker participation, savings and pension funds
- Banks play a corporate governance role
- Promotes stability and growth in the industrial sector
- Significantly higher rate of investment in manufacturing than US & UK
- Supports growth in manufacturing output and industrialisation

Does the bank led approach favour industrialisation and manufacturing performance?

	Japan	Germany	United States
Proportion of Banking System Assets in Total Financial System Assets, 1996	63.6%	74.3%	24.6%
Proportion of Securitized Assets in Total Financial Assets, 1996	22.9%	32.0%	54.0%
Proportion of Securitized Liabilities of non-financial enterprises, 1995	15.4%	21.1%	61.0%

Source: Vitols, S 2001:23; data sources: Flow of Funds Statistics, US Federal Reserve Board, Deutsche Bundesbank, and Bank of Japan.

Country	Average Output		
	1950-66	1966-73	1973-90
US	4.5	3.2	2.4
Japan	14.8	14.4	5.5
Germany	7.8	5.3	1.6

Source: Sigh 1993:8, citing Rowthorn (1992, table 3)

Drawing on the industrial policy literature and evidence on the importance of industrialisa-tion for economic development

Overview – South Africa

- South African's financial sector is currently recognised as being a global leader, and ranked as 12th on the World Economic Forum competitiveness ranking,
- It is recognised as hosting "the continent's most efficient financial market" (WEF 2016)
- Highly capitalised stock exchange,
- The banking sector is an important as a source of debt finance in SA

SA JSE market Capitalisation grew from +-R11.7 trillion in 2015 to peak at over R16 trillion in October 2017

SA Banking sector by assets were +-R5 trillion at end 2017

Difficultly of access to finance is regularly raised by business structures and firms

Research!

Firm survey – key findings on relationship with banks

- When asked about whether they saw any benefit to a bank or financial institution sitting on their board of directors firms only 31% saw a benefit to that relationship.
- Similarly, when asked if they had any concerns if a bank or financial institution took an equity stake in their company, 60% said they would have a concern.
- The majority of firms (74%) were supportive of the idea that a possible measure for government intervention should be an improvement in the regulations governing the relationship between firms and private equity financiers.

Firms argued that the banks themselves were constraining new investment because of their preference to provide finance for existing / ongoing operations as well as the red tape involved in new applications.

In that context the firms raised concerns that the banks did not understand their industry sufficiently.

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Firms view on what banks could be doing better:

- Interest rates are high and may be fine for working capital but not new investments and growth
- Red tape and collateral requirements are too onerous
- Loan tenures are too short
- Export financing products are needed
- Assist with finance for suppliers to big companies

Improve relationships with firms.

Understand the firm.

Take a longer term view on the firm

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Interviews with banks – findings

- Bank evaluate all applications by a set of criteria – so manufacturing would be viewed in same way as other firms

- Banks largely do not have manufacturing sub-sector specific knowledge so it would be at a broad level i.e. steel is in crisis so the risk profile goes up, without unpacking the varied nature of the steel sector

- Banks are risk averse so while they provide services and transaction facilities for all types and sizes of business, they tend to give more finance to larger companies, as
  - Larger firms have lower risk profiles, often with capable management teams
  - Smaller firms have less assets with which to collateralise their debt.
  - The amount of effort and time for a large loan and a small loan is similar, which can be an important consideration for bank staff

Cont.

- Financing of new investment activities was also seen as higher risk and a mismatch with depositor maturity, with less appetite from the banks
- New investments may not bring a term immediately and require more patient capital

Tier 2 banks are more open to financing of medium to large companies,
they have a different risk profile / assessment;
and
can often be more hands on in their approach to financing – may complement debt with equity

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Interviews with private equity

- Focus on private equity firms looking to invest in companies and grow firms, to realise investment down the line (about 5 years but may be longer)
- Size of investment differs (large cap to small cap)
- Manufacturing firms were covered but investments across the board
- Active participation in growing the firm – role in firm governance, and focus on improved performance, professionalization and growth, which includes support for raising finance (they have a more robust balance sheet, strong backing and therefore ability to raise cheaper finance for the firm)
- Filtering process is very high – est. 3% of firms
- Private equity funds raised offshore - impact of downgrades; funds come as financial flows but are destined for real economy
- Local pension funds could grow in that area (Reg 28 of Pension funds Act) – 10% allowance not used; & could it be increased?

An important part of the finance eco-system with scope for significant growth

Development Finance Institutions (DFIs)

- Commercial banks are not always able to provide the finance required by industry and DFIs in both the Continental and Anglo Saxon systems
- The state involvement in credit allocation is to overcome market failure and DFIs play a catalytic role for industrial finance
- State run development banks / finance institutions targeting productive investment, as well as, support smaller businesses and new entrants;
- State plays a role in supporting industrialisation and is more conducive to longer term investments
- They take on more risk than private banks; and achieve social and economic goals
- Aim is to crowd-in rather than crowd-out private financial institutions
- Importance of industrial finance to support catch up – critical for Germany and Japan post WW2 and even more critical for late industrialisers: finance needed for 'catch – up' technologies and infrastructure

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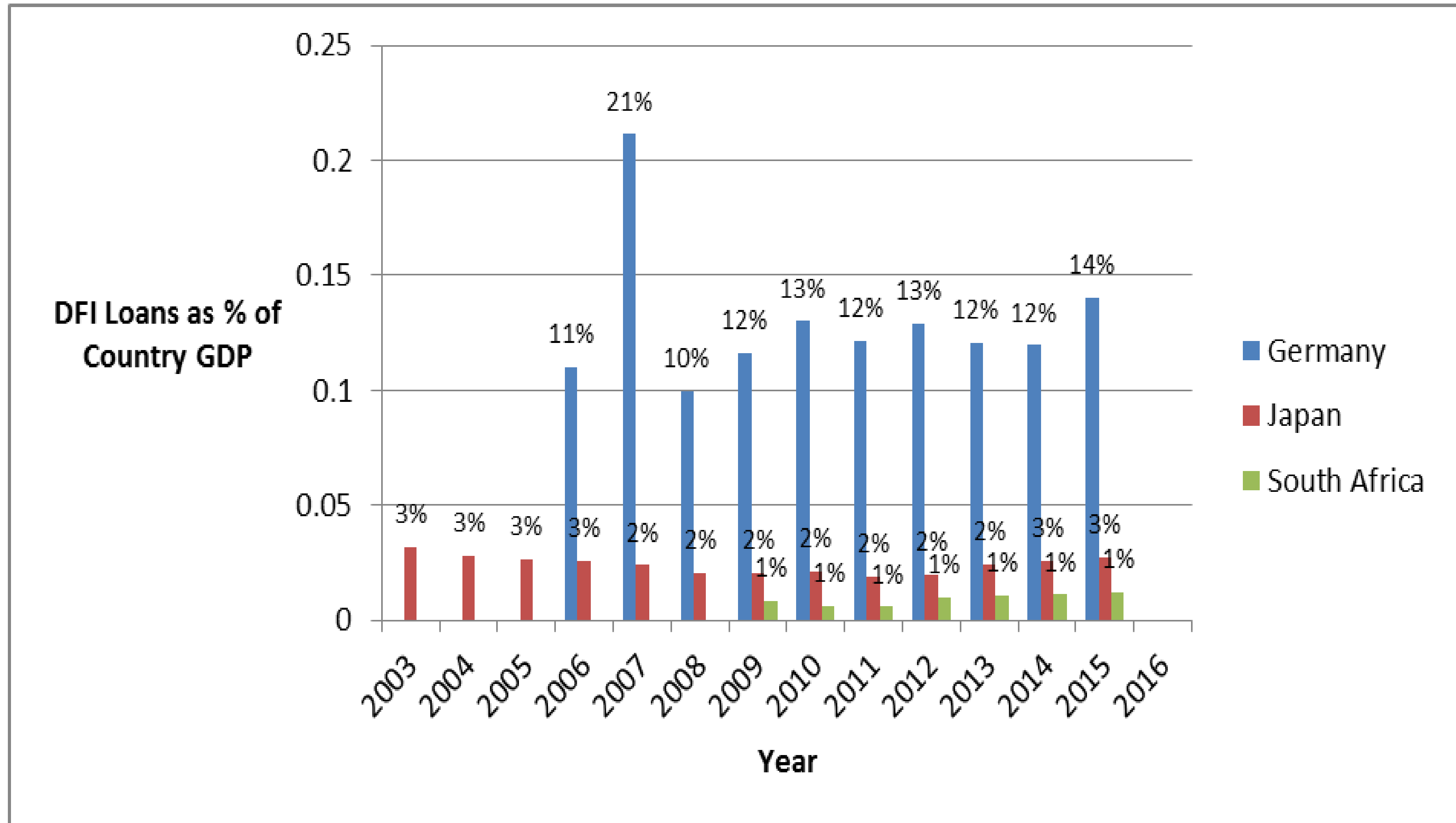
DFI Loans as % of Country GDP



Source: Annual Report and Financial Statements of KfW, DBJ, and IDC downloaded February 2017

DFIs – research findings

- From the research a minority of firms in the sample (21%) had received government finance – some from IDC and some from incentives.
- Those that had received supported raised
  - The need to reduce processing time – length and complexity of application process
  - Timing of when funds are released
  - Interest rates offered
- Both the banks and private equity financiers were open to collaborating with DFIs in the provision of finance, and some had done so in the past
- One banker noted that from time to time they ended up financing clients from the DFIs due to interest rate

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Do Firms Need Finance?

- The Annual Financial Statistics Survey (AFS) undertaken by StatsSA shows that listed firms across the economy sit with approximately R563 billion in cash or cash equivalents (2015).
- Listed manufacturing firms had R73 billion in short term debt (2017)
- The gearing of the firms surveyed differed significantly and ranged from -2.9% to 400%, the average gearing was 75% (high), the median 39% (considered normal)
- 20% of respondents that applied for a loan through a bank or DFI were refused
- Why they were refused, include: the cost of finance, low BEE scores, gearing, insufficient security or assets, and sector concerns
- The majority did not go ahead with the investment

Firms indicated that new loan finance was predominantly required for new equipment and infrastructure investment, with fewer indicating working capital and expansion

Gearing is preferred for new investments

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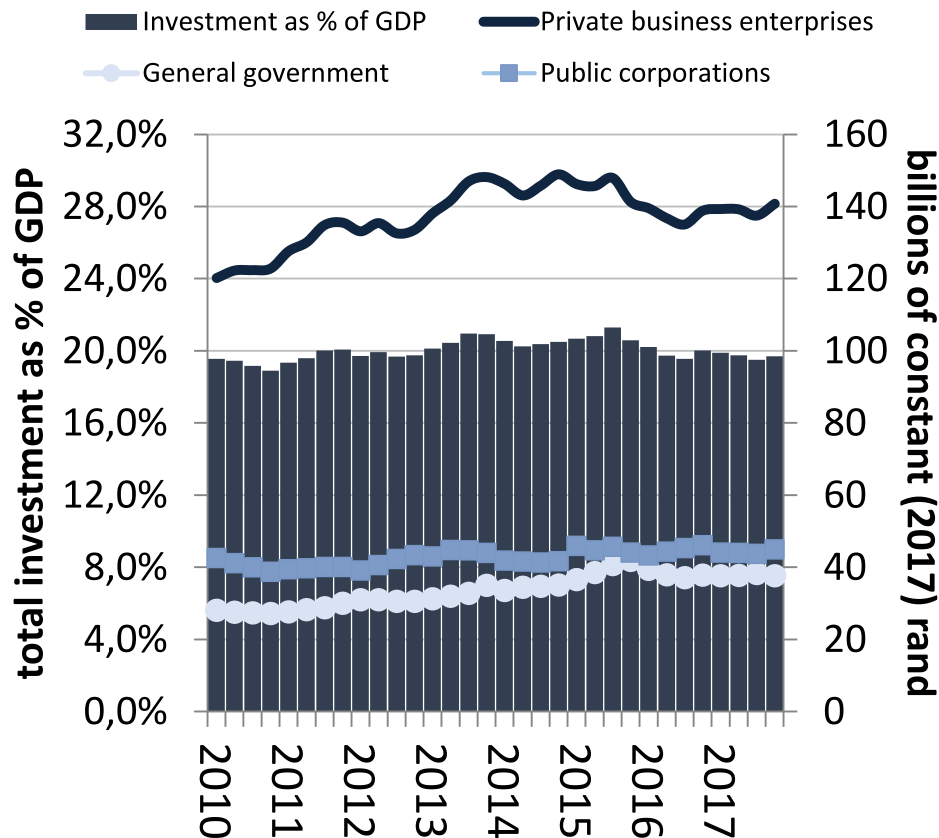
SA: Bank Led or Anglo Saxon approach?

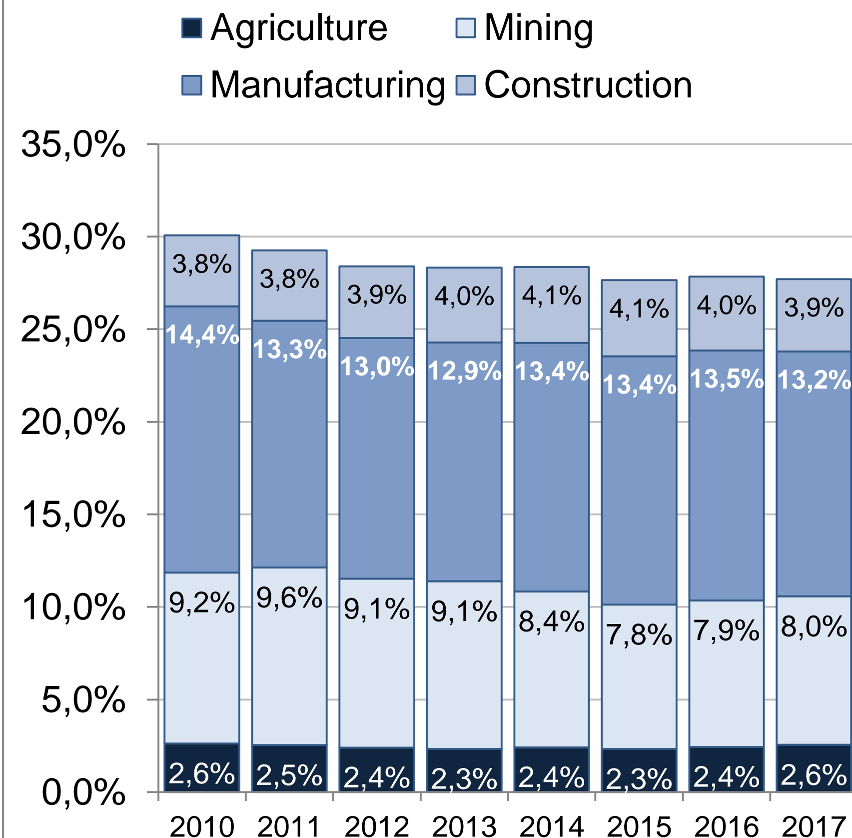
- The JSE a market capitalisation of R15 trillion at the end of 2017 was approximately three times that of SA Banks assets of R5 trillion in (end 2017)
- Moderate levels of investment, declining contribution to GDP

Quarterly investment: type of organisation and percent of GDP



Source: TIPS REB Q4 2017, from StatsSA GDP quarterly figures.

Share of the real economy sectors in the GDP, yr to fourth qr



Source: TIPS REB Q4 2017, from StatsSA GDP quarterly figures.

Conclusions and Policy implications

- Firms generally borrow money when they were buying equipment or making new investments – even if they were highly liquid
- The banks have resources but are risk adverse to financing new investments in the productive sector;
- There is a mismatch between demand and supply of finance or the pricing is reflective of the risk.
- The lack of trust is in both firms and banks; firms were more open to private equity
- SA more reflective of the anglo-saxon model both in structure and operation but still has a very strong bank sector that finances business; with tier 2 banks behaving differently
- Would a different relationship between finance institutions and firms would address the mismatch, lack of knowledge of industries and firms, and support greater levels of new investment?

Given the importance of industry for economic development and with increasingly less policy space available to governments to support industrial development, finance is an important area of policy focus for governments in terms of the role of state owned development banks, the need to improve regulation of the financial sector, and effective use of finance to support the growth of the industrial sector

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Policy implications cont.

- Opportunities for blended finance models with DFIs, Bank and private equity
- Knowledge sharing between government, industry associations, research institutes and the financial sector to deepen understanding at an industry level
- Lower the risk and cost of finance for industrial firms, though
  - Interest rate subsidies
  - Expand role of DFIs
  - Regulations (e.g. lower capital reserve ratio for targeted sectors)
  - Credit guarantee
- Balance sheet strength (assets) or substitute (i.e. credit guarantee) for small firms
- Without putting the system at risk does South Africa need to look at amendments to banking legislation to support a more engaged approach and to address a significant social need – as seen in Germany and Japan for post war reconstruction; and the institutional mechanisms to do.

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Thank you