

The Impact of Black Economic Empowerment on the Management of Small Companies in South Africa.

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SHORT DISSERTATION

submitted in partial fulfilment of the requirements for the degree

MAGISTER COMMERCII

in

BUSINESS MANAGEMENT

in the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES



UNIVER at
OF
JOHANNESBURG
RAND AFRIKAANS UNIVERSITY

STUDY LEADER: PROF. S. KRUGER

MAY 2004

ACKNOWLEDGMENTS

Ek wil graag die volgende bedankings doen:

Eerstens aan God ons almagtige Vader vir die geleentheid en voorreg wat ek gegus is om hierdie studies te kon aanpak.

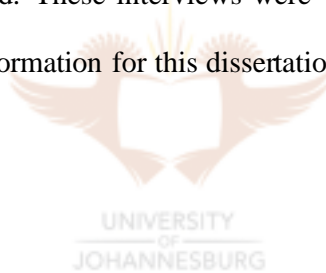
Prof. S. Kruger vir sy tyd, raad, geduld en bydrae tot hierdie studie.

Mev Rika Venter wat so baie keer uit haar pad gegaan het om te kan help waar sy kan.

My verloofde, Andrew Burton, vir die proeflees, ondersteuning en aanmoediging.

Further I would like to express my gratitude to a number of people. They took time, often at short notice, to be interviewed. These interviews were crucial for my understanding of the topic and provide valuable information for this dissertation.

Thank you!



Benjamin Mophatlane	Chief Executive Officer, Business Connection
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SUMMARY OF STUDY

The subject of this dissertation is a fairly contentious issue, with advocates on all sides debating the effectiveness and value of affirmative action, as defined in the Black Economic Empowerment legislature. The goal is to determine the affect of BEE on the management of Small and Medium Enterprises in South Africa, although SME's have been found by this study to have an influence on the effectiveness of BEE.

An overview of the origins and history of affirmative action policies, cumulating in BEE, are discussed, and the various policies and their effectiveness are examined. Special emphasis was placed on the study of the Black Economic Empowerment Commission, and the recent policies around the enforcing of BEE compliance on corporate South Africa. The biggest problem with the implementation of BEE was found to be financing. Many financial models have been attempted to provide the necessary funding for empowerment to happen, but all seem to be flawed in some way or another. Insight was gained into how BEE policies are structure d, the particular goals they are trying to achieve, and conclusions were drawn on how best these goals could be met.

The study then provides an overview of the position and value of Small and Medium Enterprises in the South African economy and the particular issues that management of these enterprises face. The value of SME's to the government's policies of addressing massive unemployment in South Africa is examined, and certain conclusions are drawn around how effective these policies are. The various constraints and peculiar problems of the SME sector are examined, in order to place the topic of the dissertation in context.

The dissertation then discusses the approach that was taken by the author in gathering the information and research material that was used to write the paper. These methods included meticulous research of the subject matter in the written press, internet sources, online libraries, as well as many personal interviews with leading industry and government personalities.

This information is then used to discuss the effect of BEE in practice, with particular emphasis on impact that BEE has had and is having on the SME sector of the South African economy. Discussion is provided around the application of the BEE scorecard, as well as a section covering finance, both local and foreign, of BEE deals. The opinions of the industry leaders interviewed are discussed and particular issues raised by them are examined in the light of the previous discussions around BEE and SME's.

Lastly, the dissertation presents a set of conclusions drawn by the author, and backed up by industry comment. These conclusions provide a clear understanding of the impact that BEE is having on SME's, as well as how SME's will have an effect on the long-term success of BEE in South Africa.

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1 INTRODUCTION

Since South Africa's first democratic election in 1994, Black Economic Empowerment (BEE) has been one of the foremost issues on the government's agenda. The government recognised that the majority of people in South Africa have for decades been deprived of all influence in the society. Black Economic Empowerment has a key role in the transformation process aimed at re-balancing the society after the years of apartheid.

The Small and Medium Enterprise (SME) sector of the economy contributes significantly to the Gross Domestic Product of South Africa, but even more so to employment. What BEE is trying to achieve is broad-based, grass-roots level empowerment of the average South African. Such an individual is not likely to be able to enter the large enterprise sector, and therefore, the SME sector holds the key to the success of BEE in South Africa. BEE, however, holds some serious challenges to the management of existing SME's, and this dissertation will discuss the impact of these challenges.

1.1 MOTIVATION

The motivation for this dissertation evolved from the author's experience in working for various companies in the SME sector. The problems being faced by these companies in complying with Black Economic Empowerment (BEE) legislature interested the author. The topic was investigated for a possible topic for this dissertation, and was chosen as it is an area that has not been extensively investigated, and is a relatively new and evolving subject.

The author felt that a detailed analysis of the problems being faced by both BEE and the SME sector, as well as the impact of the one on the other, would be invaluable experience, and may

provide a guide for management of SME's in understanding and taking advantage of the BEE requirements to grow their companies and ventures.

1.2 PROBLEM STATEMENT

Due to all companies in South Africa having to comply with the legislated requirements for BEE, the author believes that there will be a significant impact on SME's as a result. This dissertation seeks to ascertain the degree of impact on SME's, and to establish any recommendations that may be used by SME's to minimise such impact.

1.3 OBJECTIVES

The aim of this dissertation is to provide the reader with a sound understanding of the impact of Black Economic Empowerment (BEE) in South Africa, on the management of Small and Medium Enterprises (SME's). The author believes that Black Economic Empowerment must be taken more seriously by management in SME's in South Africa, not only to assist in a successful restructuring of the society, which is of utmost importance for South Africa as a country. This view was reiterated by Dali Mpofu, Chairman of the ICT Empowerment Charter Working Group: "Mark my words – in five years' time it will be almost impossible to do any business in this country, never mind with government, without having a significant black empowerment component"(Vecchiatto, 2004).

The goal is to present a dissertation that can serve as an introduction to and a problem orientation in Black Economic Empowerment for Management of small companies in South Africa. Management of SME's can implement BEE as an opportunity for growth and not a threat for business that wants to grow. The dissertation will give an understanding of how the empowerment process can impact the strategy of the company. Furthermore, the aim is to initiate the question on what needs to be done in small companies to secure the compliance

with Black Economic Empowerment regulations and policies that are in place. After having read this dissertation, the reader should also have the basic knowledge needed to identify unintended conducts that do not comply with the approach chosen by his or her organisation.

From the author's view, Black Economic Empowerment should not be treated as a compliancy issue, but rather as a vital element in building up the company. BEE should permeate the management and be a fully-integrated part of a company's policies and strategies for the future. This holds for any size organisation, but especially SME's. Therefore the understanding of Black Economic Empowerment is crucial for people in leading positions in corporations and management of small companies. The government of South Africa has a firm commitment to Black Economic Empowerment, and the principles which it supports are sound. This dissertation also seeks to confirm this viewpoint.

Before considering the effects of BEE on SME's, this dissertation will place the discussion in context, by providing an overview of both Black Economic Empowerment, and SME management in South Africa. The following will be discussed, which will help establish the size of the problem:

- What is Black Economic Empowerment, and what is it meant to achieve?
- How does Black Economic Empowerment affect business in general?
- How has Black Economic Empowerment been approached by business?
- What are the consequences of non-compliance?
- What are the future prospects of Black Economic Empowerment?
- How important a role do SME's play in growing the South African economy?
- What is government doing to encourage growth of SME's?
- Are SME's experiencing a BEE skills shortage?

1.4 METHODOLOGY

The subject for this dissertation leads to a literature study of the topic. As a literature study, the author researched the topic extensively through multiple media sources, as well as conducting personal interviews with leading experts in the various areas. The technique used to conduct the research was, of necessity, a qualitative one. Focus was placed on one-to-one interviews and focus groups as interviewing methods for information collection during the qualitative research. The qualitative technique used falls somewhere between the “elite interview” and the “experience survey”.

These interviews were conducted in a confidential atmosphere and took the form of an open exchange of views. Therefore, the author did not name some of the sources of various opinions that are presented in the dissertation since this was in several cases a precondition for the openness. This method was chosen since the author believes that the personal opinions of people in leading positions are as interesting as, if not more than, the public policies of the organisations they represent. Secondary data constituted policy documents from various public and private sector institutions. Other relevant published materials were also sourced

There are a limited number of formally published resources available, so the author obtained the subject matter from the following sources:

- Internet publications
- Magazine and Journals
- Government Publications
- The RAU Online Library
- Personal Interviews

Hundreds of articles were sourced for the information that has been referenced in this dissertation, and whilst a subset of these is actually cited, the remainder did contribute to the author's final conclusions in some manner or another. The various sources and the methods of research in each are discussed further:

1.4.1 INTERNET PUBLICATIONS

Information published exclusively for the internet contributed a small amount to the total research for this dissertation. Most of the information was however located through the internet.

1.4.2 MAGAZINE AND JOURNALS

Information obtained from magazines, journals, newspapers and other popular media sources accounts for about 70 percent of the information used in this dissertation. These articles were for the most part located through the internet, and downloaded by the author off the online sites of the media sources.

1.4.3 GOVERNMENT PUBLICATIONS

The Government Gazettes and legislative documentation, including policy documentation, was obtained from the governments set of websites through the internet. These documents were also downloaded by the author for inclusion in this dissertation.

1.4.4 THE RAU ONLINE LIBRARY

The online library of information provided by Rand Afrikaans Universiteit provided the rest of the printed sources of information used by the author. The information was retrieved from the online library through the internet using the author's sign-on to the Online Library.

1.4.5 PERSONAL INTERVIEWS

The author interviewed several leading personalities in the course of conducting the research for this dissertation. Their views have been used to obtain an insight into the actual workings and practicalities of the BEE policy in the workplace. This information was invaluable in assessing the impact that BEE has on SME's in South Africa. A list of interviewees and the topics is listed in the bibliography.

Most current information on the topics of BEE and management of SME's is available through the internet, and the author made significant use of this resource to obtain the majority of information around these topics. The impact of BEE on SME's is not however covered to any significant degree by the written press. The author obtained most of the external opinions on the impact of BEE on management of SME's from personal interviews with business and government leaders with hands-on experience in this area.

1.5 LIMITATIONS

The concept of Black Economic Empowerment is much wider than the area presented in this dissertation. The author will only present the aspects of Black Economic Empowerment that are relevant for the topic chosen. The ambition is to give a deeper understanding of how the process of Black Economic Empowerment affects business, in particular management of small companies. The conditions for, and the varying impact of Black Economic Empowerment in different sectors, will not be specifically discussed.

1.6 DIVISION OF STUDY

The approach that the author has taken in laying out the information, discussion elements and conclusions is as follows:

- An introduction to the topic is given in Chapter 1, defining the problem statement, outlining the approach taken, and setting the scene for the discussion.
- Black Economic Empowerment is examined in detail over the course of Chapters 2 and 3, focusing on BEE as a concept, and then the BEE Commission that acts as a watchdog.
- An examination Small Business in South Africa occupies Chapter 4, where the author discusses the values and contributions of the SME sector in the South African economy.
- Chapter 5 discusses BEE in practice, and examines the various problems that have been experienced since its implementation.
- The main discussion of the dissertation is found in Chapter 6, where the impact of BEE on SME's is examined in detail.
- The final chapter of the dissertation, Chapter 7, summarises the conclusions of the author, and provides recommendations for management of SME's on how to minimise the impact.

1.7 SUMMARY

Through the study of available literature, as well as interviews with leading experts in the field, the author in this dissertation will determine the level of impact that Black Economic Empowerment has on the management of Small and Medium Enterprise businesses in South Africa. An overview of each of these areas, as well as the effects of the combination will be detailed.

2 BLACK ECONOMIC EMPOWERMENT

2.1 INTRODUCTION

The focus of this chapter is to provide an overview of Black Economic Empowerment (BEE), as well as the challenges facing the implementation of such a far-reaching programme. The measurement of BEE will be discussed in detail, as well as the various obstacles facing the plan. Various models have been developed to assist with the financial aspects of BEE, and several of these, and their inherent flaws, will be discussed in this chapter. To fully understand Black Economic Empowerment however, it has to be placed in South Africa's historical context, which is the starting point of discussion.

2.2 ORIGINS OF BLACK ECONOMIC EMPOWERMENT

There is a considerable lack of clarity as to what the concept of Black Economic Empowerment really is. Different people and constituencies define it in different ways and assign it different meaning. The definition also varies over time. Black economic empowerment (BEE), Affirmative Action, National Economic Empowerment and Development (NEED) are different terms used from the late 1980's and onwards to describe mainly the same thing. In the late 1980's, white business regarded Black Economic Empowerment as a mechanism to create a black middle class with interests in the economy. The initial thought was that by partly re-arranging the racial composition of the ownership structure of the economy, the market economy and political stability would be ensured.

Corporate social responsibility programmes and black advancement initiatives were introduced to achieve Black Economic Empowerment. The creation of a small influential black business class was part of the goal. Blacks were to gain access to the formal economy

while at the same time the underlying structures of the economy were to be left unaffected (Edigheji, 2000:6-8). At this time black people were mostly put in middle management positions without any managerial responsibility. The black people that did have managerial responsibility were mainly appointed for business reasons, and not for empowerment reasons. This was when for example black people were needed to give the company insight into black peoples' consumption needs and habits.

The first democratic elections in 1994, when the African National Congress, ANC, came to power, were a political turning point. Corporate South Africa responded by appointing black non-executive directors and by selling businesses to black empowerment groups. Financial institutions provided funding to so-called Special Purpose Vehicles (SPV's) which enabled black people without capital to go into business (Batchelor & Dunne, 1999). At this point, Black Economic Empowerment was largely a function of the white businesses' efforts to change themselves. Political correctness became very important in corporate South Africa. Black economic empowerment was met with scepticism and suspicion from the black community in the late 1980's, as they feared that it would only create a black middle class without fundamentally transforming the oppressive political system and give full political rights to all. It was not until in the early 1990's that ANC converted to the concept of Black Economic Empowerment. The ANC's position has thereafter been characterised by concepts such as de-racialisation and democratisation of the economy and economic emancipation of the black majority.

After the 1994 elections, the ANC-led Government of National Unity (GNU) was focused on reconstruction and reconciliation. Emphasis was put on economic inclusivity, aimed at broadening the economic base of South Africa. This was done by promoting small and

medium enterprises (SME's) and through the Reconstruction and Development Programme (RDP). Black economic empowerment was on the government's agenda from the very beginning, although not initially as strongly as later.

In 1995 the Black Business Council (BBC) was formed as a response to the need for a black voice in business. The Council is made up of 11 black business organisations with a common aim of shaping the economic policy debate raging in the country. In 1996, with growth faltering in a macroeconomic policy vacuum, the Growth, Employment and Redistribution (GEAR) strategy was declared by President Thabo Mbeki. This policy was designed specifically for economic growth. In 1997, in the absence of an enabling policy framework for empowerment, black business that had emerged on the back of Special Purpose Vehicle (SPV's) financing within the established business sector, felt the collapse of the south-east Asian economy. Unable to pay back loans provided by established businesses many big black players listed on the JSE fell by the wayside, and a renewed debate on empowerment and development followed. In 1998 the Black Business Council (BBC) formed the Black Economic Empowerment Commission (BEECOM) with a mandate to redefine the concept of empowerment, investigate the state of empowerment in South Africa, identify the hurdles to empowerment, and recommend a policy to the government (Enterprise 2003:16).

Black economic empowerment in the early 2000's can be described as a process aimed at redressing the imbalances in the ownership and control of South Africa's economic resources by increasing black participation at all levels of the economy. This would be done by job creation, poverty alleviation, specific measures to empower black women, education, skills transfer and management development, meaningful ownership and access to finance to conduct business.

Over the years, the government expanded the parameters of its empowerment objectives in business to include training, affirmative action, affirmative procurement and equity ownership. The empowerment requirements varied between different state departments, agencies and governments on local, provincial or national level. Several government departments, for example, articulated their own specific policies for empowerment. Subsequently, it is difficult to determine what aspects of empowerment are most relevant to doing business with these public entities. Black economic empowerment can also be seen as a way to deepen the economy and stimulate growth in the country by releasing the economic potential of the black population.

President Thabo Mbeki, in his February 2003 State of the Nation address, confirmed that “development and support for small and medium business, remains a priority for government. Accordingly more financial and other resources will be committed to the development of this sector of our economy” (Enterprise, 2003:120). One of the major issues around BEE remains the difficulty to accurately measure the effective of the policy, which is discussed next.

2.3 MEASURING EMPOWERMENT OWNERSHIP

The greatest challenge facing empowerment today is that few companies recognise the benefits of BEE beyond meeting tender or licence criteria and filling in charter scorecards. Its implementation is mainly viewed as a compliance issue. Effective monitoring and review of empowerment performance and of the policy framework itself are therefore imperative. However, in the context of low levels of reporting, inconsistent standards and methodologies

as well as inadequate systems to monitor, measuring progress is almost impossible (Brown, 2004:35-37).

Public and private sector reporting on BEE to shareholders, customers and employees is central to its successful implementation. SA's private sector is gradually adapting to increased levels of disclosure, spurred on by the King II Report on Corporate Governance and, to an extent, government through instruments such as licensing, fishing quota applications, competition hearings and public sector procurement, the latter all requiring BEE reporting for evaluation purposes.

The intention is for company reporting to extend to sustainability or triple bottom-line issues – the social, economic and environmental (including BEE) aspects of their activities – and thereby to move away from the single bottom line of profit for shareholders. BEE charters have, or at least should have, added impetus, providing detailed frameworks to guide company reporting on BEE. In areas such as environmental and labour issues, significantly more progress is required. Few of these reporting instruments are consistent or public enough. Adherence to the requirements remains limited, exacerbated by varying standards and measurement systems, as well as inadequate monitoring capacity.

There are empowerment rating agencies in the market, which focus primarily on providing ratings for procurement purposes. The agencies currently rate according to their interpretation of empowerment benchmarks. Over time, these ratings are likely to be replaced by empowerment audits based on gazette charter scorecards or codes of practice issued in terms of the BEE Act. Auditing firms are gearing themselves to undertake the empowerment audits required in terms of the various charters. Notwithstanding this, it is necessary for SA business

to promote a culture that supports independent ratings of empowerment, corporate citizenship and sustainability in general, over and above the statutory or charter BEE audit obligations. The weaknesses in the approach to measurement are especially prevalent when it comes to ownership. Many companies announcing empowerment initiatives are defining their achievements according to an interpretation of the definitions contained in Government's Broad-based BEE Strategy, the BEE Act and in the charters as they see fit.

For the financial sector, the Financial Sector Charter (FSC) proposes a minimum direct BEE ownership of 10%, measured at a group level by 2010 (South African Financial Sector, 2003:11). Companies that meet a 25% direct black ownership target will get bonus points. In terms of the FSC, indirect black ownership occurs where an institutional investor holds equity on behalf of black beneficiaries. In the financial sector this can count as indirect black ownership to the extent that one can calculate the beneficial black interest of the investor in question – provided that the vendor has met the minimum direct black ownership target and taken concrete measures to promote shareholder activism.

Companies across various sectors appear to be using this provision in the FSC to argue that they have achieved a certain level of BEE ownership. However, such companies should take note that the guidelines for calculating indirect black ownership and measuring beneficial interest still have to be finalised. Companies claiming the benefit today are most likely incorrect. In addition, its applicability to other sectors requires consideration in those charter discussions.

More importantly, the recognition of indirect ownership in the FSC scorecard does not enable a company to define itself as black-owned, -empowered or -influenced if the BEE ownership

portion is made up of indirect and direct black ownership(South African Financial Sector , 2003:11). A black company is defined as one which has direct black ownership and significant control, where control in this context (for the purposes of defining black-owned, -empowered and -influenced companies) means board positions, the number and type of voting rights and the number of black people in executive management. Many companies have not yet met the required or expected levels of control to be able claim a BEE status in terms of the above definitions.

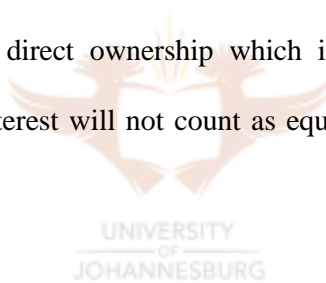
The benefits of recognising indirect ownership lies principally in acknowledging that the influence of fund managers, asset consultants and trustees over the assets in which they invest could be considerable. Already the Public Investment Commissioners (PIC) organisation is showing its hand and indicating that it can play a role as a more active investor in the companies in which it has a presence. This approach must be extended to other fund managers, asset consultants and union trustees, through education and awareness campaigns and better access to information. The FSC attempts to do this by requiring companies to take active measures to increase the influence of these stakeholders and to report on the initiatives they are implementing(South African Financial Sector , 2003:11). It is therefore clear that indirect ownership serves a different purpose and should not be conflated with direct ownership.

Similar to the confusion around direct versus indirect black ownership in companies, uncertainty exists about government shareholding, with some arguing that government's Development Finance Institutions (DFIs) or State Owned Enterprises SOE's should be considered black shareholders. Once more, an assessment of government's BEE Strategy, the

BEE Act and the various charters demonstrates clearly that these entities do not constitute direct or indirect black ownership.

Even more complex is the assessment of the transactions themselves, with questions arising around when one can count the equity one claims to have sold or be selling, and whether the manner in which the equity is funded influences the point allocation. The FSC provides some guidance to companies on the structuring of BEE transactions in all sectors. It states that the sector should provide funding for BEE transactions on terms that will facilitate meaningful ownership for BEE parties over the course of an investment and promote longer-term shareholder relationships as opposed to short-term portfolio investments.

Further, the FSC notes that direct ownership which is deferred with no issue of equity carrying upfront economic interest will not count as equity ownership until such time as the equity is actually transferred.



In recent months, a number of transactions have been characterised by varying types of deferred share mechanisms. Whilst these assist in avoiding some of the initial funding constraints, questions have arisen as to the reasonableness of whether economic interest has or will ever actually be transferred. In a similar vein one may argue that pure debt-based funding models present as much of a risk as to whether equity will vest and certainly, as past experience has shown, for how long.

Given the complexities involved, the assessment of BEE ownership transactions is unlikely to result in simple 'yes' or 'no' answers. A more comprehensive model for scoring ownership is required. The model should at least take cognisance of the following factors:

- Have the shares been issued to the BEE shareholder?
- Does the BEE shareholder have voting rights (control)?
- Has the right to economic interest transferred?
- What value is transferred today?

Transactions that adhere to all these indicators and whose value bias promotes BEE will be better positioned to score favourably. A distinction should also be made between broad-based ownership and broad-based empowerment.

Broad-based empowerment is achieved through implementing BEE as described in the definitions in the Broad-based BEE Strategy and the BEE Act. Broad-based ownership is defined as a situation where an empowerment shareholder represents a broad base of members, such as employees, collectives and/or communities, or where the benefits support a target group, for example black women, people living with disabilities, the youth, trade unions and workers. Shares are held directly or indirectly through non-profit organisations and trusts. At the same time, directors and executive management should predominantly comprise black people. Few scorecards have as yet allocated any points to broad-based ownership. Such recognition would improve on current measurement systems and enhance the impact of empowerment.

Although empowerment measurement is still in its infancy, it is bound to improve with time and experience. More definition, greater levels of capacity in implementation mechanisms and increased standardisation, especially amongst the varying charters, will aid the process. Finally, a mandatory requirement for companies to report on BEE through an amendment to the BEE Act would give impetus to reporting, which is, at this stage, only encouraged by

charters in some sectors, to a lesser extent the King II Report (Institute of Directors, 2002), the FSC (South African Financial Sector, 2003:14) and government instruments. After all, in the absence of adequate reporting, there is little left to measure.

2.4 THE FINANCIAL OBSTACLE

The government's focus on delivering empowerment, especially through its procurement and license practices, gave a strong impetus for partnerships between black companies, who wanted to take part in the mainstream operations, and white companies, seeking to adjust their company status to the new requirements. The emergence of such partnerships through ordinary market practices was restrained due to the black partners' lack of access to capital.

2.4.1 FINANCING OF EMPOWERMENT DEALS

A major obstacle facing the early BEE-initiatives attempting to transfer ownership into black hands was the lack of access to capital by the black population. In the climate where established businesses felt pressure to support black business initiatives, various creative solutions were found.



Particularly during the first years of empowerment, artificial control tools such as convoluted pyramid company structures and the issuance of so-called N-shares occurred. By issuing low-voting N-shares to investors, owners of an empowerment company could raise capital without diluting their own control over the company. These methods ensured the appearance of black control that did not always reflect economic realities. Black investors, without the financial means needed, were offered to buy shares in white companies that were seeking to change their ownership profile. Financial institutions, such as investment bankers, retirement funds and insurance companies, facilitated the ownership transformation process by starting to

provide various financial instruments, of which the Special Purpose Vehicle (SPV) would become most favoured.

2.4.2 SPV – SPECIAL PURPOSE VEHICLE

An SPV is a special purpose company established by a ‘BEE-company’, with the purpose to facilitate the purchase of an equity stake in a ‘target company’. There is no unambiguous legal definition of what constitutes a BEE-company (also referred to as an empowerment company). Therefore, the level and form of involvement by black persons required for an empowerment status vary from case to case. The target company can either be a company listed on JSE Securities Exchange SA or a private company, interested in selling an equity stake to a black partner. (BEE Commission Draft, 2001) The impetus behind this interest is often the target company’s eagerness to appear politically progressive and to qualify for government contracts that put requirements on the bidder’s empowerment status. Hence, the shares in the target company are seldom offered at a 10-20 % discount of the current market price. The incentive for a financier to become involved in the empowerment deal is, apart from being regarded as politically correct, to get access to large stakes (usually 10-30%) in coveted companies, not available without partnership with a black company.

The BEE company raises the required means to fund the deal partly through a loan from the financiers, partly by issuing preference shares in the SPV to them. The BEE company holds 100% of the ordinary shares in the SPV and therefore controls the votes.

The preference shares are redeemable in three to five years. In the meantime, the preference shares entitle the financier to a determined dividend rate from the SPV, normally expressed as a percentage (usually 60-65%) of the prime lending rate. Any equity performance achieved

over and above this dividend rate is shared between the BEE-company and the financier. The SPV financing structure places most of the economic benefit on the financier as the owner of the preference shares.

The terms of an SPV vary from case to case, but the basic philosophy behind the structure is the belief that the target company's earning potential and share price will increase due to the achievement of an empowerment status and the black group's participation. The structure relies on a bullish market with rising share values and low interest rates, enabling the BEE-company to repay the borrowed funds by selling a part of its shares as the term of the SPV becomes due.

The financial Charter will move beyond empowerment issues and will look at industry-specific issues. The global charter would initiate a move beyond the special purpose vehicles (SPV) supported by banks for employment deals in the past, which had not really resulted in empowerment. The SPV's has been a wake-up call for the financial sector after its share price had dropped from its original R100 to below R50 without any chance of regaining its former heights leaving empowerment groups with huge debts and banks with a weekend risk profile (Loxton, 2003:5)

2.4.2.1 The Effect of the Market Crisis in 1998

During the first two-three years, the positive market expectations were generally met and the SPV seemed to be a real success story for all the parties involved. However, due to the crisis on the Asian market in 1998, the market turned bearish and the interest rates shot up. The dividends from the target company became insufficient to serve the dividend rate, which led to that the payments due were added to the loan capital. This happened at a time when many

preference shares were about to be redeemed. If the BEE-company could not raise cash elsewhere, it had to relinquish a portion or even all of its shares in the SPV to the financier in order to settle the debt. In several cases, the BEE-companies were not able to meet their financial obligations, thus losing the newly acquired assets as well as causing substantial losses for the financiers.

2.4.2.2 Critique on the Model

SPV as a mechanism to finance black companies' share acquisitions has met harsh criticism after the market crisis in 1998. It has been called financial engineering, not resulting in real, sustainable empowerment due to evident weaknesses in the structure.

Some of the weaknesses are:

The black company's ownership in the underlying investment is based on debt. Even in the best-case market scenarios, the model implies that the black company would have to give up a part of its ownership in order to meet the financial requirements at the end of the term. This has resulted in that several BEE companies have exited an SPV with no or strongly diluted ownership in the underlying investment. Consequently, the structure does not contribute to real transfer of ownership to black hands.

As a result of the SPV being 'one step away' from the target company's daily operations and that the ownership stake seldom exceeds 20 percent, the BEE group's ownership is limited to one or few board seats. Therefore, it is said that the ownership does not give the black group a chance to a meaningful influence on the executive and operational level in the target company.

The participation in an SPV does not require any risk-taking from the black company. With everything to gain, black companies have been eager to close as many SPV deals as there are. This has resulted in BEE-groups acquiring corporate interests in various sectors, lacking the strategic and operational focus normally required from an ownership portfolio and with little attention to adding value to the investments.

The SPV structure separates control from the economical risk, thus not reflecting fundamental business principles.

The incentives behind the target company to find a black partner have in a number of cases been to get a politically correct ownership structure and to secure further government contracts. This has negatively affected the interest to carefully choose the right empowerment group as a partner and to support skills transfer during the partnership.

The success of an SPV mechanism relies on absolute rather than relative performance of the target company. The performance is not benchmarked on earnings or share price compared to its peers on the market, but on the target company's absolute share price performance.

These inherent weaknesses in the SPV model seem obvious and it is easy to criticise the financial institutions for initiating the SPV's and similar artificial funding mechanisms that do not help the black companies to create a sustainable capital base of their own. The financial institutions' role in Black Economic Empowerment has been important (BusinessMap, 1998). They enabled the 'capitalist without capital' to become a part of the corporate establishment and to take the first steps towards a balanced ownership structure in SA. Even if it has been recognised that this ownership transfer seldom was sustainable, there has been successful

empowerment deals financed through SPV's as well. The turbulent market situation in late 1998 made the shortcomings connected with the SPV model visible, and since then this financing method has become less popular.

2.4.2.3 New Approaches

During the past two years, financial institutions have had to reconsider their role in the empowerment process and come up with new working financing solutions. Two different directions can be recognised having emerged from the finance crisis.

2.4.2.3.1 The SPV-Model Reworked

The first type of response has aimed to rework the traditional financing mechanisms such as the SPV's. It is believed that these kinds of funding arrangements have not yet played out their role, but that they need to be adjusted in order to prevent the negative consequences from reoccurring. One initiative has been to create a secondary market for the SPV's, thus alleviating the reduced liquidity for the financier during the SPV contract. There have been indications that this can become a viable option for both financiers and the empowerment companies.

Another major flaw in the SPV structure was the out of line risk allocation on the financier alone. It is argued that in order to ensure the BEE-company's interest in active participation as a shareholder, there should be something more to loose than just the BEE-company's time invested. Subsequently, financiers have started to require some financial input from the BEE-company into the SPV-deal. The input can be of limited importance as security for the loan, but significant enough for the BEE-company to ensure that proper business principles are brought in to the deal. It has also been initiated that a BEE-company's involvement in various

SPV's should not continue to be ring-fenced, meaning that assets in one SPV in the future shall be able to be claimed for debts accrued in another SPV (BusinessMap, 1998).

Financiers are also searching for ways of passing some of the risks onto the target company. This is believed to strengthen the target company's involvement in the process, especially when it comes to choosing the right empowerment partner and to clarify its objectives with the deal (BEE Commission, 2001:286). However, the target company's participation must be designed in a way that respects Section 38 of the Companies Act, which prohibits a company from financially assisting in the purchase of shares in the company itself.

2.4.2.3.2 Creating New Solutions

The second direction can be described as a new approach towards financing empowerment deals. It emphasises sustainable long-term deals between sound companies, whose contributions are clearly defined and measured before entering the partnership (BusinessMap, 2000:36). Investments in passive holding companies belong to the history according to this approach. Access to financial means is only given to those black companies that demonstrate strong strategic focus, commitment for operational involvement in their investment and preparedness to share the risks (BusinessMap, 2000:35). Further, financiers' interest is increasingly drawn towards BEE-companies that have emerged by building an operational business from the ground, instead of having acted merely as an investment holding company without an operational track record (BusinessMap, 1998).

The financiers also insist on sophisticated corporate governance in the BEE-company. They require developed reporting mechanisms, appropriate information disclosure and remuneration based on performance. These issues were often neglected during the first eager

years of empowerment (BusinessMap, 2000:12). Regardless of whether financial institutions prefer funding instruments based on a modified type of SPV or new solutions, their current approach can be described as emphasising the integration of sound business principles with empowerment deals.

The new approach to support empowerment deals is to be welcomed by all. It will probably be successful in correcting the asymmetrical risk-return profile and remuneration not linked to performance, characteristic for the early financing models and rule out the possibilities to easy gains without any risk and active involvement. However, the first years of empowerment have not yet changed the historical fact that there is scarcely any accumulated black capital available to back new business initiatives. If the black peoples' different conditions are ignored when granting financial help, the entry barriers into the economic sphere can become too high for new black business initiatives.

2.5 GOVERNMENT POLICY PROGRAMMES

In this section two major government policy programmes are discussed: RDP, a socio-economic policy framework, and GEAR, a macro economic strategy. Together these two programmes constitute the base for the Black Economic Empowerment process. To be acquainted with the basic features of these programmes is important for the understanding of Black Economic Empowerment. It is also important to know how RDP and GEAR has a big influence on the development of SME's in South Africa.

2.5.1 THE RECONSTRUCTION AND DEVELOPMENT PROGRAMME

The Reconstruction and Development Programme (RDP) is an integrated, coherent socioeconomic policy framework, which seeks to mobilise all the people and resources of South Africa towards the final eradication of the results of apartheid, the building of a

democratic, non-racial and non-sexist future. The programme is vision for the fundamental transformation of the country. It integrates growth, development, reconstruction, redistributions and reconciliation into a unified program(RDP Fund Act, 1994).

2.5.2 GROWTH, EMPLOYMENT AND REDISTRIBUTION POLICY

Currently, government policy as reflected in the Growth, Employment And Redistribution (GEAR) document appears to not enhancing growth, employment, or redistribution(Luiz, 2000). GEAR is an appropriate policy response for a country which has crossed this threshold, in that it focuses on macroeconomic fundamentals which are in line with global trends. If South Africa's recent experience had been one of growth, then GEAR would be ideal to keep this momentum going by providing a clear economic policy statement for the private sector. The threshold effect in South Africa is much more complicated, because of the perverse political effects of apartheid. The South Africa inherited by the post-apartheid state finds itself with a fairly sophisticated economy, but one which has stagnated since the 1970s. It is because of this stationary economy that this paper argues that GEAR may not be enough to get the momentum going. However, if the government wishes to pursue GEAR, then it must do so whole-heartedly, with an absolute commitment to its entire implementation. There are two main points that need to be raised: first, although GEAR commits itself to shifting government spending from current to capital expenditure, it has failed to do so; and second, GEAR calls for greater labour market flexibility. In terms of the latter point, the government has, in fact, done quite the opposite.

The Department of Labour has introduced new legislation (such as the Employment Equity Bill) and amended existing legislation (such as the Basic Conditions of Employment Act) in such a manner as to increase labour market rigidities. The result has been that despite

moderate economic growth, employment in the formal sector has fallen. The lack of flexibility in government's labour market regime adds considerably to the cost of employment.

Business people view labour as expensive when coupled with low productivity, and in addition now also find it hard to layoff in times of economic hardship. The government cannot implement GEAR in bits and pieces. The departments of Finance and Labour would be forced to develop policies which are in sync with one another. At the moment, the impression is created that departments are doing their own thing, and that integration and co-ordination into a national economic vision are lacking.

2.6 SUMMARY

The policy of Black Economic Empowerment, formally introduced in 1994 and enhanced over the last ten years, was created to address inequalities of the past, as well as broadening the base of the South African economy. It has encountered several hindrances, the most serious of which are the difficulty in measuring the effectiveness of BEE, and the economic barriers to entry for blacks. Government and the financial sector have implemented several models for assisting black businesses with finance for empowerment deals, but some of these models have been flawed, and newer models are being sought to improve the situation.

A commission was established in 1998 to focus on the continuing implementation of Black Economic Empowerment in South Africa. The next chapter will examine this commission and its workings in detail.

3 BLACK ECONOMIC EMPOWERMENT COMMISSION

3.1 INTRODUCTION

This chapter will provide an overview of the Black Economic Empowerment Commission (BEE Commission) beginning with its establishment, and will then examine the work that the commission has undertaken to date, most importantly the definition of BEE established by the commission. The chapter will then study the recommendations that the commission has made. Every entity that recommends policy has critics, and therefore this chapter provides a summary of the various major criticisms that the commission has been subject to.

Since its establishment in 1998, the BEE Commission has drawn a great deal of attention in the South African media. In most cases where the state of Black Economic Empowerment has been discussed, reference has been made to the Commission and its ongoing research in the field. The BEE Commission has recently completed the first phase of its work. The Commission's recommendations are likely to have an influence on the government's future empowerment efforts, as well as affect the public debate on the subject. Therefore, it is important to be acquainted with the BEE Commission and the major conclusions of its research work.

3.2 THE ESTABLISHMENT OF THE BEE COMMISSION

The establishment of the Black Economic Empowerment Commission was initiated in November 1997 at a conference held by the Black Management Forum (BMF), an independent non-governmental organisation supporting the development of managerial leadership and transforming of organisations(Enterprise, 2003:16). It was recognized that the empowerment process had to be conceptualised, controlled and driven by the private sector,

from which black people and women still were essentially excluded(BEE Commission, 2001:67).

The BEE Commission was formally established in May 1998 by the Black Business Council, an umbrella body representing black business organisations, of which the BMF is one. The mandate given to the Commission was to investigate the success of the BEE progress thus far, to identify possible barriers in the process and to make recommendations for the future(Enterprise, 2003:16).

The objectives set by the BEE Commission were:

- To gain insight into the BEE process through empirical research and to make observations on the pace and results of BEE initiatives during the 1990's.
- To reach conclusions on the obstacles to meaningful participation of black people in the economy.
- To develop a powerful case for an accelerated National BEE Strategy and to make recommendations on policies and instruments required to guide a sustainable strategy.
- To develop benchmarks and guidelines to monitor the implementation of the National BEE Strategy(BEE Commission Draft, 2001:2).

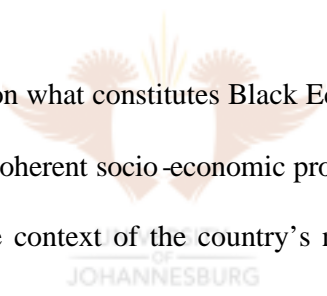
After conducting extensive research and consultations with stakeholders and experts from different sectors, the BEE Commission released a discussion document that was debated at the National Consultative Conference in September 2000. The BEE Commission's final report was handed over to President Mbeki in April 2001(BEE Commission, 2001:3).

One of the key recommendations from the BEE Commission was that true broad-based empowerment needs to be undertaken by creating employment for the masses of unemployed. This was in contrast to the previous BEE endeavours, which tended to enrich the black elite, whilst doing little or nothing to empower the vast majority of blacks. To quote BEE Commissioner Phinda Madi, “for most people, the most empowering thing would be a job.”(BEE Commission Draft, 2001:3).

3.3 THE BEE COMMISSION'S DEFINITION OF BEE

The fundamental concept that formed the base for the BEE Commission's research work was that a substantial increase of the levels of black participation in the economy is indispensable in order to attain growth(BEE Commission, 2001:1).

The Commission's definition on what constitutes Black Economic Empowerment is:

- 
- It is an integrated and coherent socio-economic process.
 - It is located within the context of the country's national transformation programme, the RDP
 - It is aimed at redressing the imbalances of the past by seeking to substantially and equitably transfer and confer the ownership, management and control of South Africa's financial and economic resources to the majority of its citizens
 - It seeks to ensure broader and meaningful participation in the economy by black people in order to achieve sustainable development and prosperity(BEE Commission, 2001:2)

Accordingly, the BEE Commission argues that BEE should be broadly viewed, including among others(BEE Commission, 2001:7):

- job creation
- rural development
- urban renewal
- poverty alleviation
- specific measures to empower black women
- skills and management development
- education
- meaningful ownership
- access to finance for households and for conducting business.

The BEE Commission emphasises that structural distortions in the economy, as well as ingrained racism across all sectors of the society, preserve the marginalisation of the black majority. The subsequent result is high levels of unemployment and one of the most unequal distributions of income in the world(BEE Commission, 2001:3).



In order to break out of this cycle of underdevelopment and to launch the country onto a course of economic growth, the BEE Commission calls for a fundamental shift in the approach from all sectors of society. The purpose with an Integrated National BEE Strategy would be to create a coordinated set of guidelines and regulations that manifest the priorities and targets for the economic transformation process and the different stakeholders' roles and obligations within this process(BEE Commission, 2001:10).

3.4 THE BEE COMMISSION'S RECOMMENDATIONS

The BEE Commission proposes the Integrated National BEE Strategy to include the following key components:

- A National Black Economic Empowerment Act, which would define BEE and set uniform guidelines against which the public and private sector can measure their performance and use when implementing BEE. In order to address market failures and to transform existing government institutions, the BEE Act should also provide for the establishment of:
 - A permanent **National Empowerment Commission** within the office of the President of South Africa
 - A **National Procurement Agency** aimed at transforming the procurement environment in the public as well as in the private sector
 - A **National Empowerment Funding Agency** with the aim to rationalise existing government funding initiatives
 - A **Rural Development Agency** to raise funds for land acquisition and rural infrastructure development

- **Uniform definitions to determine a company's empowerment status** to be applied by the public and private sector. Within affirmative procurement practises a company's BEE-rating would determine the awarding of set-asides and price preferences:
 - A **'black company'** is 50.1% owned and managed by black people. Rating for accreditation purposes: A, allowing the company to qualify for set-asides and a 15% price preference(BEE Commission, 2001:34).
 - A **'black empowered company'** is 25.1% owned and managed by black people. Rating: B, allowing it to qualify for setasides and a 10% price preference(BEE Commission, 2001:34).

- A **‘black influenced company’** is 5-25% owned and managed by black people. Rating: C, price preference 5% (BEE Commission, 2001:34).
- An **‘engendered company’** is one with 30% representation of black women within the black ownership and management portion. This gives an additional 5% price preference, for example an ‘engendered black company’ is entitled to 20% price preference, an ‘engendered empowered company’ to 15% (BEE Commission, 2001:34).

- Government, labour and business should reach an agreement on an **Investment for Growth Accord** describing the parties’ obligations to invest in areas of national priority and thereby increase the country’s fixed investment levels and promote economic growth. For example, Government Employees Pension Fund should invest 10% of its assets in productive investments within areas of national priority. Obligations to invest a certain percentage of the total assets should also be imposed on the financial sector, particularly life and retirement companies.
- A **Commercial Equity Act** to facilitate de-racialisation of business practises and ownership
- An **Empowerment Framework for Public Sector Restructuring** defining principles to be followed in the restructuring process
- An Integrated Human Resources Development Strategy.

These recommendations have been met with some scepticism in the industry, so it is worth doing a critique on the commission and the recommendations made.

3.5 CRITIQUE ON THE COMMISSION AND ITS RECOMMENDATIONS

As earlier described, the BEE Commission was established with the task to define Black Economic Empowerment and make recommendations for the future empowerment process. After the commission's work has been considerably delayed, it has been criticised to let the urgent issue of empowerment slip away from the national agenda. The slow delivery of the awaited results have been described as taking on "biblical proportions"(Mahabane, 2000:60) and raised speculations on whether the delay has been caused by some commissioners in order to serve their own agendas(Wadula, 2001:9).

As the final report was released in April 2001, its compromising and unspecified nature seems to have been a disappointment for those awaiting clear and tangible guidelines for the future development of BEE. It has also been stated that more than two-thirds of the BEE Commission's proposals are already in various stages of implementation(Dludlu, 2001:11). However, the report is clear on calling for a strong and intervening government to drive the empowerment process through the promulgation of the BEE law and creation of several new institutions. The government has objected to this excessive reliance on state delivery. This means that Black Economic Empowerment can only advance through co-operation between government, business and labour(Enterprise, 2002:42). Some of the BEE Commission's comprehensive proposals for new laws and special structures for BEE have also been questioned(Enterprise, 2002:42).

The government has argued that many of the issues raised can be addressed within the existing legislative and institutional frameworks if they are given time to prove their ability to deliver empowerment(Enterprise, 2002:42). In its final report, the Commission urges the private sector to recognise its collective responsibility to assist government in the

empowerment process. Yet, the Commission's strong emphasis on the government's active role can give an opposite effect, as it can be used as an excuse by the established (white) business, not to take an active part in the transformation process (BEE Commission, 2001).

The BEE Commission's proposal for fixed investment levels (also known as prescribed asset requirements), forcing institutional investors to hold a certain percent-age of their assets in designated empowerment investments, is seen as the most controversial recommendation. Even if the requirement for fixed investment levels is planned to be limited to 5-7 years, it is regarded as a major state intervention in an area that should be left to the market mechanisms. The fear is that it will distort the relationship between risk and return and lead to misallocation of scarce resources (Kane-Berman, 2002:12).

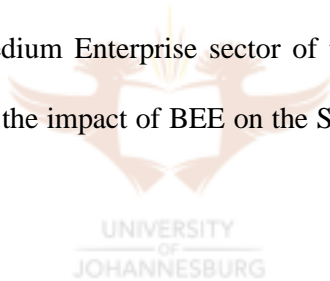
Furthermore, there is a question on who would decide what qualifies as 'productive investment' within areas of national priority. The BEE Commission has been criticised to not have dealt with the lack of skills among black people. It has been argued that this issue should be considered before placing comprehensive requirements on businesses, in order to avoid that they will resort to token conducts that characterised the first years of empowerment. The BEE Commission's goal to become a permanent, statutory body is also questioned (Enterprise, 2002:42).

3.6 SUMMARY

The establishment of the Black Economic Empowerment Commission in 1998 was as a result of the uncertainty over the effectiveness and progress of the BEE initiatives in South Africa. The commission performed in-depth empirical research into the issues and problems, and in its final report, made a number of recommendations to government and industry. These

recommendations were met with a mixed response, as there was a level of vagueness that still needs to be clarified. The broad outcome was, however, a comprehensive set of actions and recommendations that whilst perhaps not being a definitive answer to all the issues of BEE in South Africa, create a firm path towards true economic empowerment of the previously disadvantaged. A corner seems to have been turned, with the emphasis being placed on broad-based economic empowerment of blacks, at grass-roots level. The deracialising of the ownership of large, listed companies is desirable, but is no substitute for the eradication of our unemployment situation. This will stoke the SME sector of the economy, as most newly employed will be in the SME industries.

Having obtained an overview of BEE and the Commission set up to watch over the policy, an examination of the Small Medium Enterprise sector of the South African economy will be undertaken, before addressing the impact of BEE on the SME sector.



4 SMALL BUSINESS IN SOUTH AFRICA

4.1 INTRODUCTION

The subject of this dissertation requires an overview the small business sector of the South African economy, which this chapter provides. The overview provides a definition of which businesses are classified as “small”, as well as discussing the contribution to the economy and employment of these businesses. A possible solution to unemployment through SME’s is examined, and follows on into the significance of SME’s in economic growth terms. The constraints that SME’s are burdened with are the final topic of discussion in rounding off the overview of small business.

4.2 DEFINITION OF SMALL BUSINESS

Small business in South Africa has been grouped as Small and Medium Enterprises (SME), and also as Small, Medium and Micro Enterprises (SMME’s). In this dissertation, they are seen to be the same grouping, and therefore the term SME’s will be used throughout to cover the grouping of small business.

The National Small Business Act defines SME’s as “a separate and distinct entity that cannot be part of a group of companies”(Government Gazette 377, 1996). It is managed by its owners, and can be a sole proprietorship, partnership, a close corporation, co-operative or a company. The Government’s White Paper on the promotion of small business acknowledges important differences and needs between survivalist and micro enterprise on the one hand, and small and medium enterprises on the other. However the requirement for this dissertation persists with the more generic expression of SME’s.

As discussed above, one of the difficulties is that there is no common understanding on the meaning of the abbreviation SME. There are various categorisations of the concept ‘SME’ in South Africa. For the sake of clarity the following categorisation in Table 1 below will be used to broadly classify small business into SME.

Table 1: Definition of SME

	<i>Annual Turnover</i>	<i>Employees</i>
Micro	<R100 000	1 to 2
Very small	<R500 000	1 to 5
Small	R500 000 - R24m	2 to 20
Medium	R24m - R60m	20 to 200

Source: KNC & Associates(2003:3)

It must, however, be born in mind that various institutions use different definitions, making it difficult to directly compare the statistics. There is ample evidence that SME’s are the economic backbone of most countries and that they are important for employment creation.

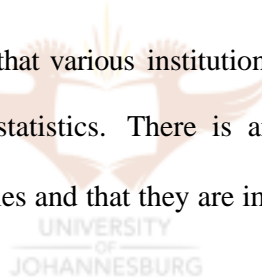
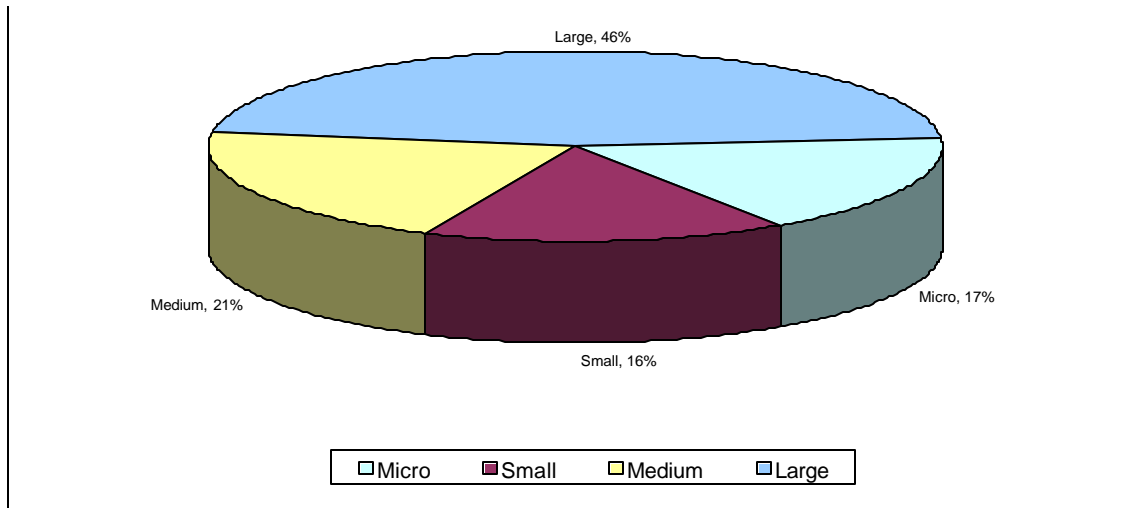


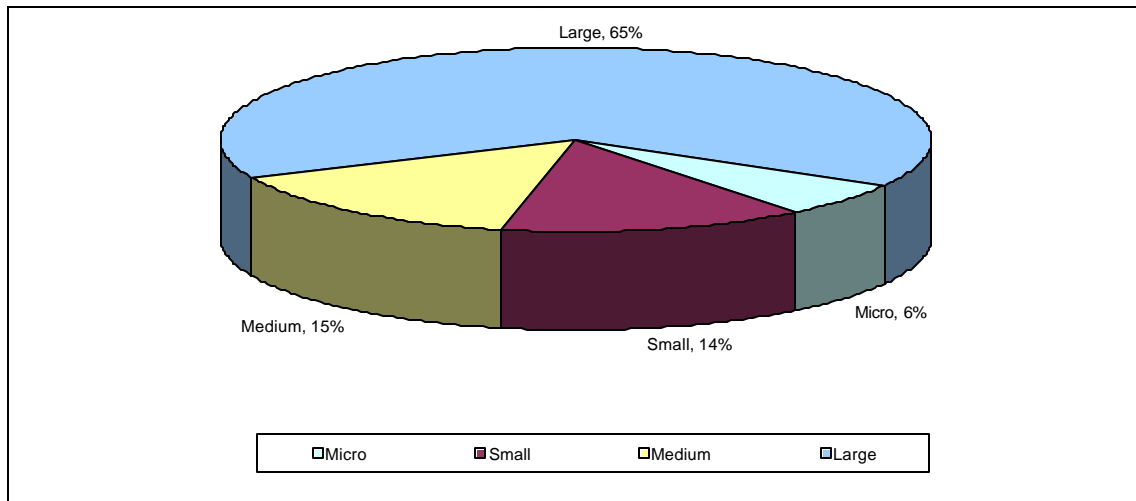
Figure 1 below shows that South Africa’s SME’s employ 54 percent of the economically active population and in Figure 2, SME’s are seen to contribute close to 35 percent of Gross Domestic Product(Statistics South Africa, 2001:51).

Figure 1: Contribution to Employment



Source: Statistics South Africa (2003:7)

Figure 2: Contribution to GDP



Source: Statistics South Africa (2003:7)

Whilst these figures are encouraging, South Africa achieved a rating of only 6.5 in the Global Entrepreneurship Monitor of 2003, which means that roughly six out of every 100 adults in South Africa are entrepreneurs. The average rate of the index for developing countries is 14.1, putting South Africa well below the mark.

Further, a survey done by Christian Friedrich(2003:11) shows that about 80 percent of small businesses in this country fail within a period of four to five years. National, provincial and local government programmes to promote SME's have been mostly ineffective. Those SME's that have flourished have utilised a common set of survival skills, which include learning how to be proactive, how to actively set and implement business goals and plan with a long-term focus, being innovative and generating and implementing new ideas.

4.3 SME's AS A SOLUTION TO UNEMPLOYMENT

Small and Medium Enterprise (SME) development was identified by the new Government in 1994 as a priority in creating jobs to solve the high unemployment rate in South Africa. South Africa's unemployment figure stands at 28.2% as of 2004(Statistics South Africa, 2003:7).

Table 2 below shows the overall labour market patterns for September 2003, based on the official definition of unemployment.

Table 2: Overall Labour Patterns

LABOUR MARKET TRENDS IN SEPTEMBER 2003 ACCORDING TO THE OFFICIAL DEFINITION OF UNEMPLOYMENT				
		Lower limit ('000)	Estimate ('000)	Upper limit ('000)
a	Total employment	11395	11622	11849
b	Total unemployment	4369	4570	4771
c	Total economically active	15764	16192	16620
d	Total uneconomically active	13394	13725	14055
e	Total aged	29158	29917	30675
f	Official unemployment rate = $b * 100 / c$	27.72	28.22	28.71
g	Labour force participation rate = $c * 100 / e$	54.06	54.12	54.18
h	Labour absorption rate = $a * 100 / e$	39.08	38.85	38.63

Statistics South Africa (2003: 7)

The definitions of the various groups provided in the table above are as follows:

- the estimated total number of people in the age category 15–65 years (those of working age);

- the number of people in this age category who were not economically active (for example, fulltime students, full-time homemakers, retired people and the disabled who are unable to work);
- those who were economically active (both the employed and the unemployed according to the official definition of unemployment);
- the labour force participation rate (the percentage of all people aged 15–65 years who are economically active); and
- the labour absorption rate (the percentage of all those aged 15–65 years who are actually employed).

The figures show that, in September 2003, there were an estimated 29.9 million people aged between 15 and 65 years. Among these people:

- approximately 16.2 million were economically active,
- 13.7 million were not economically active



The official unemployment rate in September 2003 was estimated to be 28.2% (Statistics South Africa, 2003:8). This is a significant decrease from the March 2003 figure. However there is no significant increase in employment over the same period. The drop in the unemployment rate is most probably due to discouraged job seekers no longer being classified as unemployed. This is reflected in the significant increase in the number of not economically active people.

The Government recognises the importance of developing a strong SME sector. It is internationally accepted and acknowledged that the SME sector is an essential factor in

promoting economic growth and development and the widespread creation of wealth and employment.

The emphasis of the Government's strategy is primarily on the development of SME's in the previously disadvantaged communities. Previously disadvantaged communities refer to those sections of the population who have been disadvantaged by the apartheid and separate development policies of the past. The objective of this section is to give an overview of the objectives and content of SME training and to assess the current role players and situation in South Africa as well as the problems found and highlighted by researchers in the 1990's.

4.4 THE SMALL-BUSINESS SECTOR IN ECONOMIC DEVELOPMENT

Although the statistical base of the SME's in South Africa is still poor, there can be little doubt about their relative significance. There are more than 800,000 small, medium and micro-enterprises in the country, absorbing about a quarter of the labour force of 15 million people. This is in addition to about 35 million people involved in some or other type of survivalist enterprise activities (Government Gazette 357, 1995:8).

The small business sector is highly diverse, with structures, problems, growth potential and access to support differing widely between segments. These differences relate as much to the economic sectors – retailing, manufacturing, mining – as they relate to the stages of growth of enterprises, start-up, expanding or stagnating.

From a broad strategy perspective the most important distinction is between survivalist activities, micro-enterprises, small enterprises and medium-sized enterprises, with the general term "small business" and the abbreviation "SME's" widely used to contrast this sector with

bigger business. Due to the similarity of some of the obstacles facing them, survivalist- and micro-enterprises are often grouped together, whereas many support agencies feel that medium-sized enterprises need to be viewed as a separate category warranting particular attention.

Survivalist enterprises are activities by people unable to find a paid job or get into an economic sector of their choice. Income generated from these activities usually falls far short of even a minimum income standard, with little capital invested, virtually no skills training in the particular field and only limited opportunities for growth into a viable business. Poverty and the attempt to survive are the main characteristics of this category of enterprises. Support strategies should primarily help these people - a large percentage of whom are women to get out of this sector. Given the large number of people involved in survivalist activities, this constitutes a vast challenge, which has to be tackled within the broader context of the RDP.

Micro-enterprises are very small businesses, often involving only the owner, some family member(s) and at the most one or two paid employees. They usually lack 'formality' in terms of business licenses, value-added tax (VAT) registration, formal business premises, operating permits and accounting procedures. Most of them have a limited capital base and only rudimentary technical or business skills among their operators. However, many micro-enterprises advance into viable small businesses. Earning levels of micro-enterprises differ widely, depending on the particular sector, the growth phase of the business and access to relevant support.

Small enterprises constitute the bulk of the established businesses, with employment ranging between 5 and about 50 (KNC & Associates, 2003:3). The enterprises will usually be owner-

managed or directly controlled by the owner-community. They are likely to operate from business or industrial premises, be tax-registered and meet other formal registration requirements. Classification in terms of assets and turnover is difficult, given the wide differences in various business sectors like retailing, manufacturing, professional services and construction.

Equally important for the present phase of small business support in South Africa is the recognition of the particular problems and needs of enterprises initiated, owned or controlled by those who were disenfranchised and/or otherwise discriminated against in the past. Aside from the racial dimension, i.e. enterprises owned or controlled by black South Africans, we also refer to women and all other disadvantaged and marginalised groups, including those in remote rural areas as well as the disabled, elderly people and the youth. Such enterprises are found in all four of the above categories. The government is committed, within given financial and organisational constraints, to structure its SME support in such a way that special attention is given to the problems faced by these disadvantaged enterprises.

4.5 CONSTRAINTS FACING THE SMALL-BUSINESS SECTOR

There can be no doubt that, compared to big business in South Africa and small business in other countries, small businesses in South Africa face a wider range of constraints and problems, and are less able to address the problems on their own, even in effectively-functioning market economies. The constraints relate, among others, to the legal and regulatory environment confronting SME's, the access to markets, finance and business premises (at affordable rentals), the acquisition of skills and managerial expertise, access to appropriate technology, the quality of the business infrastructure in poverty areas and, in some

cases, the tax burden. In the South African context the constraints have been particularly hard on entrepreneurs in rural areas and on women.

Generally speaking, the micro- and survivalist-enterprises are far less able to face constraints linked to finance, market access and the acquisition of skills. Even among medium-sized enterprises, problems like international competition, technology transfer and skills training can constitute major growth obstacles. These differences are of critical importance for the national support strategy as they not only stress the need for some degree of public sector involvement, but also emphasise the need for explicit differentiation in the support framework

4.6 SUMMARY

The Small and Medium Enterprise sector of the South African economy contributes significantly to the Gross Domestic Product, and even more so to Employment. In a country that has unemployment close to 30 percent, the need for significant growth in this sector is urgent. This has been noted by the government, and several programmes have been instituted to promote this growth. The potential for this growth lies with the previously disadvantaged population, and therefore these growth programmes are linked with Black Economic Empowerment to create the necessary stimulus for the growth of the SME sector. BEE has, however, had some problems in practice, and these issues are discussed in the next chapter.

5 BLACK ECONOMIC EMPOWERMENT IN PRACTICE

5.1 INTRODUCTION

The theory of Black Economic Empowerment has been in practice since the mid 1990's. This chapter will examine the effectiveness of the policy to date, as well as focusing on several key problem areas that have been experienced. The chapter discusses the vision of BEE in practice, and then looks at the phases that the implementation of BEE has evolved through. These phases are covered in depth, and possible future phases are discussed at the end of the chapter.

5.2 THE VISION FOR ECONOMIC EMPOWERMENT

“The government will lay greatest stress on Black Economic Empowerment that is associated with growth, development and enterprise development and not merely redistribution of existing wealth.” President Thabo Mbeki, State of the Nation Address 2003(Jack, 2003:1 -7).



During the State of the Nation address on 14 February 2003, President Mbeki not only highlighted the need to accelerate Black Economic Empowerment, but also charted a clear path for its implementation. Over the next year, Black Economic Empowerment can benefit significantly from the vision, explicit guidelines and proposed implementation mechanisms set out by the President in his speech.

The vision of the President is to see economic empowerment as an inclusive process, in which “...far sighted partnerships between all sectors of our society [will help create] a stable and growing economy that will erase past inequalities and draw us all... into a more prosperous and equitable future.” The vision encourages and enlists every stakeholder and participant in

our economy to contribute and be recognised for their contribution towards BEE(Jack, 2003:1).

Black economic empowerment must be an inclusive process that complements economic growth and development, rather than an exclusive redistribution exercise. This vision paves the way for the inclusion of all economic participants in the economic empowerment process. It will not only ensure that economic empowerment will be a positive process for growth, but will also ensure that empowerment will benefit from the full economic support of all South Africans.

Economic empowerment is set out to be a broad-based process with multiple dimensions. The process will include recognise and measure contributions towards various economic empowerment factors such as ownership, management, employment equity, skills development, procurement, enterprise development and corporate social investment. This broad-based approach provides the enabling environment and creates different opportunities for every South African to be included in the economic empowerment process. The approach can also reduce the risks presented by the practice of ‘fronting’, window-dressing and opportunistic intermediation. More explicit policies and guidelines to implement and accelerate the economic empowerment process are needed.

For the implementation of the economic empowerment process, the President stated that the government “...will work in partnership with the private sector and will further ensure that government actions are coordinated and monitored.”(Jack, 2003:2). The importance placed by the President on economic empowerment, together with the potential impact of economic empowerment on key government objectives, including economic growth, human resources

development and the expansion of public works programs, indicate the turning of the tide for economic empowerment. For South Africa, 2003/2004 can be the year in which we can expect the beginning of the "...economic transformation to bring about effective and significant Black Economic Empowerment"(Jack, 2003:2).

The integration of BEE in the business sector in South Africa has seen two phases so far, and will probably evolve into additional phases in the future. These phases will be discussed further.

5.3 THE DIFFERENT PHASES OF EMPOWERMENT

In the last 4 to 10 years, a dynamic empowerment process has taken place, in which it is possible to distinguish different phases with, characteristic features. It is not feasible to unambiguously define the nature and duration of an empowerment phase. Whereas some people are debating the fourth, or even the fifth generation of empowerment, the majority holds the view that the empowerment process is today shifting over to its third major phase. In this section, our aim is to give the reader a general picture of the most characteristic features in the two empowerment waves up to present.

5.3.1 THE FIRST PHASE

To understand the early years of empowerment, one has to be acquainted with the general atmosphere in South Africa after the first democratic elections in 1994. The new government was committed to deliver wealth to the neglected majority of the population. The corporate sector was eager to show acceptance to the new order, wishing to thereby prevent turbulence in the economic sector. Without a framework stating the objectives of the transformation process, empowerment initiatives emerged from both private and public actors in a non coordinated and confused manner.

The first phase of empowerment was characterised by a deal-making frenzy. Focus was on acquisition rather than the creation of wealth. Artificial financing structures, such as Special Purpose Vehicles, SPV's, paved the way for black equity ownership in white companies, playing the politically correct game and looking for an empowerment label to meet the new requirements for government contracts.

The SPV-structures encouraged black consortia to participate in a sophisticated form of gambling, where the risk to bse was entirely placed on the financiers(BusinessMap, 1998). To enhance the prospects to win, black companies started to run over each other to secure as many SPV-deals as possible. In many cases, this implied lack of focus and passive ownership of shares with no operational participation. The 'blackness' behind an empowerment company was in many cases questionable. Tempted by the discounted access that empowerment companies had to white-owned companies looking for an empowerment partner, the label of black control could be created through excessive divergence in voting rights or complex pyramid structures. It was not exceptional either to exercise pure window-dressing to secure the 'empowerment' status of a company.

The strong focus on equity transactions limited the empowerment effect to a small group of black people, a group that was already better off economically than the average black South African. Therefore, the designation 'enrichment process' has said to more correctly illustrate the character of the first phase of empowerment. In 1996, black control of companies listed on the JSE was 6.3% (R4.6 billion or 1% of the JSE market capitalisation), from zero in 1995. However, by March 2000, the figure had dropped to 2.9% which, given that black South Africans could not legally own businesses except in the townships, was still no less than a

miracle(Management Today, 2004:29). Yet the decline of black control on the JSE continued. The reasons for these results are: These newly formed black companies were largely investment vehicles-created with massive loans and by tapping informal savings and pension schemes – by black people who bought large chunks of existing corporations thereby taking control of them. The vehicles were over-gearred with a heavy debt burden and began their life in a bull market with no provision for the soon to follow, bear market. There seems to be a general consensus that BEE will only survive should black business people assume some of the financial risk themselves. In almost all of the failures, no risk was taken by the parties concerned – instead, priority was given to entitlement up front. It is also clear that BEE means creating space and opportunities for historically disadvantaged individuals to play a significant role in the economy. They must be given opportunities because they will add value, not simply being rewarded for being black. Tokenism in itself has become a despised experience for those who become a despised experience for those who have been forced into leadership without the necessary preparation. (Management Today, 2004: 29)

5.3.2 THE SECOND PHASE

Lessons from the market crisis revealed that there are no short cuts to genuine empowerment. It gave an impetus to redefine the concept of Black Economic Empowerment and gradually led to the present phase, called the second phase of empowerment, where there is emphasis on active and committed operational involvement instead of mere equity ownership. After the first impatient wave, second generation empowerment can be described as a slower, but a more meaningful transformation process aimed to give empowerment companies a substantial and permanent role in the economy. Operational control, adding value and internal affirmative action policies are the keywords in this phase of empowerment.

Many black empowerment companies have been structured as unfocused investment holding companies. This was overlooked by the market during the first years, since partnership with black empowerment companies brought access to government tenders and privatised assets. With an increasing number of empowerment companies, 'blackness' does not provide an edge anymore. To be of interest, black empowerment companies have to be focused, add value to their investment and have a good reputation(Gqubule , 1999:44). As Jakes Gerwel, adviser to South Africa's former president Nelson Mandela has expressed it, "[b]lack empowerment companies are no longer 'just black cherries that can be picked and put on top of something'..."(Klein, 2000:22).

BEE investments and listing on the JSE started as a trickle. But over the first few years, as the JSE share prices went into a orbit on the back of a worldwide stock market boom, the tickle become a flood as dozens of BEE companies tried to make a killing in what has been called the casino of capitalism. Black control on the JSE dropped to shocking levels with the poor share price performance of many black companies. Most of the stakes had been purchased using the SPV financing model(Enterprise, June 2002:32). This financing model ties the repayment of a loan to the underlying company's cash flows and not to the share price, which can be volatile and not related to the company's actual performance. This model allows the BEE company to buy assets and the target company is almost always unlisted. The debt is placed within the operating company and not at the shareholder level, through SPV's, which gives more security to the financier. To get access to cash flows, a black consortium and the financier must get into a position of control, which means smaller transaction, and become actively involved in operation(Enterprise, June 2002:32).

The government had to move swiftly to introduce empowerment charters in several sectors of the economy after various delays which caused misconceptions and concerns among black business leaders(Enterprise, 2002:42).

Financial institutions are increasingly talking of a bottom-up approach and are losing interest to finance unfocused empowerment conglomerates. Thus, the new empowerment companies concentrate increasingly on start-up operations and practise direct control of investments and subsidiaries. Subsequently, the first-generation empowerment companies have been forced to show clear focus by selling off non-core investments in order to be attractive to investors. During the first years, which were dominated by SPV-structures, financial institutions took on a disproportionate amount of risk and reward compared to their empowerment partners. As the lack of capital remains a serious obstacle to empowerment deals, SPV-like financing solutions still exist to some extent. Nevertheless, a more appropriate allocation of risk and rewards is seen as crucial



An increasing number of successful empowerment transactions involving unlisted companies have contributed to shift the focus away from the JSE, as well. The stock exchange is still a potent and very visible symbol of economic power though, and the process of black empowerment will not be complete until there is substantial black ownership of JSE-listed shares(Enterprise, 2002:42).

Ownership of shares, either in listed or unlisted companies, is no longer perceived to be the only and most appropriate deliverer of sustainable empowerment. The second phase of empowerment has seen the apartheid “big is beautiful” attitude fade, and there is an increasing emphasis on the promotion of SME’s and empowerment on grass-root level. It is now

believed that job creation, skills transfer and broad-based true empowerment must come from the small, entrepreneurial companies.

5.4 SUMMARY

The path that the implementation of Black Economic Empowerment has followed since the days of its inception has seen several problems that have had to be overcome. The vision that has guided BEE over the last decade has ensured that it has remained a fair and justifiable policy. The actual implementation of BEE has, however, undergone some evolution, passing through two distinct phases to date. BEE has seen positive influence on the business sector in South Africa, but has also highlighted serious issues, which have caused a rethink of aspects of BEE, mainly the financing of empowerment deals. How these phases have affected the management of SME's, as well as the ongoing impact of BEE, will be discussed in the next chapter.



6 THE IMPACT OF BEE ON SME'S

6.1 INTRODUCTION

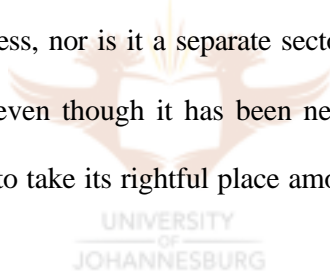
The central topic of this dissertation is covered in this chapter, which ties together all the information gathered about black economic empowerment, the BEE commission, management of small business in South Africa, and the realities of BEE in practice. The impact of BEE on SME's is assessed, beginning with a review of the evolution of BEE. The framework in which BEE is applied is covered, and then the BEE scorecard and its effect on SME's are examined. The issue of finance for SME's and BEE is covered in depth, including government initiatives, distribution of finance and foreign investment. Lastly, the chapter provides a summary of the opinions the author obtained from leading industry and government persons during the course of researching the information for this dissertation.

6.2 THE EVOLUTION OF BLACK ECONOMIC EMPOWERMENT

After the elections of April 1994 the issues of economic empowerment and growth have been placed high on the agenda of the Government of National Unity of South Africa. With millions of South Africans unemployed and underemployed, the government had no option but to give its full attention to the fundamental task of job creation, and generating sustainable and equitable growth. Small and Medium Enterprises (SME's) represent an important vehicle to address the challenges of job creation, economic growth and equity in South Africa. Throughout the world one finds that SME's are playing a critical role in absorbing labour, penetrating new markets and generally expanding economies in creative and innovative ways. The stimulation of SME's must be seen as part of an integrated strategy to take the economy onto a higher road - one in which the economy is diversified, productivity is enhanced, investment is stimulated and entrepreneurship flourishes (South African Government, 1995).

The real engine of sustainable and equitable growth in South Africa is the private sector. In the principle of working together with partners in the private sector – big and small businesses – realising hopes and aspirations for the economy. This is not an overnight process. Commitment to ongoing and serious consultation with all the major stakeholders will ensure that management of SME's will be guided in the right direction.

According to the Minister of Trade and Industry, Trevor Manuel MP, all of these efforts should be viewed within a broader vision of the South African economy, which includes all the business sectors - big business, multinationals, parastatals and also the small-enterprise sector - as part of an integrated, interdependent process. The small enterprise sector is neither a “junior partner” in that process, nor is it a separate sector that has to be treated according to different rules or principles, even though it has been neglected and lacking in the past and therefore needs to be assisted to take its rightful place among all the sectors (Republic of South Africa, 1995).



The Government of National Unity is committed towards a strategy of high and sustainable economic development. To achieve this, the economy needs to move on a growth path of increased investment, enhanced productivity and expanding employment opportunities - and all of this within a mould of increasing general competitiveness. While the better organised large enterprise sector should be able to move towards the envisaged growth path with relatively limited support and prodding from government, the transformation of the SME sector requires and justifies concerted policies of wider scope as well as the deliberate creation of an enabling environment.

Such initiatives need effective inputs from all segments of the economy and close co-operation between government and the private sector. The ultimate goal is to make SME's equal partners in all the economic sectors, and to maximise the sector's contribution to the Reconstruction and Development Programme. In this transformation process government is a facilitator and not an implementer.

In fact, small-business support programmes are best implemented by institutions that most closely reflect the entrepreneurship and risk characteristics of small businesses themselves. Such institutions are typically small localised non-governmental organisations (NGOs), private consultancies, partnerships and companies. Finally, while government's role at the outset of this process is interventionist, it will be scaled down systematically after the first five to ten years.

6.3 FRAMEWORK AND GUIDELINES FOR ECONOMIC EMPOWERMENT

In order to facilitate the acceleration of the economic empowerment process, the government will seek to promulgate an enabling legislation on economic empowerment. In addition to the formulation of clear guidelines and policies, economic empowerment may receive an added drive through the economic and financial benefits to be awarded to economically empowered entities. To provide further clarity for Black Economic Empowerment, a non-statutory advisory council will be established to facilitate and co-ordinate government's initiatives relating to economic empowerment.

The historical background of the South African economy holds important indicators that may indicate the impact of what Black Economic Empowerment may have on management of Small Companies in South Africa. Since the first democratic elections in South Africa in

1994, Black Economic Empowerment has been one of the foremost issues on the government's agenda. The government of South Africa recognises that the majority of the people of South Africa for decades have been deprived of all influence in the society. As a result of discriminatory laws and practices, there are firmly established structures and patterns that do not vanish simply by repealing discriminatory laws. Black economic empowerment has a key role in the transformation process aimed at re-balancing the society after the years of apartheid. It is the government's policy to actively promote a more equitable distribution of wealth. This is believed to be necessary in order to secure the newly started democratic process in South Africa.

The government of South Africa promotes Black Economic Empowerment in a number of ways. Beyond enforcing empowerment through legislative measures, emphasis is put on how well the business is compatible with the principles of Black Economic Empowerment when granting State contracts, licenses (for example broadcasting, fishing, casino, radio and cellular telephone licenses), and giving financial and other assistance to business.

Therefore, it is critical for all companies, and particularly companies having dealings with the government in the course of business, to understand the concept of Black Economic Empowerment and its impact on business in South Africa today and in particularly the SME's. The impact of BEE is starting to filter through to small companies, and management of SME's are starting to come to terms with the effect on potential growth for the companies. SME's has up to now been in a position where new business is relying on the BEE scorecard.

6.4 THE BROAD-BASED EMPOWERMENT SCORECARD

As part of the BEE Commission's Report of 2001, a broad-based black economic empowerment scorecard to be used for the business sector was introduced. The scorecard measures each company's contribution towards key economic empowerment factors such as ownership, management, employment equity, skills development, procurement, enterprise development and corporate social investments. There are three main advantages for the introduction of such a scorecard – these are:

- Reducing the risks presented by fronting, window-dressing and opportunistic intermediation
- Facilitate the inclusion of all economic participants in the economic empowerment process
- Efficiency in the measurement and monitoring of the economic empowerment process.

The BEE scorecard is the primary measurement tool of corporate compliance with the BEE requirements. As such it has a profound impact on all levels of business in South Africa. Initial focus, however, has been on large enterprises and the high-profile equity holding structures. Such large organisations usually make use of SME's for outsourced services, and because the scorecard provides a weighting on procurement, the BEE score of the SME has an influence on the larger organisation. The BEE scorecard is therefore starting to have an impact on SME's therefore, as most SME's depend on the contracts from larger organisations for growth and development.

6.5 GOVERNMENT FINANCING INITIATIVES

The government recognised at an early stage in the implementation of BEE that the scarcity of black capital could choke the empowerment process. To address this issue and as a part of its

national strategy to promote the SME sector, government introduced new institutions with the aim to increase black entrepreneurs' access to financing:

- **Ntsika Enterprise Promotion Agency** was established by the Department of Trade and Industry (DTI) in 1995. Through support, managerial development and programs funding, it aims to increase local and provincial SME Service Providers' ability to deliver non-financial support to SME's.
- **Khula Enterprise Finance** was established in 1996. Its main objective is to provide loans to SME's through a network of financial retailers. These are banks, Non-Governmental Organisations (NGOs) and provincial development corporations. Other products consist of credit guarantees to secure SME loans, and granting of seed loan and capacity building for new financial retailers.

6.6 FINANCE FOR BEE

The financing of this process is strategically important for the economy. BEE companies must have a credible financing component in order to proceed. The absence of this component would generate two problems: the first is that the extent of BEE will be limited as there will not be enough financial support and the occurrence will not be broad-based; secondly, investment funds will be diverted into asset transfers and with the danger of a flow of funds out of the economy from the sellers of assets. Both outcomes are socially, economically and politically dangerous. BEE has to be part of South Africa's overall growth strategy (Department of Trade and Industry, 2004).

The following must be taken into account in the financing of BEE:

- **Maintaining macroeconomic balance** – This means that BEE cannot be financed by taking on excessive debt, large scale deficit financing or by assuming excessive sovereign contingent liability,
- **Increasing the growth rate** – We need to ensure that the rate of investment rises. This means that we have to remain attractive to domestic and international investors. Thus, it is also essential for those who are sellers of assets to reinvest in the economy. This second factor will require an economy capable of higher rates of growth,
- **Intensifying economic transformation** – This means ensuring that we increase the levels of employment and participation in the economy and those economic benefits are shared more equitably across the geographic dimension and by all social groups. This means more access to all forms of social service and infrastructure for all citizens. In this area, BEE is particularly important,
- **Diversifying the size and type of enterprise** – The financing strategy has to take particular care to ensure that all forms of enterprise have access to finance. This is a particularly acute consideration for SME's and also for new forms of enterprise such as co-operatives,
- **Commercial risk must remain with the private sector** – The State will facilitate access to capital and collateral – both structural problems for the black community – but it will not assume commercial risk. This must remain with the enterprises, the entrepreneurs and investors. This is crucial from the point of view of the macroeconomic stability of the economy but more importantly it will improve the quality of enterprise development and, therefore, the competitiveness of the economy.

Taken together it is clear that we have to ensure the financing of BEE within the parameters of the existing macroeconomic and microeconomic reform strategies. If this is not done, then

BEE will only create small wealthy black elite in a low growth economy that is likely to be less globally competitive. The question that arises is whether it is possible to pursue our sound policies and still provide for a financing strategy that will make a significant impact on the rate of effective BEE. It is quite conceivable to do this effectively if we improve mechanisms of coordination and introduce innovative financing structures.

6.7 DISTRIBUTION OF FINANCE TO SME's

Most SME's at start up are not self-funded; they require some form of start up capital, in order to start operations. The source and distribution of finance to SME's is of key importance to their survival and long-term success. Table 3 below summarises the key source and financial needs of SME's:

Table 3: Source and Needs of Finance of SME's

Size of Enterprise	Current sources of enterprise finance	Financial requirements & characteristics
Small	Commercial banks, own investments	<ul style="list-style-type: none"> • Capital need for equipment and working capital. • Rely on leasing finance and factoring. • Also need longer-term loans for equipment and steady overdraft facilities. • Need amounts between R50, 000 & R2 million.
Medium	Established black relationships, outside equity finance, other financial service providers, sometimes listed on stock exchange.	<ul style="list-style-type: none"> • Equity, long term investment finance, equity to finance growth, working capital. • Need amounts between R2m – R5m

Source: KNC & Associates(2003:5)

Government policy has targeted growing the SME sector to stimulate long term and sustainable development and also to address the lack of business enterprises among the previously disadvantaged individuals and to create greater equity in the economy.

From the above table it is clear that financing, especially venture capital, should cater for the business aspirations of SME's. However the funds are usually geared to the later development stages. Venture capital funds spend considerable time analysing past performance and future prospects of enterprise in which they consider to invest. One aspect that features prominently in such analyses is the stage of development in which an enterprise finds itself. Young enterprises with a short or non-existent track record are more risky prospects for investment, but may hold out the promise for higher returns.

6.8 FOREIGN INVESTMENT AND BEE

The South African economy is currently undergoing a period of structural adjustments as a result of South Africa re-entering the global economy after the sanction era. The SME sector will be positively affected when foreign avenues will be available for surplus capital and outsourcing opportunities accrue. There are some concerns that foreign investment may be affected by BEE requirements on foreign companies, but these have proven unfounded to date. Responsible management of SME's is required to promote successfully BEE in the company. This includes the following:

- Adopting links for social responsibility
- Procurement outsourcing
- Profitable small business initiatives
- Create joint-ventures
- Gains in Market Shares

- Return on investments
- Increase in Sales

The potential influx of foreign capital in larger companies would have a positive impact on the SME sector of the economy. Improved capital bases would allow SME's to secure longer contracts with larger companies, which are better for SME's for three main reasons:

- SME's find it easier to negotiate with finance houses once they have been awarded long contracts as these provide a guarantee of repayment
- SME's face steep learning curves and are unlikely to prove successful immediately.
- SME's require more nurture and assistance in the short run and longer contracts facilitate this.

6.9 INDUSTRY OPINIONS ON BEE AND SME'S

The author conducted several interviews with leading persons in the BEE and SME arenas, and found that the theory of BEE is difficult to apply in the real world. Almost all the interviewees felt that although government was attempting to address the development of the SME sector through bodies such as Khula and Ntsika, its efforts were often misguided and that government was suffering from real capacity constraints. Khula as criticised for relying too heavily on commercial banks as intermediaries, whilst Ntsika's system of accrediting training institutes was also criticised.

Many interviewees argued that government was part of the problem. Its tendering system is complicated and often inaccessible to SME's. Additionally, government has become infamous as a late payer which places huge burdens on companies; SME's in particular cannot cope with such a situation. The irony is that whilst government is spending vast quantities of

money in trying to stimulate the SME sector, it may also be responsible for their termination through its payment record.

The interviewees felt that the SME sector of the South African economy is facing major obstacles and challenges. The ir opinions can be classified under seven headings:

- **Finance** – It was generally felt that this is an area which has been significantly addressed and that it has become less of a problem. However, it remains an obstacle and commercial banks were singled out as being far too conservative and risk averse in their lending which, in turn, negated Khula's efforts.
- **Labour** – Labour legislation was criticised repeatedly for raising the cost associated with employment. Complying with tougher labour laws was a costly exercise. Small and micro-enterprises rely heavily on informal labour contracts so as to keep costs down and this was being challenged by new laws. The SME sectors find it difficult to attract skilled labour and the cost of unskilled labour was seen as too high.
- **Trade** – Although South Africa has seen significant deregulation in the past decade, some felt that overregulation was still an issue and that licensing, health and safety needed to be more relaxed.
- **Tax** – The complexity of the tax system raised the cost of doing business because SME's do not have the capacity to administer this area and found it difficult to afford accountants.
- **Procurement** – The public sector tendering system was regarded as inaccessible to SME's. It was too complicated and tenders were too large for SME's.
- **Infrastructure** – This is a particular problem in the townships where inadequate roads as well as electricity and telephone networks hampered SME's development.

- **Demand** – This came up repeatedly as the primary challenges facing SME's. The growth of this sector was being stunted by the lack of a steady demand for their products. It is in this area that links with big business have a critical role to play but these are as yet underdeveloped. The reasons given by business revolved around problems are that the risk factor is too big in awarding contracts to SME's with limited track records. Another factor is the high costs revolving training.

The SME sector is already large in South Africa but it is not yet fully integrated into the economic mainstream. For the SME sector to realise its potential as a dynamic, innovative centre it must develop links with the rest of the business sectors because only in this way will its business become fully sustainable. Industry leaders feel that real profitable opportunities exist in outsourcing and big business needs to be proactive in exploiting these. The impact of Black Economic Empowerment on the management of SME's causes a number of challenges which are unique and immense and thus presents many challenges for future research.



Following important points came out strong during the interviews with industry leaders:

- Research must be undertaken on the mobility of SME's from the periphery and informal sector into the formal sector and economic mainstream
- The phenomenal increase in outsourcing over the past decade presented many opportunities for small business and these need to be documented.
- The impact of government procurement on SME's must be understood.

The recent emphasis on the flexible economy and industrial districts has focused on the developed world and we need to understand their impact in a developing country context. More research on the links between big and small businesses must be conducted to understand

the resistance of big companies to doing business with SME's. Only then management of SME's can begin to understand the obstacles facing SME's and their integration into the economic mainstream.

6.10 THE INFLUENCE OF AFFIRMATIVE ACTION ON SME CULTURE

The changes which SME culture must undergo in South Africa are essential. Affirmative action is more than the recruitment of a larger number of black men and women for positions which are dominated by white men. It includes the development and management of people in the small business enterprise and the eradication of racism and sexism. It seems as if the SME culture will be affected by the appointment of larger number of black men and women and also change in socio-political composition(Human, 1993:76). According to Fourie (1995:71) multiculturalism implies an acceptance of and appreciation for the existence of cultural diversity in the community. The dynamic nature of SME's and ethnic cultures in South Africa and also the dynamic relationship between cultures makes it impossible to predict the typical type of SME's culture of the future(Human, 1993:76). The culture change in SME's is a controversial aspect in the management of small business enterprise.

6.11 SUMMARY

The policy of BEE has been backed up by action from the government, in seeing the implementation of BEE. This has had an influence on SME's, particularly in the areas of finance and competition. SME's that are slow to comply with BEE find that it is difficult to compete with those that are compliant. The author's summary, recommendations and conclusions drawn on this dissertation topic are presented in detail in the concluding chapter.

7 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

7.1 INTRODUCTION

After examining all aspects of BEE and the impact on SME's, the author has been led to several conclusions. These conclusions focus is on attitudes and problems related to Black Economic Empowerment in the SME's, as well as on affirmative action, window dressing and skill shortage in SME's.

7.2 GENERAL ASPECTS

BEE can be successful in SME's if a sensible pragmatic approach is pursued. At the end of the day it is not skin colour that determines success, but people who are able to deliver. The ultimate objectives for management of SME's must be to empower companies to propagate empowerment and job creation. The funds generated by the empowerment companies must be channelled into education and training. This is the only way for management of SME's to uplift the human capital. The required resources plus human intellectual capital would enable organisations to combat any future challenges.

Economic growth, or the lack thereof, is often discussed at the same time as Black Economic Empowerment. Some argue that economic growth will be achieved only if government policies regarding affirmative action, general redress and equality are repealed and f, by extension, business is allowed to pursue profit without hindrance. Others argue that it will be achieved only if the previously marginalised persons are included in the mainstream and redistribution of wealth is taking place. There are many aspects to both these opinions. What one must keep in mind is that affirmative action, and other legislation that is criticised, is there to change the economic complexion of the country and deepen the democracy, by

ensuring that black people contribute to the country's growth and shaping its future. It is also clear that BEE means creating space and opportunities for historically disadvantaged individuals to place a significant role in the economy (Management Today, 2004:29). Hence, the question is not only whether empowerment generates growth more than growth would deliver empowerment. It is a question of democracy, getting rid of the burden of apartheid and of fulfilling the expectations that was created by the election manifesto and the new democratic order.

The efficient functioning of the market in South Africa is described to be distorted by racism, which remains fundamentally ingrained across all sectors of the society. Out of this perspective, Black Economic Empowerment is necessary in order to create a non-racist, efficiently functioning market. The government of South Africa regards Black Economic Empowerment not only as an instrument to achieve empowerment for the historically disadvantaged individuals (HDIs), but also as a tool to integrate the South African society into the surrounding global environment. To be competitive on the international market, it is not feasible to have the majority of the population outside the economy.

Government has already proposed setting aside R10 billion over the next five years to support the BEE process. This will in part be financed from the extraordinary proceeds of the exchange control measures announced in the 2003/4 Budget Speech. A new mandate for the National Empowerment Fund, and a review of the roles of other development finance and support institutions, to ensure that these resources are effectively and efficiently employed, will be developed by the DTI and National Treasury. Financing mechanisms will be varied and will include guarantees, grants, incentive schemes, loan and equity financing. A market

making facility is being considered in order to prevent undesirable ring fencing and therefore an illiquid situation for BEE assets. This is likely to be limited to more strategic areas.

Taken together it is understandable that we have to ensure the financing of BEE within the parameters of the existing macroeconomic and microeconomic reform strategies. If this does not succeed, then BEE will only create small wealthy black elite in a low growth economy that is likely to be less globally competitive. It is quite conceivable to do this effectively if we improve mechanisms of coordination and introduce innovative financing structures.

To ensure that the benefits of empowerment are shared across society and impact as widely as possible, the aim is to mobilise all South Africans to support BEE as an integral component of economic stability, and to increase South Africa's and the region's productive capacity. Partnership initiatives are thus critical. The reality is that the government has to act to advance Black Economic Empowerment if South Africa is to attain the equitable, non-racial and non-discriminatory society that is embodied in the Constitution (Buthelezi, 2003:67)

This view is opposed by others arguing that despite the flaws, which were mostly connected to the first generation of empowerment, black success stories have had an important psychological role for the black community. The success of some black businessmen has inspired the rest of the black population and dispelled the illusion that business success is a whites' phenomenon only (Batchelor & Dunne, 1999).

The instant achievers have served as role models in this evolution. You have to start somewhere. Total dismissal of Black Economic Empowerment because a few people have enriched themselves in the beginning of the process is harsh. Black economic empowerment

aims at changing the conditions for living for the masses in South Africa, which is a process that needs time to give result.

Complying with the broad-based Black Economic Empowerment Act is not just good law, it is good business. The broad-based BEE Act is aiming to establish a legislative framework for the promotion of BEE and business that exclude them could face difficulties in dealing with the public sector, government and other state-owned enterprises.

The first few years after the democratic elections were coloured by private companies eager to attain a politically correct ownership structure. These first empowerment operations had no regulatory guidance from the government side. It took a long time before the government issued clear empowerment criteria for the procurement procedures that the companies could follow. Thus, the empowerment that took place during the first years was not controlled by the government and can therefore not be taken as evidence of that the government's empowerment endeavours only work for the few. The past years can be seen as a learning period for the government. The South African government is regarded as good at creating policies but not as good at implementing them. They need to walk the talk. The government has received heavy criticism for the lack of monitoring of its various programmes. To evaluate the effect, or lack thereof, of different programmes and initiatives is almost impossible due to the lack of adequate statistics.

The informal sector in the country is large. This is caused by the inherited apartheid system and creates several problems for the new government. Many people are not in the registers, they have no permanent address and they earn too little money to pay tax. The tax base in South Africa is only about 30 percent. South African has managed to become one of the

world's most successful income tax collectors. However the difference between tax due and tax collected is still at a substantial R30 billion annually. Most of this is in the formal sector. While governments attempt to improve the tax system for SME are welcome, many small businesses are ill-equipped to face the complexity and multiplicity of tax returns. During Trevor Manuel's budget speech in February 2002 he said, "It is common knowledge that the burden of tax and regulators compliance impact adversely on small business...A simplified approach to calculate VAT obligations will be investigated"(Enterprise, 2003:64).

While the income gap between whites and blacks has narrowed, there is now a growing gap between the earnings of high- and low-income black people. Thereby, the political debate has increasingly changed from being a race issue to a class issue. Legislation created in order to achieve Black Economic Empowerment keeps the focus on race. Some people, who believe that it constitutes reverse racism and is based on the same methods as the abolished apartheid system, see this as negative. Nevertheless, to remedy a racial issue, the same tools need to be used if results are to be achieved within a reasonable time. A system that recognises the history for what it is is needed in order to correct it. There are huge inequalities in South Africa, due to its racist history. It would be naïve to say that all groups of people are on the same level now that the statutory discrimination has been repealed.

The government implemented Black Economic Empowerment legislation and policies with the ambition to create a non-racial society. To address a problem through legislative measures may have the opposite effect than was intended though. The problem becomes more of a legislative issue, which can dampen the public debate. By setting legal requirements on a certain level, there is also a risk for a minimum approach.

It is wishful thinking to believe that the market would make a speedy correction of itself out of moral beliefs or a sense of social responsibility. South Africa's history of apartheid is still close by. People, both black and white, have lived practically their whole lives segregated and under different conditions and possibilities. It takes a lot of courage and willingness to re-evaluate your view of the world that you have been accustomed to. Time is needed – perceptions and mind-sets could need generations to change.

7.3 AFFIRMATIVE ACTION

In South Africa, affirmative action takes place in what once was the most structured racist society in the world, now in the process of deracialisation. This makes the character of affirmative action in South Africa unique compared to affirmative action that has taken place elsewhere. Rather than aiming to create opportunities for a minority, as it is usually used for, affirmative action in South Africa aims at transforming an economy that for many years barred the majority of the population from any meaningful role. Affirmative action is resented by some of the previously legislated advantaged. They consider it to be reverse racial discrimination, contradicting the ANC promise of colour-blind non-racialism. While the ANC government views more equitable representation through affirmative action policies as a precondition for successful nation-building, opponents perceive the policy of affirmative action as undermining national reconciliation (Adam, 2000:48-55).

During the first phase of empowerment parallel positions were created; Black people, without the qualifications needed, were recruited to managerial positions, while white people continued to run the business. This was done to open doors for government contracts or to score public relations points. The use of parallel positions has led to the misconception that affirmative action is about putting incompetent black people in positions they cannot handle.

This kind of conduct does not constitute true affirmative action. The essence of affirmative action is to recognise the people who have suitable ability and training, and assist them in gaining positions in business life that they were previously denied (Roberts, 1997:18).

The change which SME's must undergo in South Africa is essential. Affirmative action is more than the recruitment of a larger number of black men and women for positions which are dominated by white men. It includes the development and management of people in the small business enterprise and the eradication of racism and sexism. According to Fourie (1995:71) multiculturalism implies an acceptance of and appreciation for the existence of cultural diversity in the community. This diversity is reflected in everyday experience and development. The dynamic nature of SME's and ethnic cultures in South Africa and also the dynamic relationship between cultures makes it impossible to predict the typical type of SME culture of the future (Human, 1993:76). Each member in the SME develops a specific view of life and the world which is based on his or her ethnic identity, culture and socio-economic status. The deliberate culture change in SME's is a controversial aspect in the management of small business enterprises.

7.4 WINDOW-DRESSING

Window-dressing, fronting and rent-a-black, are all definitions of the same kind of conduct, namely when black business-people are lending their faces and fronting to white businesses. They are invited at equity level to give the company an artificial black empowerment profile, which creates a lot of problems. Most often the black shareholder does not get involved at operational level. The business is still run by white managers, which means that there is no managerial skills transfer to blacks. The biggest damage is made as companies that practice window-dressing compete with real black empowerment companies under the empowerment

banner. The black entrepreneurs, who most often are operating under tougher conditions than the white businesses, are the big losers(Mzolo, 2004). It is completely undermining the affirmative procurement policies and other empowerment ambitions designed to develop black operational capacity and economic growth.

7.4.1 REASONS FOR COMPANIES PRACTICING WINDOW-DRESSING

When you look into the reasons why companies practice window -dressing, many explanations are given. One is that empowerment is seen as a pure cost. Money decides and window-dressing will therefore happen as long as you can get away with it. Another reason is lack of time. There is time pressure to make the management level look good. Sometimes window-dressing is said to occur because it is hard to find professional black people.

Those who oppose these arguments mean that window-dressing is an evidence of white companies' attempts to exploit and circumvent empowerment regulations out of reluctance to transfer economical power to black people. From this perspective, pure racism is the ground. The argument that professional blacks are hard to find is countered by the argument that companies do not look in the right places. Companies are blamed for lacking dedication and for not putting efforts in to find suitable qualified people as affirmative action employees. The thinking is believed to be more of "we need a black face; lets get it over and done with". There is also a suspicion that companies willingly employ incompetent black people to prove that affirmative action does not work. Brain drain is a big influencing factor(Qoza , 2003).

The focus on equity ownership during the first phase of empowerment made window -dressing a lucrative and relatively easy way to acquire the needed empowerment status. In today's South Africa window-dressing will become expensive in the long run, at least if the company

is labour intense. The new labour legislation puts a growing number of requirements on companies to employ historically disadvantaged individuals. Meeting these requirements by creating parallel positions is costly. Window-dressing would not exist without black people willing to participate in that kind of conduct. The reasons for their participation are several. One of the major reasons is, of course, the common human desire for fast and easy money. Many of the so-called historically disadvantaged individuals feel entitlement. They have been excluded and deprived for so long and cannot wait to get wealthy. The ones that have got a job may be exposed to huge financial pressure from the extended families and feel responsibility to take care of them (Financial Mail, 1997:22).

7.4.2 GOVERNMENTS ROLE IN WINDOW-DRESSING

The government can partly be blamed for the window-dressing that has occurred. The problem which was faced was that in the post-1994 period, many private sector companies, including banks, which had been jilted into some planning for BEE, suddenly become complacent on realising that there was no clear decisive policy in place which was either punitive or reward-oriented to compel or motivate the organisations into action (BEE Commission, 2001:35). There was a need for a coherent and uniformed BEE policy, with guidelines and targets, to encourage further private sector participation in BEE. Government and the private sector should provide the institutional support and capacity to ensure sustainable black participation (BEE Commission, 2001:35).

The government has not been sufficiently well organised and co-ordinated to ensure a systematic implementation of the programmes for affirmative procurement, and a great deal of work still has to be done to co-ordinate the various government departments (Chalmers, 2001:6).

7.5 SKILLS SHORTAGE

As a result of the apartheid educational system, the market of well-educated black South Africans is not only small, but also skewed. For example, there is a significant lack of black people with technical degrees. Due to the demand on black professionals, fully trained black people are much more expensive than their white counterparts. The very active headhunting industry creates problems for companies that put time and money into training staff (Roberts, 1997:19). According to Brian Khumalo, CEO of Leaders Unlimited/Korn Ferry International, “The word has gone out that there is a dire shortage, and particularly senior black executives are taking shameless advantages of the situation by demanding unrealistically high salary packages”, speaking at a seminar on Black Economic Empowerment in the ICT sector in Johannesburg (Khumalo, March 2003).

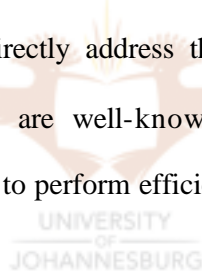
South Africa's Finance Minister Trevor Manuel has claimed that black professionals are pricing themselves out of the economy and that the government finds it difficult to deliver services because the skills needed from black people are unaffordable (Wadula, 2001:2).

The best qualified black candidate gets better work opportunities overseas that create an employment gap in South Africa. Khumalo said “it is clearly evident that many of the professionals leaving South Africa are black. This is certainly our observation from our experience and speaking to people in the market.” Khumalo says the continuing loss of professionals is a real threat to the government's hopes of the economy growing by 3.5% this year (Khumalo, March 2003).

7.6 FUTURE FOR BEE MANAGEMENT IN SME'S

There are indications of a shift towards a new phase of empowerment. The waterline between the second and third phase of empowerment may spring from the recently released, long-awaited BEE Commission's report on the present state and future of Black Economic Empowerment.

The fact is that the South African economy has a missing middle in the SME's are underdeveloped. This has a number of consequences for growth and development. Faced with the historical legacies, the promotion of the growth and development of viable SME's is important for growth, development, equity and political reasons(Enterprise, 2003:6). Given the recognised need to promote SME's as a vehicle for growth and development, it is necessary to have policies that directly address the distributive, allocation and economic inefficiencies and constraints that are well-known(Enterprise, 2003:6). Once SME's are provided with credit they will have to perform efficiently(Enterprise, 2003:6).



With unemployment among young black South Africans of about 40 percent and the black ownership on JSE estimated at less than 2 percent, it lies near at hand to see Black Economic Empowerment as a failure. Especially when, at the same time, white South Africans, approximately 13 percent of the population, earn 44 percent of the country's net income(Reuters, 26 March 2001:4).

All sides do not share this view, though. The people decrying the slow advancement of BEE are blamed for seeing the transformation process too narrowly, ignoring the progress made by unlisted companies and the development that has taken place in the rural areas. To use a leading black businessman's words, "BEE has not been a failure. It has been a steep learning

curve". South African as a country can look back to the past 10 years of Democracy and we can learn out of our mistakes and use the learning curves to make South African a better world to live and to work in, for yourself and generations to follow.

The government has shown doubt to the BEE Commission's strong reliance on the government to lead the empowerment process. Therefore, we believe that a considerable shift in the government's present role is not likely to follow. The government has a strong belief that the existing legislative framework will prove to be sufficient to serve the future empowerment process given adequate time.

When judging the progress of Black Economic Empowerment up to date and giving suggestions on the appropriate way forward, the complex reality where the first empowerment initiatives were led off must be considered. Several good BEE initiatives came to nothing due to the fact that the economical environment was not structurally geared to accommodate them. At the time, there was no regulatory framework to support and give structure to the process. When the framework started to be built, the objectives were not fully clarified, leading to some government strategies clashing with each other. It also noteworthy that appropriate statistics still hardly exist.

The government therefore seems to lack the basic tools for policy creation and evaluation. With a newly introduced policy for the restructuring of State Owned Enterprises (SOE's) and legislation for affirmative procurement, these two areas are likely to be additionally emphasised in the future as the major deliverers of empowerment. Therefore, the pressure on the market to enter equity relationships with black companies in order to secure government contracts or ownership in restructured SOE's will continue. This is likely to increase the

number of joint ventures and equity transactions between established firms and black companies.

The effect of the affirmative procurement policies will in the future not be limited to companies that deal directly with the state. Companies that have business with the state will be asked to show that their own procurement has a strong affirmative element. These requirements will put pressure on the companies' suppliers to have an appropriate empowerment status in order to secure contracts. Therefore, companies with no direct business contact with the state also have to conform to the state's affirmative procurement regulations.

In order to uniform and facilitate the evaluation of a company's empowerment status it is possible that the government will carry out the BEE Commission's recommendations on how to define a black, black empowered, black influenced and engendered company. However, the BEE Commission's proposal keeps the focus on equity ownership as a determining factor for a company's empowerment status (BEE Commission, 2001:10). It is believed that, in the future, the empowerment status of a company will be determined by the composition of the company board and executive leadership, together with commitments and actions that conform to an empowerment profile, rather than the company's shareholder base (Business Day, 2001:9).

The decreasing concentration on equity ownership that was seen during the second phase of empowerment is believed to continue. It is argued that the masses cannot earn their living as shareholders, wherefore the government's focus should be kept in areas where significant results can be achieved, namely education and job creation.

The lack of access to financing is expected to continue to be the major obstacle for empowerment. Financial institutions are blamed for constituting the least-transformed sector in South Africa and for not showing enough commitment to the apparently needed transformation of the society(Sowetan, 2003: 16). State driven financing initiatives have been introduced over the years to improve the empowerment company's scarce access to capital. The results have thus far not fulfilled the expectations, and the government's financing programmes have been blamed for involving too much politics. It is increasingly argued that the private sector's contribution is needed in order to address the problem(Sowetan, 2003: 16).

Overall, the BEE strategies that have been initiated by the government have had very little emphasis or focus on SME's. This, in the opinion of the author, is something that needs to be urgently addressed if the desired outcome of broad-based grass-roots economic empowerment is to be realised. BEE holds the promise of the most significant changes to the South African economy since the advent of democracy. It is only through the inclusion SME's in the BEE equation that this promise will be realised. Those in management of existing SME's should heed the groundswell that is going to occur in the near future.

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