

## PERSPECTIVE

# South Africa's Slow Progress

March 10, 2017



Mark Mobius  
Executive Chairman  
Templeton Emerging Markets Group

I recently had the opportunity to visit South Africa, which has seen its fair share of challenges over the past few years. Arriving in sunny Cape Town with its beautiful views of the Atlantic and Indian oceans, spectacular Table Mountain and invigorating weather, I found it difficult to become too negative about the country, at least from a traveler's perspective simply because the people are so friendly and because the integration of so many cultures living and working together make me optimistic.

Cape Town sits at the southern tip of Africa, and is just one corner of a tremendously diverse nation. There are 11 official languages in South Africa: Afrikaans, English, Ndebele, Northern Sotho, Southern Sotho, Swati, Tswana, Tsonga, Venda, Xhosa and Zulu.

I had just finished reading Roger Crowley's "Conquerors: How Portugal Forged the First Global Empire," which tells the story of the intrepid, ambitious and aggressive Portuguese explorers like Bartolomeu Dias who, after the deaths at sea of many of their compatriots, were finally able to reach and pass around the tip of South Africa in 1487. Portuguese King John II named that tip the Cape of Good Hope (which eventually became Cape Town) because of the fortunes they expected to find ahead in the East Indies.

In the 1600s, the Dutch East India Company overtook the Portuguese and established resupply posts for their ships in the Cape area. The Dutch-style homes are testament to how favorable they found the place. Afrikaans is actually a dialect stemming from Dutch settlers, sometimes referred to as "kitchen Dutch."

By the start of the 1900s, Britain had won full control of the country, and South Africa's gold and diamonds created many fortunes. Traveling via train from Pretoria to Cape Town, I stopped at the historical De Beers diamond area, where millionaires were created almost overnight in the late 1880s for those lucky few who discovered large diamonds there.

My colleagues and I were able to see the "Big Hole," an enormous crater in the ground that was dug out over the years by hand. Two brothers (Diederik Arnoldus De Beer and Johannes Nicolaas De Beer) had owned the land and rented out plots where diamond hunters could dig. Eventually, Cecil Rhodes (who became famous for the Rhodes scholarship, among other things) purchased and consolidated all the mines and became one of the world's richest men.

There are, of course, many books and articles about South Africa's history and apartheid, a legacy the country still grapples with. The African National Congress (ANC) spearheaded the struggle to end apartheid, and by the 1990s, apartheid laws were abolished and the ANC's most notable political prisoner, Nelson Mandela, was released from jail.

I had the opportunity to meet President F.W. de Klerk around that time and heard him describe the very difficult time he had reconciling his own party to the change.

The meeting with President de Klerk was in his office in Cape Town and it was clear at that time that he and Mr. Mandela did not agree on a number of issues and he was quite frank about it. But his tolerance and patience shone through the challenges he was facing. His openness and strength of character made me confident that the political transition would work.

Since then, the country has become known as the “Rainbow Nation,” not only because of its multicultural diversity but also because of its tolerance. For example, South Africa was one of the first countries to legalize gay marriage.

The ANC won by a massive majority in South Africa’s first universal elections in 1994, and has continued to win subsequent elections. Unfortunately, the government change has not substantially improved the economic situation for the majority of people previously denied political and social freedoms; unemployment levels hit a 13-year high of 27% in 2016.<sup>1</sup> Poverty remains prevalent, and in 2014, the United Nations Human Development Index of South Africa ranked the country 116 out of 188 countries and territories. The country has failed to significantly improve its standing since the 1990s.<sup>2</sup>

The ANC’s previous dominance is beginning to crack amid South Africa’s lack of economic progress. The Economic Freedom Fighters (EFF), founded by the radical Julius Malema—former president of the ANC’s Youth League who was thrown out of the ANC—has been rising in popularity.

If South Africa’s economic situation doesn’t improve, attracting the young and unemployed could make the EFF a more potent force. Opposition parties have been gaining control of key cities, and their strength has increased when they are able to better provide services such as water, power and public transport.

Since taking office in 2009, Jacob Zuma’s administration has been plagued with scandals and allegations of nepotism. One political blunder was the appointment of a finance minister many saw as unqualified—who was then quickly replaced after a dramatic market reaction.

Despite setbacks, the ANC still supports Zuma, and it seems that he will be able to survive his second and final term, which ends in 2019. Some analysts say that over the next two years, the ANC will likely become increasingly subject to competing factions, resulting in government paralysis and potential for further downgrades in the country’s credit ranking. The country’s economic growth has also suffered, although we are seeing signs of improvement on the horizon.

## **Economic Growth**

South Africa has been lacking any real growth drivers over the past year, and estimates for 2017 gross domestic product (GDP) remain lackluster, albeit slightly better than in 2016. The International Monetary Fund is projecting growth of 0.8% this year, while the South African Treasury predicts growth of 1.3%.<sup>3</sup>

On the fiscal side, the government is trying to manage the deficit as best it can with finance minister Pravin Gordhan at the helm, but the slow economy and a small but highly taxed base makes it harder to grow government revenues. Revenue is dependent on a healthy tax base, but the percentage of households receiving at least one social grant increased to 45.5% in 2015 from 29.9% in 2003.<sup>4</sup>

Higher food and fuel prices ignited inflation last year, but we believe better rains, more abundant crops and a stronger currency should help prices stabilize, along with interest rate stabilization or even a rate cut. Overall, we are cautiously optimistic but think the situation will remain tough. The South African consumer will likely continue to remain under pressure from higher utilities, transport costs, low wage growth and constrained credit.

South Africa’s debt position is not as bad as some other countries’ (including Brazil), although the government debt-to-GDP ratio has risen to 46% today from 25%–30% in 2008.<sup>5</sup> There is a general consensus among observers that plenty of government waste exists, with unnecessary spending, corruption, public sector inefficiencies and inflated pricing. At the same time, the government’s wage bill is rather high; the number of people employed in the public sector increased to 2.69 million at the end of the 2014 from 2.16 million in 2008.<sup>6</sup>

## **Consumer Themes: Finance and Retail**

Consumer finance is a big business in South Africa and one we were interested in learning more about from an investment standpoint. Aggressive and innovative firms and retailers have been able to penetrate lower income groups that major banks had not previously serviced. The executives at a consumer finance firm my colleagues and I visited told us the company has been adding thousands of new customers every month and is servicing millions of clients. Looking at the economic environment, they said despite the country's high unemployment rate and high risk of unsecured lending, they have a wide gap between the average lending rate and cost of funds, which has brought in good profits. However, they noted the default rate is rather high.

South Africa essentially has a multi-tier economy with consumers at various levels of income, education and access to technology. While in many parts of the world banks are closing fully staffed physical branches and replacing them with ATMs or computer links, I was a bit surprised to hear of plans to increase physical branches in South Africa. Physical branches are still needed in order to interact with lower-income customers who are not familiar with banking and need the face-to-face interaction. The officers told us that in many cases, personal financial education is needed with the customers to ensure they understand payment schedules and the like. The firm we visited also has a dedicated information technology staff, of course, and can do credit checks in seconds.

South Africa has a large and established formal retail market. We visited a fashion and household goods retailer that also had an internal financial services division providing credit to consumers. Like many other South African firms, it has been able to expand overseas via acquisition.

A South African supermarket chain we visited likewise had grown and expanded into other African countries and also into other lines of business. The management we spoke with felt the potential for Africa was huge relative to other markets, including Eastern Europe, Latin America and Asia. Nevertheless, poor infrastructure in countries in Sub-Saharan Africa has presented a challenge to expansion there.

Internet penetration in the retail business is low in South Africa; various reports show online sales of general merchandise, electronics and clothing are only about 1% of total sales. Improved internet infrastructure and penetration has been a barrier to growth. However, things do seem to be improving as more high-speed fiber cable is being laid, and the mobile networks have been improving coverage and data speed in the country. One firm we visited has a growing business laying fiber optic cable to meet the growing high-speed internet demands.

An executive told us many South Africans were apprehensive about purchasing clothing online, preferring to go into a store and try garments on. He expects spending patterns to change, with the younger generations now more comfortable shopping online and embracing foreign brands, too.

While South Africa has its challenges, the consumer sector is one where we continue to search for potential opportunities. We think economic improvement and the increased spread and acceptance of technology could prove drivers for companies in this space.

In my next blog, I will outline the main issues and areas of the South African economy that we are watching as investors.

*Mark Mobius's comments, opinions and analyses are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.*

## **Important Legal Information**

All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

---

1. Source: Statistics South Africa, Quarterly Labor Force Survey, November 2016.
2. Source: United Nations Development Programme, "Human Development Report 2015," Human Development Index.
3. Source: IMF World Economic Outlook Update, January 2017. National Treasury Republic of South Africa, 2017 Annual Budget Review. There is no assurance that any estimate, projection or forecast will be realized.
4. Source: Statistics South Africa, "General Household Survey 2015."
5. Source: National Treasury Republic of South Africa, 2017 Annual Budget.
6. Sources: Statistics South Africa, Africa Growth Initiative at Brookings, United Nations University, "Demographic, Employment and Wage Trends in South Africa," June 2016.