Volume Three, Number Two June, 1969

THE RHODESIAN JOURNAL of ECONOMICS

The Quarterly Journal of the Rhodesian Economic Society

INDUSTRY IN RHODESIA

A TWO-DAY SYMPOSIUM

PART ONE

PAPERS **Page**

Volume Three, Number Two June, 1969

THE RHODESIAN JOURNAL of ECONOMICS

The Quarterly Journal of the Rhodesian Economic Society

INDUSTRY IN RHODESIA

A TWO-DAY SYMPOSIUM

PART ONE

PAPERS Page

Volume Three, Number Two June, 1969

THE RHODESIAN JOURNAL OF ECONOMICS

PAPER No. 6

N. H. B. Bruce

Mr. Noel Bruce has been Governor of the Reserve Bank of Rhodesia since May 1965. He was formerly with the South African Reserve Bank for 17 years and then Chief Cashier of the Bank of Rhodesia and Nyasaland.

Paper Number Six

FINANCE FOR INDUSTRIAL DEVELOPMENT

THE GOVERNOR OF THE RESERVE BANK OF RHODESIA

MR. N. H. B. BRUCE

To secure finance for sound industrial undertakings is less difficult than is the case in some other fields of economic activity such as, for example, mining or agriculture. To a large extent this arises from the fact that in the industrial sphere it is generally possible to assess the potential results of contemplated projects with greater accuracy than in most other sectors of the economy. The intelligent entrepreneur would, for instance, undertake a survey of the potential or existing level of demand for the article which he plans to produce, he would determine the cost of raw materials and the sources of supply, the cost of power, the availability of labour of the right calibre, the cost of premises, marketing costs, and so on. In the majority of instances these factors can be accurately gauged. From this data the industrialist is able to determine the price at which he would have to sell his product in order to yield an acceptable margin of profit and to demonstrate whether or not he will be able to compete successfully with other manufacturers or comparable imported goods. Armed with this information he is in a position to make serious approaches to the various available sources of finance and to persuade them of the feasibility of his project, provided always that he can also satisfy them that he will have the necessary expertise and equipment to deliver a good quality article. In the agricultural, mining and even in the commercial fields the unknown and, therefore, the risk factors, which are almost invariably of material importance, are more numerous and all too often there are some unanswered questions which tend to make investors hesitate.

We can rightly say that during the past five or so years industry in Rhodesia has not experienced undue difficulty in securing the necessary finance for its expansion, nor for the establishment of viable new ventures. Two factors which have contributed to this state of affairs are worth mentioning. Firstly, diversification in the industrial sector has in many cases not required large amounts of capital. Secondly, the degree of protection provided by the Government, who have naturally had to bear in mind the need to maintain reasonable price levels, has been such that investors could be satisfied that fair profits would accrue to them.

For the sake of convenience and also because it is in a way more logical I propose to examine the question of finance for industry under the two main headings of short-term finance or working capital and, long-term finance for the acquisition of fixed assets. In certain circumstances there is no clear dividing line between these two types of funds and in considering the problem one soon finds oneself having to look at what is commonly referred to as medium-term finance, this too I shall touch on.

Short-term Finance

In using the term short-term finance in relation to industry one has in mind funds required for relatively limited periods in order to meet the costs of stocks of raw materials, transportation expenses, wages and, in brief, all those expenses that we know as costs of production and marketing. Also, the cost of finished goods held in stock pending delivery to the market. In the case of goods for which the demands are highly seasonal the short-term financial requirements can amount to considerable sums, for example, manufacturers of pesticides find it necessary to accumulate large stocks during the off seasons so that they can be in a position to meet the peak demands for their products during the growing seasons.

The main sources of supply of short-term funds are, of course, the commercial and merchant banks. Because of the nature of their resources the commercial banks do not readily entertain approaches for long-term accommodation. By far the greatest proportion of the funds at their disposal are derived from deposits which are repayable on demand and for that reason the banks are obliged to lend emphasis to the provision of temporary, fluctuating overdraft facilities. Strictly speaking these funds are made available for limited periods to finance operations which by their very nature should place the borrowers in a position to effect repayment of their loans within agreed periods; in practice it happens all too often that good customers tend to get their overdraft facilities renewed from time to time with the result that they come to regard their commercial bank facilities as near permanent sources of working capital. Very much the same situation arises in the relationship between merchant bankers and their customers; the technical procedures are somewhat different but the effects are very much the same. Generally, the merchant banks make available acceptance credit facilities against the security of goods in transit, or in the process of manufacture; these facilities are revolved in the case of good customers and tend to become more or less permanent within negotiated ceilings.

Lest I should leave the impression that it is a simple matter to obtain short-term finance from the commercial and merchant banking institutions I should perhaps point out that, in addition to the fact that the banks will require to be satisfied that the operations of their potential customers are viable, they will also wish to be satisfied that the level of capital invested in their customers' undertakings is sufficient to provide the long-term needs of the ventures and that there is little danger of the funds made available by them being diverted into the acquisition or replacement of capital equipment. Furthermore, a bank likes to know that the loans which it makes are what is known in banking parlance as "self-liquidating" loans. In other words, a banker wishes to be satisfied that when the objectives for which the facilities are provided have been achieved customers will have the necessary money to effect repayment of their loans; more often than not the banker would wish to see the money actually pass into his customers' accounts.

It might be of interest for you to know that at the end of April of this year the total loans made by the commercial banks to the domestic industrial sector amounted to £10.7 million.

One should, however, not overlook retained profits as a source of working capital. A prudent business man will endeavour to provide himself with at least a certain amount of working capital and will not rely entirely on loan funds. As is only too well known there are occasions when the demand on bank credit exceeds the supply and, there have been times when, in the interests of the overall economic structure, official curbs have had to be placed on the provision of credit. While it is reasonable to expect that the industrial sector will be the last to be affected directly by any such restrictive measures, there can be no guarantee that circumstances could never arise which would justify the curtailment of credit to industry. It is also common knowledge that the use of loan funds for working capital can only be justified if the ruling rates of interest are reasonable in relation to current profit margins. There can be no certainty that either of these factors will remain static and the prudent industrialist will, therefore, endeavour to secure his long-term position by working towards the achievement of a financial structure which will necessitate his reliance on loan funds for working capital only to the extent of fluctuations in his requirements above reasonable levels determined in the light of experience. These levels will, of course, be different from industry to industry.

So far as new industries are concerned, it can be expected that in the initial stages they will require to have rather greater recourse to short-term loan funds than longer established undertakings. Provided the long-term capital resources are adequate in relation to necessary fixed asset requirements and anticipated turnover can be reasonably accurately determined, there should be no difficulty in obtaining short-term loan funds on a basis that will enable investors to achieve reasonable rewards during the first years of operation when shareholders must also expect the retention of some profits for the provision of working capital, expansion and reserves to see the industry through slack periods.

Long-term Finance

For any new industrial venture the securing of long-term finance naturally precedes the need for short-term funds. In Rhodesia, as indeed in any other country, there is only one principal and inescapable source of long-term funds, namely, the investor. It is possible to place the investor into different categories but irrespective of the class of investor the criteria applied in deciding whether to put money into an industrial venture, or not, remain basically the same. The cardinal criterion is, of course, the prospect of an attractive reward.

There are a number of ways in which long-term capital can be raised for industrial undertakings. These are, perhaps, best examined under the following headings:

(a) Private Funds.
(b) Development Organizations.
(c) Share and Debenture Issues.
(d) Financial Institutions.

(a) Private Funds

At the present stage of industrial development in Rhodesia where limited reliance can be placed on export markets and industries are, therefore, largely geared to the requirements of the domestic market, it remains possible in a number of instances for individuals to finance their own projects. This applies particularly to the manufacture of specialised items which sell at relatively high prices and for which the quantitive demand is low. Also, where the cost of capital equipment is modest in relation to end product value and a relatively high degree of skills in production are demanded.

There is a certain danger, however, that successful undertakings within this class can be under-capitalised with the result that they tend to rely heavily on short-term loans, which can at times become so costly that profit margins are adversely affected to a degree which militates against the generation of sufficient surplus net income to provide for expansion or periods of reduced business activity. Proprietors of such businesses would be well advised to guard against these particular risks and to take timely action to ensure that they have sufficient resources to finance healthy growth and to see them through periods of business recession. Should proprietors not be in a position to increase their investments in undertakings of this nature from their private resources, consideration can be given to the establishment of public companies with quoted share issues. But, it must be conceded that most businesses which are initially of small size and which are successful, pass through an in-between stage when they become too large for private resources to satisfy their financial needs and when they are still too small to justify an invitation to the investing public to subscribe to an equity issue. It is at this stage that the development organizations which exist in this country can give significant assistance, they are especially well equipped to bridge this period in the life of an industry and to assist it to develop towards the stage where a successful public flotation can justifiably be expected.

(b) Development Organizations

There are a number of institutions in Rhodesia which use the word "Development" in their titles. It may sound attractive but in a number of cases this word is interpreted rather loosely and the institutions which use it are not truly development organizations; they are perhaps best described as medium-term loan institutions.

There are, however, two organizations which truly conform to the accepted concept of development institutions, namely, The Industrial Development Corporation of Southern Rhodesia Limited (the I.D.C.) whose resources are mainly derived from the Government and The Industrial Promotion Corporation of Central Africa Limited (known as Ipcorn) which was originally sponsored by the Bank of Rhodesia and Nyasaland. While the Reserve Bank of Rhodesia has inherited a large interest in this Corporation the major part of its capital was derived from domestic and non-resident institutional investors.

The main purpose of these two institutions is to promote the establishment of new industrial ventures and to encourage the expansion of existing undertakings. Opportunities do arise for the establishment of new industries where the promoters might have the necessary experience and expertise but do not dispose of sufficient resources to meet the initial high costs of acquiring fixed production assets, or cannot afford to provide the finance to meet the cost of a relatively long period of personnel training and development before net returns can be expected. It also happens that the viability of a project must be demonstrated before private investors can be persuaded to subscribe to a share issue, and that the promoters do not dispose of sufficient funds to bring an undertaking to the stage where they can confidently seek public support for an equity issue. It is in such instances that the two development corporations referred to play an important role. They would naturally not lend their support to ventures which cannot be expected to meet with success and they would invariably insist on making their own independent evaluations but this can only be to the advantage of the promoters who should welcome objective, independent assessments of their plans since they also could not wish to invest in undertakings unless such projects are likely to be profitable. The development corporations have ready access to a wide field of expert advice which is not always available to industrialists and which, if it were to be sought independently by promoters could be costly. It can, therefore, be advantageous in appropriate cases to seek the support of development corporations.

It should perhaps be pointed out that the development corporations are not investment institutions and that while they might insist on acquiring an interest in the share capital in return for any financial assistance which they might agree to provide, the objective would not be to secure a long-term investment. Invariably it is the intention to provide assistance up to the stage when an industry is fully viable and can safely contemplate the flotation of a public company at which time the development corporation would generally sell its shareholding, preferably if it can, at a reasonable premium which it would justly see as its reward for the risks entailed in the assistance given in launching a new industry. More often than not a development corporation would also insist on some participation in the management, usually at Board level, especially in the initial stages, since this is virtually the only way in which it can ensure that the funds provided are properly applied and wisely used.

A further advantage to be gained from securing assistance from one of the development corporations is to be found in the fact that they, who are known to be thorough in their investigations, are generally in a better position to persuade third parties to participate in the provision of long-term capital funds in the initial stages when new industries are still unproved. This practice is common to development institutions who are conscious of the advantages to be gained from a spread of partners in the early years of a new industry. This can also be of considerable value at the time when the public can be invited to subscribe to a share issue.

(c) Share and Debenture Issues

Reference has been made to some of the difficulties that are encountered in the issue of equities for public subscription where it is desired to launch new industrial undertakings which can afford to start in a modest way and to expand over a period of time, and ways in which these problems can be overcome have been indicated. There are, however, types of industries which cannot be established in a small way with a view to subsequent expansion, undertakings such as a fertilizer factory, the manufacture of agricultural machinery, certain food processing plants and others which demand a minimum through-put to be viable and initial relatively heavy expenditure on plant and equipment, come to mind.

It would be rare to find instances where such large industrial projects could be financed at any stage from personal resources or where the development corporations in this country could provide the shortfall. There can also be no doubt that the volume of domestic savings, good as it may be in relation to the gross domestic product, is insufficient to provide the finance for projects that fall into this category. It becomes obvious then that in the limited number of instances where the local establishment of large industries can be contemplated it is almost invariably necessary to seek the support of non-resident investors.

As a rule external investors find it desirable to be in a position to dispose of their investments in Rhodesia should they consider it desirable to disinvest in this country for one reason or another. This requirement can best be met by offering participation in the form of a quoted shareholding since, while it may sometimes be difficult to dispose of large blocks of shares on the Rhodesian Stock Exchange at any one point of time without inviting losses, the prospect of disposing of such equity over a period of time has advantages.

It is also true to say that there are non-residents who are interested in investing in this country, and this does not only apply to investment in large undertakings, but that they are not always in a position to take the lead in the establishment of new industries for the reason that they could not, in addition to providing funds, make available the necessary management and technical personnel. In these circumstances they much prefer to acquire shares in existing proved undertakings which might be ready for expansion, or to join with Rhodesian residents in promoting the establishment of a new industry which can seek the necessary manpower from new sources inside and outside the country.

The issue of shares or, for that matter debentures with or without conversion rights where it is clear that potential investors would prefer to be assured of a determinable income from the start, provides the ideal vehicle for the mobilisation of the small man's savings. This is a source of capital which has often been overlooked in this country but it has proved to be much larger than anticipated in other underdeveloped and developing countries such as India which by international standards is regarded as a poor country. In our own country we have seen three relatively large issues placed on the market during the past two years. All three have been heavily over-subscribed.

We are fortunate in Rhodesia in having a sophisticated and well-managed Stock Exchange. Unfortunately, it is not always appreciated how this can best be used to finance both the expansion and establishment of industrial undertakings and there appears to be a surprising reluctance to resort to the flotation of new public companies.

Perhaps the willingness of Rhodesian investors to hold quoted securities is best illustrated by the fact that, according to recent calculations residents of this country now hold external securities with a market value of well over £60 million. The fact that external securities are held does not mean that they are considered to be a better risk but, in a very large measure, can be ascribed to the shortage of local scrip and the narrow spread of available Rhodesian securities. This situation can be changed by realistic and soundly based share placings in the Rhodesian market. Having regard to the universal inflationary pressures currently experienced and the consequential erosion in the value of money, investors are showing a distinct preference for share capital ownership and are less inclined to consider long-term investments in the form of loans.

(d) Financial Institutions

In the context of our subject one has in mind under the heading of financial institutions those concerns which specialise in medium- to long-term finance. Some few years ago it was a common complaint in developing countries that sources of medium-term finance were either non-existent or very limited. To avoid any misinterpretation it may be as well to mention that medium-term funds are generally regarded as moneys that are procurable for periods from about four to ten years. Broadly speaking, and certainly in the language of bankers, such finance is regarded as falling within the overall heading of long-term.

In Rhodesia we have of late seen a significant advance in the development of institutions which specialise in this type of finance and we have also seen fairly long-established institutions increasingly doing this kind of business. Used wisely, medium-term finance can be of immeasureable value in the development of industry.

Frequently existing industries find themselves faced with desirable expansion which would not justify an increase in permanent capital but which would demand the use of loan funds for periods ranging over some few years during which period the increase in output would enable the industry to recoup the costs of expansion. Finance for such purposes is usually not readily obtainable from the commercial and merchant banks and while it is true that medium-term money can be raised against the issue of redeemable debentures the amounts required do not always justify this course of action. It is in these circumstances that the types of institutions which specialise in medium-term finance play an important part. They are willing to make funds available for a reasonable number of years against the security of plant and equipment or property, provided they can be satisfied that the borrowers will be able to earn and accumulate sufficient cash funds during the tenor of the loans to enable them to effect repayment on the due dates.

The hire purchase finance houses have also moved into this field. They are prepared to enter into what they call lease-hire agreements extending in certain cases over periods of up to 7 or 8 years. In terms of these agreements they purchase existing plant from industrialists and then hire the equipment back to the former owners thereby releasing cash funds into the hands of their clients who are able to apply these moneys towards the cost of expansion programmes. Alternatively, these finance houses will meet the cost of new plant and equipment which can be hired by industrialists who are thus relieved of the need to find large sums for the outright purchase of such capital equipment.

The provision of medium-term finance on the lines mentioned is, of course, not confined to the expansion of existing industries. It is conceivable that in the case of new industries the initial costs of establishment may exceed a level of permanent capital which can be justified by the anticipated net returns in the long-term, in which case shareholders could well prefer to see a capital structure which includes medium-term loan funds and which would result in the deferment of profit earnings on equity holdings for a few years in the expectation of a higher level of returns on a more stable basis thereafter.

In conclusion, it can confidently be said that short, medium and long-term finance is available in Rhodesia to meet the needs of sound industrial development designed primarily to meet the demand of the local market but that in the case of large capital intensive industries it will for some time to come be necessary to attract external capital. Lastly it must be said that for the time being balance of payments considerations demand selectivity in the approval of new industries and the expansion or diversification of existing undertakings.

DISCUSSION OF PAPER SIX

Mr. Kirkpatrick said that the Governor had mentioned that Rhodesia was suffering from a gap in the sense of the difficulty involved in attracting external capital. He asked whether Mr. Bruce could comment on future prospects over the next few years of attracting capital from South Africa. Secondly he asked whether the Governor thought that the Merchant Banks should extend their activities beyond the short term movement of goods—in other words was there a gap which the Merchant Banks could fill in supplying capital up to the 3 to 5 year basis?

Mr. Bruce said he could not remember talking about a gap and he did not believe that Rhodesia did have a gap so far as the attraction of external funds was concerned at the present time. Mr. Bruce said he believed that industries which were well conceived would still be able to attract external capital despite the difficult international circumstances. He cited the fertilizer factory as an example.

So far as the Merchant Banks were concerned, Mr. Bruce said he did not believe that the necessity did exist for Merchant Banks to move into the medium-term lending field in Rhodesia. The hire purchase finance houses had assisted in filling this gap which was one that existed in Rhodesia about seven years ago. There were also institutions associated with the commercial banks which were specifically designed to fill this medium-term gap.

Mr. Voss asked the Governor to give his views on the impact of the undistributed profits tax on the generation of capital within the industrial sector—in other words the accumulation of profits being denied to the shareholders by virtue of the imposition of the tax. Mr. Bruce said he was not a tax expert but he thought that the tax must to some extent adversely affect the retention of profits. He said he would not like to talk about the justification of the tax but to simply face the fact that the undistributed profits tax was an inhibiting factor so far as capital accumulation was concerned.

Mr. Bertram said that while there was evidence of a significant rise in industrial activity, there had been very little—if any—movement in the level of commercial bank advances to industry. They were standing at practically the same level as they had five years ago.

Mr. Bruce replied that the figures suggested that industry was not having to provide credit to its customers to any excessive extent but it was able to generate its own resources to a very large extent and was also attracting longer term investment and making use of medium-term finance.