

alert



A landscape of lumbering giants

In the rich layer of data produced by SBP's SME Growth Index a relief of the underlying structure of the South African economy is clearly visible, and it does not look good for the development of established small and medium enterprises, and consequently for economic growth.

The picture that emerges is of a landscape inhabited by lumbering giants – corporates, parastatals and conglomerates – that can easily squash any smaller species that do not find a way of hanging on and moving with them.

SBP's **SME Growth Index** is a longitudinal study, the first of its kind in South Africa that tracks the lives and travails of a panel of 500 small business owners, looking specifically at what makes them survive and grow. The businesses have been selected randomly from the urban tourism, manufacturing and business services sectors – industries that have been identified by government as critical for economic growth. The first results of the SME Growth Index, which will be repeated annually for at least three years, appeared late last year in a headline report (downloadable at www.smegrowthindex.co.za). This paper takes a closer look at further data emanating from the same survey, and what it suggests about specifically the manufacturing and business services firms on the panel.

Most striking in the latest set of data is who the companies on the panel do business

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with, specifically the fact that no fewer than 49% of small manufacturing businesses and 37% of business services firms see big corporates as their main clients. At first sight, it may not seem all that remarkable. After all, small factories seldom sell to the general public - they tend to sell their products to wholesalers and, if they're lucky, straight onto the supermarket shelves of the large retailers. So if asked who their main clients are, they are likely to say "big business".

But have a look at the fuller picture:

Main clients (%)	Manufacturing	Business Services
Big business	49	37
Foreign	3	1
Government	3	12
Individuals & households	12	12
Parastatals	1	1
Small business	29	31
Various	3	5

For economist Iraj Abedian, who conducts the Manufacturing Confidence Index through his firm Pan African Investment and Research, the figures show an unfortunate dominance of the South African economy by big business and a dangerous dependence of the country's small businesses on them, to the detriment of economic growth, job creation and the multiplier effect of any large-scale investment into the economy. For him, the telling figure is just how few small businesses see other small businesses as their main clients, namely 29% of small manufacturers and 31% of business services companies. In a healthy, more equitable economy, 80% of these small firms would see other small businesses as their main clients, he says.

Researcher Mike Herrington, who does the South African chapter of the Global Entrepreneurship Monitor at the UCT Centre for Innovation and Entrepreneurship, expressed initial surprise at seeing so many business services firms who identify large corporates as their main clients. It seems implausible to him that a big bank, for example, would use a small computer-networking business to supply a local branch, rather than have one, manageable contract with a large computer company with a national footprint. All of the businesses on the SME Growth Index sample have between 10 and 50 workers and most of the business services firms are IT providers or specialise in financial services such as accounting and insurance.

But Abedian argues that, firstly, it is common practice for many large businesses to indeed have a main supplier contract with for example a large law firm for their main legal work, but that they would use smaller regional suppliers to handle local, less important cases. Secondly, the very fact that so many business services firms regard these crumbs off the corporate table as their main source of income shows just how strongly big business dominates, and how shallow the small-business sector is by comparison. South Africa simply does not have a rich seam of small to medium sized distributors who buy at the factory gate, or a community of SMEs who provide a fertile field for small computer networking companies or accounting firms to grow.

If there were, one would expect a much higher figure of small manufacturers and businesses who regard other small businesses as their main clients. It is much more natural and comfortable for them to do business with other small businesses. The relationships are more personal, less formal, more synergistic and more flexible. The tendering procedures of government and corporate procurement are the opposite: rigid, impersonal and very expensive. Winning one in twenty tenders is considered a successful ratio, and each tender takes time and energy which small businesses do not have in abundant supply.

This seems to be the main reason for the relative small number of the panel who identified government and parastatals as their main clients, despite years of both lip service and genuine attempts to use state procurement as a catalyst for small-business growth. Neil Rankin of the Wits School of Economics who analysed the numbers for SBP's SME Growth Index, says added to the usual restraints of tendering processes a key barrier to doing business with the state is probably government inefficiencies, which include short lead times and late payments.

The possibility that it is simply too uncomfortable for small businesses to have state entities as their main clients calls into question the role that government procurement can play in small-business development.

Given the overall lack of development of the South African small-business sector implied by these figures, the limited number of small businesses that mainly export, 3% in the case of manufacturers and 1% in the case of business services, comes as no surprise. Apart from the dominance of large corporations which stems from the nature of South Africa's prominent mining sector, there are historical factors for lack of small-business development and specifically export orientation among them. Up until 1996, the politics

of apartheid had limited the South African market to 20% of the population, and the world economy was closed to South African goods and services. The result was that many sectors had as few as one or two competitors whose operations were kept small by the limited size of the market. After 1996, when the world became the market, South African firms were rendered internationally uncompetitive not necessarily because they were inefficient, but because they lacked scale and synergy between them to compete overseas.

Nevertheless, the research shows that 45% of small manufacturers on the panel dabble in export, even though it may not be their main target market. And of the business services firms, a surprising 37% do international business. The implication is that South Africa's small manufacturers and business services firms have strong potential to grow internationally, by for example making use of opportunities opening up in the rest of the African continent, which has become one of the fastest growing regions in the world.

A possibly important figure in the SME Growth Index for anyone concerned with the development of local exporters is that 69% of the small manufacturers who do export, also import. A total of 44% of business service firms who export, also import. This implies that should these imports feed into the production process, then factors that constrain importing would negatively affect firms' exports.

The figures also imply that anyone concerned about job creation in South Africa should probably be concerned about exporting. Exporting firms employ larger numbers than those who don't.

Shallow market, few players

More data from the SME Growth Index bears out the theory of a shallow economy with few players. The panellists were asked to describe their market share and the number of competitors they were up against. The median small manufacturer estimated on average that they had a market share of 25% for their main product and the median business services firm 15%. As intuition would predict, the size of their market share seems to rise as the age of the businesses increase as well as the number of workers they employ. But there seems to be a dip of market share when firms employ more than 30 people and reaches the maturity at age 30.

The dip, explains Rankin, may well be due to businesses redefining their markets as

they grow. When a local business dominates a suburb, it may well boast 90% market share, but as soon as it opens another branch in an adjacent area, its market immediately becomes bigger, and market share may halve even as the turnover doubles.

Most experts, however, are very sceptical about business owners' opinions about market share as many believe that very few owner-managed businesses have any accurate idea of what their market share is. The kind of research that can measure the market share of a business with any accuracy falls strictly in the domain of large businesses. Besides, one business may define its market as the local suburb, another as the sub-continent, and finally, it is a well-known phenomenon for businesses – big and small - to talk up their market share in the absence of accurate figures.

But despite these misgivings, experts do agree that there is value in how the businesses perceive their market share, and the overriding impression is that there are few players in these sectors of the economy. The impression is reinforced by the panellists answer to the question about their number of competitors. The median manufacturing firm has six competitors for their main product, and business services companies have ten.

Rankin says: "It's the South African story: relatively few competitors, relatively large market shares and relatively large mark-ups in various sectors."

A strange contradiction?

An intriguing paradox emerges from the latest set of SME Growth Index data. On the one hand the figures show that no fewer than 40 percent of small factory owners also own other businesses, as do 30% of the owners of business service firms. This in itself is unremarkable. It is natural for business owners, who tend to collect capital when they are successful, to hedge into sidelines and second or third businesses. The fact that there is a slight increase in this tendency as firms grow older seems to bear it out.

But how does one marry this phenomenon with the astounding figure that the median manufacturing firm, irrespective of age or size, produces 90% of its turnover from one single product? A slightly lesser concentration on one product, but still high at 70 percent, is to be found among business service companies. It seems that South African small business owners, when they do diversify, do so into other businesses instead of in the product range of their main business.

Abedian is surprised neither by the high product concentration, nor by the ostensible

contradiction with business owners hedging into other industries. Globalisation has undoubtedly led to specialisation, and this is reflected in the figures. The necessity to use economy of scale in order to compete against factories and service providers from across the globe forces business owners to concentrate on one product.

So why the diversification into other industries? It is Hedging 101. If you are going to hedge because you are worried about the risks to your business, do so across various industries. It is the same with banking executives, for example, who certainly don't put all their savings into banking shares.

But Herrington believes that such concentration on one product is a major weakness of the South African manufacturing sector. It can and should be avoided, if only because every product has a limited lifespan and if a business therefore sticks to one product, it will go down with it. Furthermore, a diversified product range can entrench your position in a market and make you a stronger player even in the face of global competition. He warns that the focus on one product by business owners is often caused by the opposite of globalisation – a myopic view that stems from leading “narrow lives”.

Lessons and policy implications

Be realistic

Policy makers and small business developers need to understand that developing the small business sector in any country is an extremely complex, long-term endeavour. Even more so in a country where the paucity of small businesses is not only the result of historical policy mistakes, but also where it was forged by the very structure of the economy. South Africa's economy came of age through mining, which required huge, patient capital. The big mines required big suppliers that never developed the capability or impulse to handle small businesses in their supply chains.

In the absence of radical policy interventions South Africa's economy will probably remain dominated by large corporates for decades to come. Small business development will have to take place in this context.

But keep the goal in mind

The danger of coming to grips with just how difficult it is to develop small businesses in such an economy is that the mega-project as an economic-development mechanism

almost always seems easier and sexier than messy small-business development. It is necessary for policy and decision makers to be reminded of why small-business development is crucial: there is abundant evidence that they create wealth and jobs and promote equality. Without them, the multiplier effect of mega-projects on economic development disappears, and they simply become imported white elephants. There is also ample evidence that small-business development, if done effectively, pays political dividends. People are aspirant - they want to start their own businesses if only to be in charge of their own destiny. Politicians need to be reminded of the popularity of individual economic self-determination.

Look into issues of diversification and concentration

The second round of SBP's SME Growth Index in 2012 will probe the extent to which the concentration of South African small manufacturers on one product is an unavoidable necessity and whether, as some academics believe, it is simply due to myopia and lack of strategic skills among business owners. Where it is found to be the latter, interventions might need to be designed through existing and new small-business support programmes to help established small businesses diversify their products.

Use the integration of big and small businesses

One of the few platforms that South Africa does have to develop small businesses is the integration between small businesses and their large clients. Skills and awareness training among small business owners about aspects such as client relationship management, invoicing and delivery on time can keep and increase the number of small businesses in corporate supply chains. There may be a possibility that such training and awareness could enhance and strengthen trade between small business peers.

The sensitisation and skills development among corporate buyers could possibly have the same outcome, especially if evidence can be produced that small-business integration into large supply chains has a favourable effect on the bottom line.

Authorities must test their policies for the effect that they have not only on big business on the one hand and small business on the other, but also about their effect on the integration

of the two. Policy makers have to remain aware that any regulatory interventions come at a price to the economy as a whole. A complex balance must be maintained.

SBP's SME Growth Index is the first and largest study of its kind to be undertaken in South Africa. It differs from previous studies in breadth, scope and intent. It delves into the wide spectrum of factors germane to the operation of a business. It also focuses on the drivers behind SME survival and growth. While much of the government's attention has been on supporting the establishment of start-up enterprises, the Index emphasises the enormous and sometimes unacknowledged contribution made by established small firms with the potential to expand, generate wealth and take on additional employees. The Index aims to support evidence-based policy-making for the SME sector in South Africa. SBP's goal, as research and development specialists, is to support the types of policy and practical interventions that will best ensure an environment in which a strong and sustainable SME economy can flourish.



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