Go offshore – for the right reasons

Business Day Version August 4th 2017

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South African business leaders are demonstrating a heightened taste for expansion offshore.The reasons for doing so seem obvious enough. The stagnant SA economy now offers them minimal growth opportunities. Yet they are likely to be well rewarded for growing earnings. Clearly such growth could be helpful to managers – is it as likely to be helpful to their shareholders?

It all depends on how much of their capital or debt incurred on their behalf is employed to pursue earnings growth. Unless the extra cash generated by expansion abroad or domestically can be confidently expected to provide a cash return in excess of the opportunity cost of the extra cash invested (cash in for expected cash out, all properly discounted to the present with proper allowance for the maintenance and replacement of the assets acquired) the investment should not be made. One wonders how many of the offshore acquisitions by SA companies offshore can confidently offer their SA shareholders positive Net Present Values?

Why then the near flood of such acquisition activity? Every director should know (but may not) that growing earnings or earnings per share may not be helpful to shareholders, if too much capital has been expended to realise growth in earnings. If managers are incentivised to grow earnings regardless of the extra capital employed to do so, they should not be surprised when managers seek growth wherever it can be found, regardless of how much it costs and whether or not it destroys wealth for shareholders. The golden rule of finance is always relevant: positive net present value (NPV) strategies are worthy of consideration but negative NPV strategies should be declined, especially if they are being made for “strategic reasons” (when an investment is made for “strategic reasons” it often means that there are no “financial reasons” for pursuing it).

A further benefit to managers from expansion offshore will come in the form of a more diversified flow of earnings when these include earnings generated independently of their SA operations. Full exposure to SA risk may threaten the survival of a business and so their own employment prospects. Conglomeration usually comes at a price – that of the cost of a head office or holding company discount. Executives who diversify earnings on behalf of their shareholders are not doing them a favour. Shareholders can do it themselves at a fraction of the cost, and they can exit when they wish by simply selling assets in their portfolio.

SA institutional portfolios subject to a 25% limit to their offshore holdings may have a stronger case for JSE-listed companies investing offshore on their behalf. These companies, with minimal exposure to the SA economy, can raise capital on the JSE on superior terms to those available to them elsewhere. Or, to put it alternatively, they can benefit from a higher share price (in US dollars, on the JSE) by catering to the SA institutional investor.

For the private SA investor able to invest abroad, essentially without limit, it makes little sense to pay any premium for access to offshore earnings, dividends or the capital appreciation provided by a JSE listing. The private investor can diversify directly, without exchange control constraints, by investing in the most promising of companies listed offshore.

All this is not to suggest that SA companies and their managers cannot succeed offshore. Some have created great wealth for their SA shareholders by doing so. But such attempts should be made on their own strict investment merits; Chasing earnings growth regardless of properly measured returns on the capital at risk, is not nearly a good enough reason to go offshore. It would be better to return cash to their SA shareholders by paying dividends or buying back shares or debt. And let shareholders decide for themselves how they wish to diversify their risks.

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