The downturn in business profits and its implications

South African companies are under pressure. The total net operating surplus (NOS) for all corporations (a proxy for company earnings) fell 3.8 per cent last year, which is the worst outcome since the past recession (NOS fell 0.9 per cent in 2009).

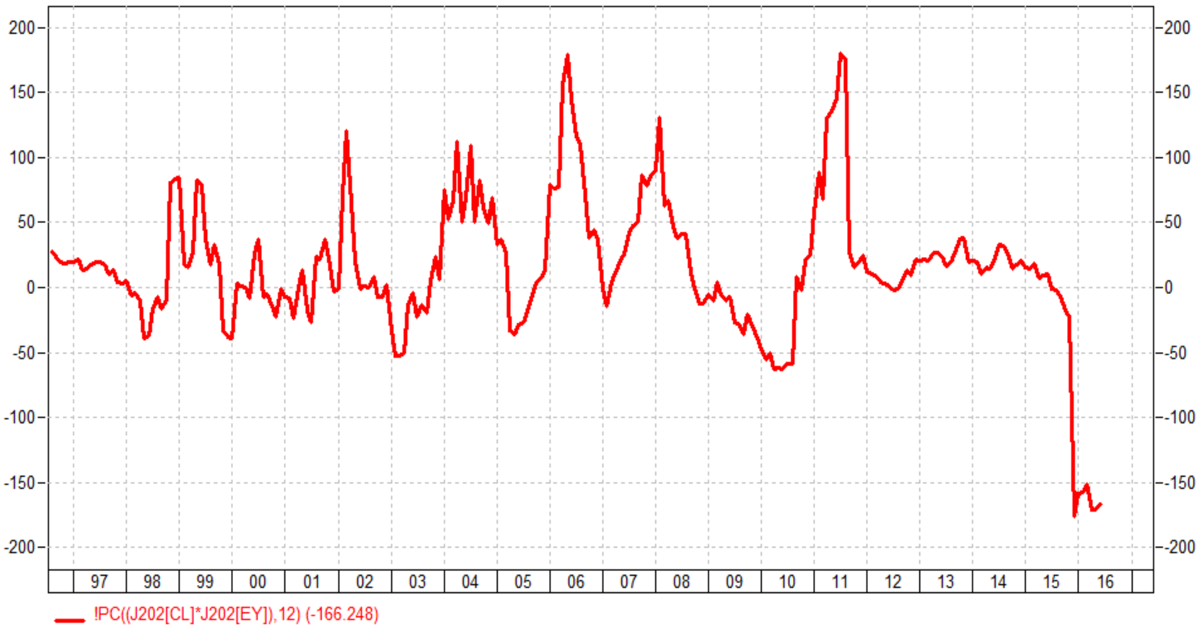
Meanwhile, the share of NOS for corporations in the total GDP declined from a recent peak of 15.8 per cent in 2008 to 11.9 per cent last year – its lowest level since the emerging markets crisis of the late 1990s.

One reason for the fall in corporate profitability is the continued firm advance in labour compensation. Compensation for workers in non-financial and financial corporations (excluding compensation captured under the accounts for households, non-profit institutions serving households and general government compensation) increased firmly by 8.0 per cent and 9.3 per cent respectively in 2015, or 8.2 per cent in total.

A number of small businesses recorded solid earnings growth over the past year. Still, the deteriorating business environment is reflected in the weakness of earnings of small businesses registered on the Johannesburg Stock Exchange. The earnings data for this index is heavily distorted by the relatively recent inclusion of mining-related stocks (whose earnings had collapsed). Nonetheless, in the absence of firmer economic growth, the earnings of small businesses more generally are likely to be adversely affected.

JSE small capitalisation stock earnings – distorted by specific industries

%yr



Source: I Net

What are the implications?

In response to lower profit margins, businesses are likely to cut costs, including expenditure on capital and hiring. This implies continued restraint of domestic spending. In turn, this is, generally, bad news for small businesses.

Further, net operating surplus is the base from which company tax is collected. Considering the extent of the profits downturn it appears as though the National Treasury's budgeted 4.9 per cent increase in company tax for the current fiscal year (National Treasury Budget Review, 2016) is too optimistic. Weak income growth in the economy more broadly, puts the government at risk of revenue shortfalls in the fiscal years ahead. In turn, the risk of increases in taxes lingers.

At least, as far as small businesses are concerned, the fiscal authorities have attempted to promote small business growth through tax incentives, recognising the importance of small businesses in job creation.

The Treasury calculates small business corporation tax savings due to reduced headline corporate taxes and the Section 12E depreciation allowance amounted to R2.23 billion in 2013/14 (the latest year for which an estimate is available).

If the additional incentives relating to Research and Development (R&D), the film incentive, learnership allowances and urban development zone incentives are included the savings for all corporations increased to R4.61 billion in 2013/14.

But these incentives cannot compensate for the myriads of forces that are impacting small businesses in South Africa adversely, including weak productivity outcomes, soft domestic spending, periodic infrastructure bottlenecks and higher interest rates.

As regards the latter, I have argued on numerous occasions that funding remains a key constraint for small business development in South Africa. The Treasury agrees. Hence, in 2008 the venture capital company regime was initiated in order to incentivise equity funders to invest in small businesses. However, the Treasury notes in its February 2016 Budget Review that “the application of certain provisions on these companies may result in potential investors abandoning plans to take up this incentive”. Encouragingly, the review indicated that treasury officials are investigating the possibility of addressing this.

But funding conditions have become tighter.

Long-term interest rates have increased and the Reserve Bank seems set to increase its policy rate further. The Bank should be closer to the end of its interest rate hiking cycle than the beginning, provided its inflation forecast, which shows headline CPI peaking at an average of 7.3 per cent in 1Q17, pans out. Nonetheless, communication from the Bank suggests it is not done yet.

There is also the uncertain outcome related to Standard and Poor's sovereign debt rating decision due in June 2016. Arguably, the prospect of a downgrade is to a large extent already priced into the bond market. Even so, the deterioration in South Africa's ratings in recent years is a cause for concern; especially since there is no clear path visible, as yet, leading to higher economic growth.

Overall, ongoing adjustment to the real economy through this year appears inevitable – unfortunately.

Written by Arthur Kamp, Investment Economist, Sanlam Investment Management