8. South African Case Studies

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INTRODUCTION

This chapter presents four recent foreign entries into South Africa. Section 1 covers two automobile component companies: NGK Ceramics (catalytic converters), which entered as a greenfield and Behr (radiators and airconditioners) which entered via an acquisition. Both entries were in response to significant changes in the sector's policy environment, but NGK focuses on exports while Behr supplies the domestic market. The next case is concerned with the unusual occurrence of technology-seeking investment in an emerging market context. It involves the acquisition of a South African industrial equipment firm – Ziton – by a US corporation (EST) because of the former's superior fire detection technology. The final case is the entry of the Dutch bank, ABN Amro, to South Africa in response to financial sector liberalisation after 1994. Three different entry modes were used for the bank's three divisions – greenfield for banking, partial acquisition for securities trading and full acquisition for vehicle leasing. This case also illustrates the implications for emerging markets of major corporate strategic shifts by global giants.

AUTOMOTIVE COMPONENTS–NGK CERAMICS AND BEHR

In this automotive components case study, two contrasting firm types are examined. NGK Ceramics is a recently established greenfield plant that produces the ceramic substrate that is part of a vehicle emission control system. The plant is an example of a new type of export oriented investment in the automotive industry and is part of a very rapidly growing sub-sector. Behr South Africa produces automotive radiators and air conditioners and was acquired by the Stuttgart based Behr Group in 1999. It has very different origins. Production was established as early as the 1960s under South Africa's local content programme and the firm developed to supply the domestic market both for original equipment (OE) and aftermarket components.

Foreign Investment in the South African Automotive Components Industry

Prior to the 1980s, a rapidly growing domestic vehicle market together with high protection had acted as a magnet to foreign firms, which invested extensively in the South African automotive industry. Most of the main vehicle makes were assembled in South Africa although some of these operations operated under licence. Local content requirements, which were introduced from 1960 and gradually extended, ensured that firms sourced a certain portion of components locally. Exports of both vehicles and components were negligible.

In spite of the rapid influx of foreign investment in previous decades, by the late 1980s levels of foreign ownership were relatively low both among vehicle manufacturers and component producers. At this stage, only three of the seven vehicle manufacturers in SA had majority foreign shares. Many of the largest component groups were also locally owned and listed on the Johannesburg Stock Exchange. The relatively low share of foreign ownership was a function of a number of factors. The 1980s had been a period of economic stagnation and political turmoil unattractive for foreign investment. Japanese firms had for many years been prohibited by their government from making direct investments in apartheid South Africa although many had license arrangements and there was large scale two-way trade. In addition, in the 1980s an active international campaign encouraged disinvestment from South Africa, which was particularly effective against American firms: both Ford and General Motors transferred ownership to local interests during this time. In any event, the industry was highly inward oriented so that access to export markets was not a critical consideration for South African firms.

The Impact of Government Policy

The South African automotive industry has been through wrenching changes over the past 15 years as it has opened up to international competition (Black 2001). Liberalisation began in the late 1980s and accelerated in the 1990s partly as a result of major changes sweeping the global automotive industry over this period but also reflecting the opening up of the South African economy with the demise of apartheid and important changes to government trade policy relating to the automotive industry.

The first major change to the protectionist trade policy in the automotive industry was in 1989 when the introduction of Phase VI of the local content programme signalled a partial shift from protection to export orientation. The

Motor Industry Development Programme (MIDP) introduced in 1995 continued the direction taken by Phase VI and entrenched the principle of import-export complementation by which exports could earn import rebate credits. It also introduced a tariff phase down at a steeper rate than required in terms of South Africa's WTO obligations.

Import-export complementation enables automotive firms to use import credits to source components and vehicles at close to international prices. There is, therefore, considerable pressure on assemblers and distributors to gain access to import credits via exporting. Assemblers can, of course, achieve this through exporting vehicles and vehicle exports have increased from an average of less than 15,000 units per annum for the years 1992 to 1994 to approximately 110,000 units in 2002. But vehicle producers have also played a major role in expanding component exports either directly through subsidiary companies or through facilitating major contracts into their parent company global networks. This has encouraged large investments in certain components, the most important of which has been catalytic converters[35], the industry in which one of the case firms operates.

The change in trade policy and resulting internationalisation of the industry manifested in growing exports and imports has had major implications for ownership. With the domestic market under pressure from imports and the introduction of an import-export complementation system, which effectively supported exports, it has become increasingly important for local firms to have links to international markets. This could most easily be achieved by establishing relationships with foreign firms. Thus a key potential asset brought in by a prospective foreign shareholder or owner is the access to markets, which they could provide. Recent foreign investment has, therefore, frequently been linked directly or indirectly to export production.

The access to international networks, which foreign owned firms could provide, is complemented by their control over the technology necessary to supply export markets and to meet the increasingly demanding requirements of domestic vehicle assemblers. In South Africa, before the recent influx of foreign investment in the automotive industry, the technology used and products produced by local firms were, however, generally licensed from major European, American or Japanese suppliers. While the South African plants may have had many features in common with that of the foreign licensor there were also significant differences. These differences were typical of manufacturing firms developing under import substitution policies. Firms in protected developing country markets tended to operate at much lower scale, were highly flexible and oriented to the domestic market (Katz 1987, Black 1996).

The pressures on SA firms to break into export markets and therefore to secure a foreign partner, have been complemented by the rapid internationalisation that has taken place in the world automotive component industry. Trends towards 'global sourcing' and 'follower sourcing' have had major implications in emerging markets where the trend is towards fewer first tier suppliers. In South Africa, and indeed in other emerging markets[36], assemblers increasingly prefer to source components from joint ventures and wholly owned subsidiaries rather than from domestically owned firms. This is not only to achieve economies of scale but also to achieve quality levels in accordance with that achieved in the home plant.

As indicated in the following case studies, the particular dynamics of the industry have had important implications for the form that FDI has taken and for the outcomes that have resulted.

NGK Ceramics South Africa (Pty) Ltd

NGK Ceramics (South Africa) operates a recently established plant in Cape Town, which produces the ceramic substrate for catalytic converters, which form part of the emission control equipment in modern vehicles. It is 100 per cent owned by the Japan based firm NGK Insulators Ltd.

The Catalytic Converter

The catalytic converter industry is growing rapidly worldwide. The use of converters has been a standard requirement for many years in the case of vehicles operating in developed countries but increasingly stringent legislation requires the use of numbers of catalytic converters in both petrol and diesel vehicles.

The production of a catalytic converter essentially requires three steps. The first is the manufacture of the ceramic monolith or substrate, which is a high technology product made of special clays with a very large internal surface area due to its honeycomb structure. This step is in itself divided into two processes, the extrusion of the monolith followed by firing at very high temperatures. NGK (Japan) and Corning (US) are the two main suppliers worldwide accounting for 90 per cent of global supply and 95 per cent of South African supply. NGK has plants in Japan, Belgium, the US, Indonesia and South Africa.

The second phase in the production of a catalytic converter involves the coating of the honeycomb monolith with a solution of platinum group metals, which create the filter effect. In the third phase, the ceramic monolith is 'canned' or packed into a stainless steel pressed casing.

In South Africa, the industry has seen dramatic growth of production. Nearly all of the production of catalytic converters[37] is destined for the export market once they have been coated and canned and exports have increased from ZAR 197 million in 1994 to ZAR 4,683 million in 2001 and the country now supplies approximately 12 per cent of global supply.

The South African based industry is for the most part foreign owned and started with the establishment of plants, which undertook the coating and canning of the imported ceramic substrate. Backward integration into the ceramic substrate is a more recent development with the two world leaders, Corning and NGK Insulators itself, recently establishing plants in South Africa.

The NGK investment

NGK Insulators Ltd is a large Japan based multinational whith sales in 2000 of US$ 2.978 million and 11,900 employees. While the company has production capacity in many countries, it is still very much dependent on the Japanese market which accounts for 72 per cent of sales. The ceramic products division, under which the South African subsidiary falls accounted for 17 per cent of turnover in the year ending 2000 (NGK Insulators 2000).

As indicated above, by the late 1990s, South Africa had become a leading global producer of catalytic converters with a number of coating and canning plants in operation. The announcement of major export contracts provided a clear indication of further expansion and provided additional justification for further backward integration through the establishment of production capacity in the ceramic substrate (BT 8/8/99). In 1999, NGK's major international rival, Corning, announced that it was to build a new plant in Port Elizabeth to fire ceramic substrate and this forced the hand of NGK. The Japanese firm ran the risk of losing market share to Corning and it also faced requests from its customers operating in South Africa to open a facility.

The new facility was established according to very tight deadlines, with construction beginning in May 2000 and the start of commercial production in January 2001. Capital invested in the plant is approximately US$ 20 million including working capital. The plant has a capacity of 6 million pieces per annum and employs 90 workers. The plant technology itself involves firing of the substrate and testing of the product. These are sophisticated processes. The two huge kilns are state of the art, each with many individually controlled burners to allow for very precise and even control of temperature throughout the kiln. Each kiln has a capacity of 30,000 pieces which are fired for 60 hours at carefully regulated temperatures of up to 1,400 degrees Celsius. Testing is extensive involving dimensional integrity, isostatic and compressive strength, web thickness, water absorptiveness and expansiveness. While most of this is selective testing, each product is laser tested.

The plant has made extensive use of expatriate personnel. The managing director is British and in the early stages of establishment there were up to eleven Japanese technical and managerial staff at the plant. This has now been reduced to four and is likely to be reduced further.

Since production started the plant has met all output, quality targets and achieved a 100 per cent delivery rate. In March 2002 it was running at the optimal level of over 90 per cent of capacity and the kilns were in operation around the clock while other sections of the plant operated on a two shift basis for five or six days per week.

The phenomenal growth of the South African industry can only be understood in the context of South Africa's automotive policy. As explained above, the policy enables exporters of automotive products to rebate import duties on both vehicles and components. This has encouraged carmakers to establish export production in order to offset the duty burden on imports of both vehicles and imported CKD components. Producers of the ceramic substrates do not receive import credits but have benefited from the desire by vehicle manufacturers to increase export volumes of completed converters and to raise local value added.[38] Catalytic converters have been the component of choice and virtually all vehicle assemblers have arranged large-scale exports to their parent plants. Catalytic converters had certain advantages in this respect, not least that they are high value products as a result of the precious metal content. Furthermore, in spite of the fact that they are high value components, catalytic converters have relatively few components and production can therefore be established with relatively little labour and ancillary investment. Independent vehicle importers such as Peugeot have also set up contracts of this sort in order to rebate import duties. The import rebate system is now being phased down rapidly and industry growth rates are likely to slow.

The rapid expansion of this sub-sector has, however, created sufficient critical mass to attract investment in ancillary industries, which now provide significant agglomeration advantages. There now exists a large network of companies linked by a sophisticated logistics infrastructure and with a well established reputation in international markets. Arguably the industry has now created sufficient critical mass in terms of both volume of output and the localisation of the bulk of the value chain to make it internationally competitive. An important next step could be the localisation of the extrusion process, which would involve large capital investment and the importation of very sophisticated technology.

More conventional advantages include the fact that South Africa is a major producer of stainless steel and has considerable expertise in precious metals technology. More recently a further factor has undoubtedly been a 'bandwagon' effect. Foreign firms scouting South Africa for component export opportunities cannot fail to notice the country's leading position in this sector and have been quick to emulate their competitors.

Behr South Africa

The Behr Group is a large German multinational firm with global sales of €2.31 billion and 13,400 employees in 2000. Its major products are vehicle air conditioning and engine cooling systems which together account for over 85 per cent of turnover. Twenty per cent of the vehicles built in Europe use Behr cooling equipment but in common with many other German suppliers, the share of production outside of high cost Germany is growing. Production (as opposed to sales) outside of Germany accounted for 49 per cent of total sales in 2000, up from 37 per cent in 1996. In emerging markets Behr has plants in Brazil, India, the Czech Republic and South Africa. The Behr Group is growing rapidly with total sales having increased by 82 per cent between 1996 and 2000.

Reasons for the Acquisition

The Behr Group acquired its South African operation from the US firm, Federal Mogul, in May 1999. Federal Mogul had itself purchased the firm as part of a worldwide deal when it took over T&N plc, the UK based component supplier, a year earlier. T&N plc held a 51 per cent stake in T&N Holdings, a company listed on the Johannesburg Stock Exchange. The latter firm's divisions were friction materials; pistons, bearings, gaskets and heat transfer equipment. The T&N Heat Transfer division did not fit into the Federal Mogul structure as the latter company was not involved in this sector and this relatively small acquisition would not have given it critical mass in the sector.

As the South African automotive industry has become more internationally integrated, foreign owned vehicle manufacturers have become drawn more closely into the networks of the parent company. This increasingly meant that they wanted selected suppliers to be located in South Africa. The Behr Group faced these pressures from key customers (BMW, Daimler Chrysler and VW) who were looking to expand vehicle production in South Africa. In particular, the Mercedes C Class export project offered the prospect of large contracts in the form of the air conditioner, radiator and condensor for this vehicle, which was to be built in volumes of 50,000 per annum in South Africa. According to the managing director of Behr (SA), the German group was faced with three alternatives. The first option was to invest in a greenfield facility. A second alternative was to purchase an existing firm and the third possibility was to simply continue their license arrangements with existing firms operating in South Africa.

Essentially the decision on mode of entry revolved around risks and resources. The greenfield route was considered to be very demanding in terms of resources and also involved fairly high levels of risk. Maintaining a licensing arrangement was seen as risky because it involved losing control of core technology. T&N (and then Federal Mogul) had already been supplying the BMW 3 Series under license but this was on an assembly basis and Behr was reluctant to license its core technology. A license arrangement which involved assembly would allow only low value added in South Africa.

Investing in emerging markets fitted with Behr's expansion strategy. While it was a multinational firm, it was very much German based and "there was a perceived need to have a global footprint" (Interviews). For this reason Behr had invested in Brazil in 1992. It also has an operation in India and is looking to integrate this more closely into the Behr network.

From the side of the South African operation, it was important to have a global partner. In the words of local management, “the MIDP was starting to bite” and without a foreign investor the company “could have stagnated into the aftermarket or even died”. The Behr Group proved to be an ideal candidate. Not only was Behr actively looking for an investment in SA as a result of pressure from its customers but it already had a well developed relationship with the South African company because of technology developed by the latter, which had been licensed to Behr. The Behr Group purchased 100 per cent of Federal Mogul Heat Transfer in May 1999 for an amount of €25 million, roughly equivalent to net asset value.

Performance of the Subsidiary

Behr (SA) produces radiators, automotive air conditioners and condensers. Half of sales are original equipment and the remaining half are to the aftermarket. Direct exports account for a third of sales and are nearly all to the aftermarket. While the company does not export significant volumes of original equipment components, it supplies domestically assembled vehicles, many of which are exported. The basic strategy of the South African subsidiary has been to focus its activities in selected core areas. Turnover doubled between 1998 and 2001 to approximately ZAR 620 million. Rapid growth is expected over the next few years and the SA firm is highly profitable.

It is clear that this investment has been advantageous for the local operation, which faced the prospect of cutting production and increasingly competing on price in the aftermarket. Local management expect that employment would have fallen and the company would have struggled to maintain its technological edge. Since the acquisition, in each business division there have been productivity and efficiency improvements. By 2001, Behr (SA) had 1,100 employees in four sites, up from 1,000 three years previously. Prior to this, the firm had been experiencing “jobless growth” as it restructured in the face of tariff reductions and growing export opportunities.

As has been typical in the component sector, perhaps the most important contribution of the investor has been to facilitate access to key automotive customers. The Behr Group is one of the largest worldwide suppliers to the three major German automakers (VW, Daimler Chrysler and BMW) all of which have plants in South Africa, which increasingly act as a base for export. The export drive has necessitated the introduction of new technology on a large scale and the car firms have actively promoted investment and joint ventures by German component suppliers. In the Port Elizabeth airconditioner plant, production has been greatly increased through obtaining the contract to supply the C Class Mercedes. The Durban plant produces the radiator for the C Class but has also seen an expansion of exports into the aftermarket. The copper based radiator plant at Silverton, Pretoria, which was looking at reducing production because of the transfer of technology to aluminium-based radiators, has attracted additional business. Production from a recently closed copper based plant in Spain has been transferred to Behr (SA) and the same was expected to happen with a copper based plant in the US.

A few years prior to being acquired by Behr, the South African heat transfer division was spending 4 to 5 per cent of turnover on R&D. This was significantly higher than most component producers in South Africa and the firm was doing fundamental research and development. The South African operation had even developed innovative production technology, which had been licensed to the Behr Group. This process involved a new method of braising aluminium radiators using a specially developed powder. But this innovative capability was not a significant factor in the decision to make the acquisition and the situation has now changed radically. After the acquisition took place, all R&D activity in South Africa was transferred to Germany or shut down. The South African subsidiary now only does development work although its capability for this is expanding partly due to the high cost of assistance from the parent company.

South African management sees this development as positive for two reasons. Firstly, the South African subsidiary is now able to focus to a greater extent on its core activities. Secondly, they now have access to cutting edge R&D. A recent example of access to this know-how was a huge saving achieved in the course of a short visit from the parent company by a specialist in furnace technology. The Durban plant was set to invest ZAR 13 million in a new furnace to increase capacity but by reorganising the spacing of parts and the adjustment of heating elements they were able to increase the capacity of the existing furnace with no additional investment.

Since the acquisition the management team is virtually unchanged and there have been no expatriate staff introduced with the exception of technical staff seconded for relatively brief periods. Some of the plants have not changed very much since the acquisition. The biggest change has been at the Port Elizabeth air conditioner plant, which put in a new more automated line to supply components for the Mercedes W203 vehicles.

Other changes have been in purchasing where the company is now able to source sub-components much more effectively and at world prices. Significant savings have, for instance, been made on aluminium tubes. Savings on sourcing components are particularly important in the air conditioner plant where imported content is as high as 65 per cent.

The South African location offers a competitive source of supply into the Behr global network. Labour, tooling costs and some overheads such as buildings are very cheap in South Africa. An area where Behr (SA) is particularly competitive is in small batch production for the aftermarket. This is because levels of automation are relatively low and the South African subsidiary has considerable expertise in rapid changeovers and low volume production. This cost advantage has become increasingly realised by the parent company and the South African subsidiary is "playing an important role in the development of the worldwide spare parts business, as a supplier of heat exchangers" (Behr 2001).

Conclusion

With the liberalisation of the South African automotive industry, there has been a shift in the rationale for FDI. Previously a sheltered but growing domestic market provided attractive opportunities for foreign firms. The orientation was mainly towards the domestic market and there was some scope for domestic adaptations. Local companies also invested in this sector and were able to operate on the basis of licensed technology.

The basis of expansion has now become much more export oriented and it is increasingly important for component firms to have either direct or indirect access to export markets. The major asset contributed by foreign vehicle producers and component suppliers has undoubtedly been access to international networks. Carmakers have actively sought out component suppliers who are able to export and to supply components which meet the increasingly exacting standards of their own increasingly export oriented assembly operations.

Foreign firms have played a major role as conduits between domestic firms and the international market in four main ways. Firstly, they have arranged large export contracts for component suppliers by facilitating access to their global networks. Secondly, they have brokered new investment by encouraging foreign suppliers to establish joint ventures with foreign firms or to set up new plants. Thirdly, they have brought in new technology and, fourthly, they have frequently accelerated the transfer of industry best practices in production organisation to their suppliers. One of the main factors leading to the perceived success of the MIDP therefore, is that it has facilitated the increased internationalisation, which has underpinned growing exports and investment in the industry. Thus the spillovers resulting from foreign investment in the vehicle industry have mainly been of a vertical nature accruing to those suppliers who have had greater access to markets and technology as a result of being drawn into the international networks of multinational car companies (Saggi 2002).

The mode of entry (acquisition or greenfield) has tended to be a function of conditions in the particular sub-sector concerned. Where local firms operating in the sector have been available, a joint venture or outright acquisition has been favoured on the grounds that this was a cheaper and faster way into the market and also brought in local expertise and know how. In some instances this would involve a South African firm, which was already using licensed technology from the prospective investor. The latter case clearly reduces transaction costs for the prospective investor, as there would already be an existing relationship and possibly some commonality in the equipment and processes used. This clearly enhances the benefits of an acquisition relative to a greenfield investment. In the case of acquired firms the result has been a reorientation of production and incremental additional investment rather than wholesale changes to the plant and organisation, as would be the case in the extreme brownfield example. Greenfield investments have been pursued primarily in sub sectors where there has been no domestic capacity.

INDUSTRIAL MACHINERY – ZITON

Recently, outward investment by firms based in emerging markets has become of increasing importance. In spite of being a developing country, outward FDI from South Africa has exceeded inward FDI over the last decade (Nordas 2001). Firms of this type clearly are likely to offer a range of additional assets, which may be attractive to foreign buyers. Such assets may include advanced process and product technology as well as international distribution capabilities. The second case, Ziton, provides such an example. The company had developed from small beginnings into the world's twelfth largest producer of fire detection equipment with an international distribution network. It then attracted a buyer in the form of a US firm, which was interested in its technology and also wanting to expand its market share in Europe

Background to the Acquisition

Ziton was acquired in 1999 by US based Edwards Systems Technologies (EST), itself a subsidiary of SPX Corporation, a Fortune 500 listed company with a turnover of US$ 2.7 billion, 23,000 employees and operations in 21 countries. SPX Corporation pursues a strategy of expanding businesses, which have scale and growth potential. It has four major divisions: technical products, industrial products, flow technologies and service solutions. EST is one of nine groups within the technical products division. It has 500 employees in the US alone and has historically produced mainly for the US market.

The worldwide fire detection equipment market is growing fairly rapidly and is also experiencing rapid technological change. The global market is worth approximately US$ 600 million and growth prospects are good especially as legislative requirements for fire detection equipment continue to be tightened around the world. Competition is based on technology and features rather than simply on price. The requirement for approval by a recognised agency is a significant barrier to entry as this is expensive and time consuming and raises risks for new entrants.

The Early Growth of Ziton

From its roots as a small family owned company engaged in installing fire detection equipment in 1969, Ziton (originally called Firefite) developed into a major company with proprietary product technology and a global market. Ziton products are in the mid range in terms of price and quality and the company is a system producer providing full service support. At the time of the acquisition in 2000, Ziton had 450 employees in South Africa and also had a distribution and marketing office in the UK. Its 3.5 per cent world market share for fire detection equipment included 10 to 15 per cent of the UK and Australian markets, significant shares in a range of other European markets and 90 per cent of the South African market. Exports accounted for 80 per cent of annual sales of ZAR 400 million.

In the early stages of its growth, Firefite began to import equipment on behalf of other suppliers. Initial production was crude and took place in the home of the founders, using the kitchen oven to fire the parts used! The first products designed were conventional detectors and reverse engineering was used extensively. From the start because it "insisted on a high degree of home-grown components, Firefite established a fertile platform for encouraging rapid learning in-house in the area of production processes" (Wood 2000).

International operations started in 1984 with the opening of its UK office. In the same year, Ziton's first major technological breakthrough was the development of an analogue fire detection system, the first in the world. At the time of the sale to EST, 80 per cent of the product range was proprietary and the firm remained a world leader in analogue based fire detection equipment. The company has grown through organic learning and at the time of the purchase had an R&D staff of 50 - very large for a company of this size. Such has been the success of Ziton that it has been used as a case in business school courses on the development of indigenous technological capability (Wood 2000). The early emphasis on being close to the market has been retained and the firm developed a large international marketing and service back up capability with specialist representatives in over 30 countries.

The Acquisition and Recent Developments

EST took control of Ziton in October 2000 after a lengthy due diligence process. A previous potential buyer, which planned to shut the South African operation and transfer all the technology to the US, was rejected and the founders of Ziton have negotiated an arrangement by which the local operation had to be maintained. In fact EST are gradually transferring more production to Cape Town and all staff have stayed. EST has made a small injection of capital but as yet has not made major changes to the company.

Under the circumstances it is highly unlikely that EST would have established a greenfield plant in South Africa. It appears that even if Ziton had not been available, another acquisition elsewhere would have been the preferred option. EST had also considered a greenfield operation in Malaysia. There were four main factors motivating EST to acquire Ziton:

- Relatively low cost producer

EST found that Ziton's production costs were relatively low. The managing director estimated that they were 75 to 80 per cent of US production costs and in some cases the cost differential was even greater. The main cost advantages over the US are in labour and overheads. Labour costs are a third of the US cost and with labour efficiency being a third less than the US, unit labour costs are approximately half of the US level.

Overhead costs are much lower in South Africa - in most cases between a third and 60 per cent of the US cost. This was evident in a number of detailed cost comparisons, for instance dollars per line of computer code, and in the case of injection moulding, the cost per injection and per mould. In the case of an engineering document change, costs in South Africa were only 18 per cent of those in the US. Overall, overheads were 40 per cent of US level and total production costs (labour and overheads) are 50 to 60 per cent of the US level.

Surprisingly, there also appeared to be some savings in procurement costs compared to the US for products such as electronic components. Ziton also claimed that in some cases they were able to secure lower prices for major capital equipment items being imported from Europe and Japan. Management cited the case of pick and place robot imported from Japan at a price 20 per cent lower than EST had paid some 6 months previously. The electronics, plastics and metals being used are mainly locally sourced with circuit boards produced in China.

The reasons for the company being competitive are a combination of the technology they have as well as high volume production. While Ziton produces a wide range of products, a few account for the bulk of output. Four detectors and two bases account for 85 per cent of turnover and are each produced in volumes of approximately a million per year.

The previous owners took a conscious decision to avoid high levels of automation partly because they considered this to be cheaper in the South African environment but also because they felt it important to create employment. This philosophy combined with the rapid growth of the firm meant that they never had to retrench staff. Because of Ziton's low production costs, the new owners plan to relocate a third of US production to Cape Town. But they will also be introducing higher levels of automation so employment is not expected to rise significantly.

- The technological capabilities of Ziton

According to the co-founder of the company, one motivation of EST was to gain access to world leadership in certain types of technology especially as EST lacked cutting edge technology, which would enable it to compete effectively in the European market.

Indeed Ziton's technology and low engineering costs were such that in the due diligence process, EST decided that it would make sense to establish Cape Town as a base for its third engineering centre. EST's established engineering centre is in Sarasota, Florida and it has recently made an acquisition of a California based company, which will provide the engineering centre for gas detectors. Cape Town will be the third centre, involving an expansion of the existing Ziton research centre. More ambitious plans to develop a new type of detector in Cape Town were reversed in the face of the perceived political risk of investing a large amount of intellectual capital in South Africa.

The managing director's view was that while Ziton has some useful technological attributes, these were not critical determinants of the investment:

> 'The product line was in fact remarkably similar to what EST was producing but was just a lot cheaper. Having said that, Ziton had a unique combination of design and manufacturing….the whole style of the thing. Unlike some acquisitions where (the acquiring company) might have said "that is a brand name or that is a product or a patent which we have to have at all costs", it was a basket of things that they looked at including some key personnel'.

Although Ziton now has access to EST's engineering centres, the operations manager felt that to date there has been a greater transfer of technology from South Africa to the US than vice versa although there had been some sharing on a number of projects. EST have brought no new expatriate staff into Ziton although a number have visited on short assignments.

- A well established market and distribution system in Europe

An important aspect of EST's strategy is expansion in Europe taking advantage of Ziton's established marketing and distribution system. The objective here is to take advantage of the expected expansion of the European market as legislation changes. Current legislation in Europe is far more lax than in the United States with fire detectors only required in public buildings such as schools, hospitals and old age homes and it is expected that European legislative requirements along the lines of the US standard will lead to a rapid expansion in demand in other European countries.

- Complementarities between the two companies

There is considerable complementarity between the two companies. EST supplied at the top end of the market while the Ziton range was in the middle or lower end. EST plans to expand its market share in the US by introducing the Ziton range through its own distribution network.

Conclusion

The acquisition of Ziton represents a fairly unusual case where a foreign firm has invested to purchase technology and an international distribution and marketing network from a company based in a developing country. Before the acquisition, Ziton was considering a stock exchange listing and both the co-founder and the current managing director felt that expansion would have continued if the acquisition had not taken place.

It appears that Ziton has been an attractive acquisition for EST. It has been able to obtain a firm, which is operating profitably, with a significant share of markets in which it is only weakly represented. Ziton also has products, which may enable EST to raise its market share in its home (US) market. The combined group is now the third or fourth largest producer of fire detection equipment worldwide. In addition EST has secured a low cost production base as well as a firm with high levels of expertise.

The link to SPX provides access to capital as well as markets in new areas. This particular example of FDI has much in common with a normal acquisition but there has been a substantial rearrangement of the assets. The European distribution network is now an integral part of EST giving the US company direct access to an established network in a major and fast growing market. At the same time EST appears set to make much greater use of the low cost production and engineering capability of the South African operation, a benefit which appeared to have been much enhanced by the depreciation of the rand in late 2001.[39]

Ziton is a firm that could fit quite easily into the operating environment of a first world multinational firm. It was export oriented, had operated without significant protection and its own production operations were of a world class standard albeit significantly more labour intensive than would be the case in an advanced country. In addition the firm was profitable and could have continued to expand possibly with additional funding obtained through a stock exchange listing. All these competitive attributes make a brownfield investment less likely in the sense that the complete reorganisation of assets, as has been common in cases of ‘deep restructuring’ in Eastern Europe (Meyer and Møller 1998), would presumably have been both wasteful and expensive. Nevertheless, it is clear that the purchaser valued the assets of Ziton somewhat differently to its original owners. A key objective for EST was the European distribution arm, whereas the original owners appear to have placed more value on Ziton’s technological capabilities. EST appears to have come to a later realisation of the Cape Town plant’s low cost production and engineering capabilities.

In the more developed emerging markets, particularly where economies have not been unduly protected, it seems likely that foreign acquisitions would be less likely to take a brownfield form because potential takeover targets are likely to operate in ways that are familiar to potential multinational buyers.

FINANCIAL SERVICES – ABN AMRO

Because services are produced and consumed simultaneously, internationalisation in the services sector traditionally has involved 'market-seeking' direct investment to establish a commercial presence in foreign markets. Many multinational corporations in producer service sectors undertook substantial FDI during the 1990s aiming to construct 'global service networks'. Increasing competitive pressures in existing markets led these firms to offer corporate clients a 'global package deal' involving both product diversification and a wider geographical spread of operations (Dicken 1998, p. 393).

In the financial services industry, foreign entry facilitated integration into global financial markets and enhanced access to capital. During the early 1990s, host governments and international banks therefore had a mutual interest in deregulating and removing entry barriers to emerging market financial systems, and foreign banks became major players in many countries, especially in Central and Eastern Europe and Latin America (Roldos 2001, Clarke et al 2003, Dicken 1998). Financial system health is critical to aggregate economic stability and growth, with the trade-off between promoting market competition and avoiding potentially costly bank collapses especially important. National financial regulation and the strength of domestic banks are crucial factors in relation to foreign bank entry.

This case study examines ABN Amro's entry into, and presence in, South Africa, which has been shaped by three factors: the bank's efforts to create a global services network, the powerful competitive threat of South Africa's major domestic banks in the context of the liberalisation of the financial system, and the impact of the global financial market downturn from March 2000. ABN Amro established a branch in South Africa in June 1995, one of the first four to do so after banking was liberalised. The greenfield banking entry was soon followed by a partial acquisition in securities trading. In November 1995, the Johannesburg Stock Exchange was liberalised, and in June 1996 ABN Amro purchased 40 per cent (jointly with local and foreign partners) of Huysamer Stals, a South African stockbroker.

Entry Driver: ABN's Global Strategy

ABN Amro was formed in September 1991 through a merger of Algemene Bank Nederland (ABN) and Amsterdam-Rotterdam Bank (Amro). Both banks had reached their limits of expansion, but were confronted with rising competitive pressures. Both had relatively small shares (between 7 and 9 per cent) of the Dutch retail market, but limited M&A options, so that their merger was a "marriage of necessity" (Evans 1997, also de Vries et al 1999). Though Amro was successful in the Dutch corporate market, its corporate clients were increasingly expanding beyond Holland, especially into Europe, and needed a bank with a substantial international network. Amro's international business was small, contributing only 11 per cent of profit in 1986. Like many other mid-size European banks, it had begun looking for a partner amongst its European peers as '1992' loomed (Economist 26/3/88).

ABN, on the other hand, was small in the Dutch domestic corporate market, but a bigger player than Amro internationally, earning more than one-third of its profits outside Holland. It was long-established in South Asia and Latin America, and entered the US retail market (focussing on the Mid-West) in the late 1970s. During the 1980s, it successfully pursued a strategy of acquisitions in many countries. Continued international expansion was essential for future growth, but by 1990, ABN needed a capital infusion to strengthen its balance sheet for further acquisitions. A share issue was unattractive because it would dilute ownership, merger with a major European bank would (it was feared) lead to loss of the bank's identity, and the major Dutch insurers had significant US interests so that a merger was ruled out by the Glass-Steagall Act. This left only another Dutch bank as a possibility, with Amro as the leading candidate for organisational culture reasons. After the Dutch central bank relaxed its restrictions on mergers between Dutch banks from 1990, with its own eye on '1992' and the ongoing evolution of the European Union, the ABN-Amro merger moved ahead quickly.

At the merger, the new bank had operations in 48 countries, with 375 foreign branches, and was ranked 18th globally, in terms of total assets. The bank was organised into four autonomously operating divisions: the Netherlands Division; the International Division, supplying banking and financial services to both multinational corporate clients and consumers outside Holland; the Investment Banking Division, engaged in securities issuing and trading; and the Lease Holding Division, supplying fleet and equipment leasing services.

The merger sparked aggressive international expansion, and the bank's geographical spread and product diversity grew very quickly. By 2000, ABN Amro was in 74 countries, and had 2,709 branches and 76,140 employees outside of Holland (ABN Amro Annual Report 2001).[40] It had retail banking activities in 23 countries. Aiming to be a universal bank, it had begun investment banking only in 1992, but subsequently moved strongly into this area (Evans 1997).

Expansion was mainly via acquisitions, with an emphasis on relatively cheap targets that could be incorporated into the ABN Amro network and grown from within. There were two broad thrusts to the strategy. One focussed on retail operations within national economies, with an emphasis on large domestic markets such as the US, Brazil and India. ABN Amro hoped to establish a second “home market’ in Europe, but failed in this ambition. The second arm of the strategy aimed at a global financial services operation, with a multinational corporate client base. Based in a medium-sized financial centre, ABN recognised the limits of its investment bank prospects in the ‘first tier’ financial centres of London, New York and Tokyo. “We’re not an investment bank, we’re a universal bank. We want a balance [between] the more volatile profits in investment banking [and] the far more stable return from commercial banking.” (Evans 1997)

Rather than the more intensive, lending institution-focussed operational structure of investment banks in the first-tier centres, ABN Amro’s strategic orientation was customer-focussed and extensive. Adopting the slogan ‘the network bank’, it aimed to provide ‘relationship’ banking on a global scale, offering corporate clients as wide as possible a range of services in as many markets as possible. “In the overall relationship [between bank and client], we have more to offer than a Wall Street firm, because they can’t do business with a multinational in Ecuador or Taiwan.” (Evans 1997, also Els)

Entry into a market for ABN Amro thus involved not only market-seeking, to acquire new corporate clients in the new market, but also market-sustaining motives. Entry was intended also to expand the (geographical) scope of the bank’s network, to benefit existing clients investing in or trading with the newly-entered market. These clients in effect obtained network externalities, contributing to brand loyalty. In many countries, ABN Amro established large local branch networks to attract new clients: “we’re also interested in providing commercial banking services to [national] tier-two and tier-three companies, so we need a presence in ….secondary centres” (Evans 1997).

Entry into a new country was seen as a very long-term commitment: “We’re here to stay. We don’t close down branches easily.” (Evans 1997) Furthermore, the bank aimed to build on local strengths in order to secure domestic markets. The standard entry strategy was via partial acquisition of a well-established domestic institution. ABN Amro was cautious and risk-averse in selecting acquisition targets, avoiding expensive high-fliers in favour of modestly-priced middle-of-the-road respectability. The bank did not rush to impose its own identity or full control: it delayed re-branding to retain customer loyalty, and delayed acquiring outstanding shares especially from local managers. The bank emphasised its respect for local culture, and used local senior managers provide continuity for domestic business networks and employees: “The key is having the right local guy. .. a top manager who knows the market in, say, Delhi. If you just send someone from Bombay, you can forget it. …If you start by hiring second-tier local people, you’re never going to be successful” (Evans 1997).

ABN Amro's strategic approach would be fundamentally transformed from 2000, as discussed below. But first we look at the opening of the South African market to foreign banks.

Entry Driver II: Financial Liberalisation in South Africa

Before 1995, foreign banks could enter South Africa only as representative offices (agencies performing administrative and marketing functions only) or subsidiaries, which could take deposits, but were incorporated locally and got a South African rating. At end-1994, there were 40 foreign representative offices and 6 subsidiaries in the market. The major step liberalising the sector internationally was to allow foreign banks to open branches from May 1995. Branches are subject to the same operating conditions and capital requirements as subsidiaries and domestic banks. They are licensed to take deposits and deal in the forex and securities markets, and face the same liquid asset and minimum reserve balance requirements. Branches were barred from simply trading off their parent's balance sheet – as with subsidiaries, the foreign parent bank had to establish a strong balance sheet for the branch via a substantial infusion of "endowment" capital. Initial endowment capital was a minimum of ZAR 50 million (US$ 6.25 million)[41], with operating capital to be maintained at 8 per cent of assets, risk-weighted as for domestic banks. The initial endowment has now been raised to ZAR 250 million (US$ 31.25 million). But there are two important differences between subsidiaries and branches. Firstly, branches have the same international rating as the parent bank, allowing them to borrow more cheaply. Secondly, foreign branches were effectively excluded from the domestic retail market, since the minimum deposit by a natural person was set at R1 million (US$ 125 000), a limit dropped in 2001.

South Africa's banking system is highly concentrated – at the end of 1994, the four largest banks (all privately-owned) held 80 per cent of the banking assets and 82 per cent of deposits. The capital and deposit requirements imposed on foreign branches provided significant protection for the major domestic banks, which were already under pressure in the retail market from non-bank competitors, particularly consumer goods retailers, and from the rising costs of their branch structure. Lack of access to their parent's balance sheet was a further disadvantage for the foreign banks. But the ability of branches to use their parents' rating created strong incentives for banks to opt for a greenfield entry by establishing a branch rather than a subsidiary. This further protected domestic banks from becoming acquisition targets, though foreign banks until recently expressed little interest in acquiring domestic banks, given the small retail market and high purchase price (Euromoney Sept 1998). Price:earnings ratios for small South African banks were 14 to 18 during this period, but the large banks with extensive branch structures had ratios between 30 and 45. An acquisition would also have required regulatory approval, raising the transaction costs and delaying entry.

Liberalisation in the securities market followed a different pattern, in which domestic firms received little protection. In 1992, the Johannesburg Stock Exchange (JSE) began investigating regulatory reform, leading to new legislation implemented in November 1995. Similar to the 1986 'big bang' on the London Stock Exchange, the JSE's 'little bang' permitted limited liability and foreign membership, and introduced negotiated commissions and proprietary dealing by member firms together with capital adequacy requirements. Commissions dropped from 65 basis points to 25 between 1998 and 2001. Until 2002, foreign entrants were required to set up subsidiaries rather than branches. Domestic brokers were required to adapt to the new regulatory environment while simultaneously facing new competitive pressures from foreign investment banks seeking a share of an attractive new market. Given their distribution and sales networks, domestic firms were attractive acquisition targets for foreign firms.

Following liberalisation, entry into both the banking and securities trading market segments followed rapidly. In the mid-1990s, the South Africa financial services market was attractive for both market-seeking and market-sustaining investment. Growth in real output in the FIRE (Finance, insurance, real estate) sector has averaged 5 per cent per annum since 1994, compared with 2.7 per cent for the economy as a whole, and financial sector employment has increased significantly, in contrast to the decline in the rest of the formal economy. There were 638 companies listed on the JSE at the end of 1995, and in 1996, JSE market capitalisation ranked 14th globally (JSE Annual Report 1996), suggesting a large base of potential domestic clients, themselves increasingly engaged in cross-border operations. There was also a very strong foreign presence in industry and services – in 1994, over 550 foreign direct investors (firms with more than 10 employees) and nearly 1,000 more, smaller agencies and representative offices of foreign firms (chapter 7). Activity on the JSE was expanding quickly, trading volume rising from 2.2 billion shares in 1992 to 5.15 billion in 1995. The political and economic changes in South Africa also promised a wave of privatisation and 'black economic empowerment (BEE)' deals for investment banks.

The number of foreign banks grew rapidly: before liberalisation, there were 40 representative offices, which grew to a peak of 61 in 2000, while 15 branches were established during the period, though only nine are major international institutions. Seven smaller foreign banks have established subsidiaries. These numbers reflect that for many banks, entering the South African market was attractive, but not sufficiently so to justify the costs and risks of establishing a branch. Half of the entrants limited themselves to a representative office, and others entered in this form first, later establishing a branch. In the equities trading market, there have been approximately twenty foreign entrants of whom twelve remained in January 2003, when the JSE had 59 members.

ABN Amro's Entry: Choosing the 'right local guy'?

ABN Amro sought early-mover advantage in the banking sector by opening a branch immediately (Els). Greenfield entry via a branch (rather than a subsidiary) was predictable, given the incentive structure facing foreign banks, as discussed. The timing reflected ABN Amro's 'extensive network' approach at the time: an ABN Amro SA manager pointed out that "South Africa was the last big sophisticated market in which [the] bank did not have a presence" (Euromoney Sept 1998).

The target markets were the South African operations of its corporate clients elsewhere in the world, and the 'top 100' South African companies, particularly those with cross-border activities. The latter were offered access to off-shore borrowing in addition to banking services, and by May 1996, ABN Amro had been lead arranger on three large loans (each over US$ 100 million) for major South African corporates. "Expansion into Africa [was] a large part of the bank's South African strategy" (Euromoney Sept 1998). The bank also expected large FDI inflows into South Africa from Europe and the US.

ABN Amro also moved early into the bond market, issuing a four-year bond in October 1995 in the new Eurorand market, and taking on a market-making role in the domestic bond market as soon as private institutions were allowed in 1997. Though it requires a strong capital base and returns are low, the attraction is that dealers (predominantly foreign banks) build reputation and can generate new business in the secondary market.

ABN Amro's entry into securities trading in South Africa appears less well-planned, even though entry via partial acquisition of a mid-size firm was on the face of it more in keeping with the bank's standard approach than the greenfield entry into banking. In May 1996, ABN Amro and NM Rothschild had begun a joint venture in global securities trading. In South Africa, Rothschild was setting up Kagiso Financial Services (KFS) as a merchant bank focussing on privatisation and corporate finance, with the Kagiso Trust (a 'black empowerment' group) and Huysamer Stals (HS).[42] ABN Amro seems to have 'tagged along' with Rothschild and joined the deal, which involved the 40 per cent partial acquisition of Huysamer Stals in November 1996, with ABN Amro's stake 15 per cent.

But, as discussed below, HS was a poor choice of target, given ABN Amro's objectives in South Africa. Although HS was a well-established broker, in business for about 30 years, its base was the retail segment of the white Afrikaans-speaking community. It had an extensive branch network in South Africa and Namibia, serving large towns in addition to the main cities.

It focussed on private clients rather than the institutional investors which ABN Amro sought.

In March 1998, ABN Amro purchased the outstanding 60 per cent of HS, the other 25 per cent still held by Kagiso Trust. It stated publicly it was raising its stake two years earlier than planned. Additional staff were hired to serve private clients, though the eponymous Werner Stals claimed that ABN Amro was aiming for significant market share from the major savings institutions: "there will be six to eight really global players in the local market [after a shake-out], the rest will [be] discount brokers or serve private clients" (FM 6/3/98). Reflecting similar confidence, HS was rebranded in August 1998, and the firm committed to moving in November 2000 to a branded building immediately adjacent to the new JSE building, as Johannesburg's financial district migrated from downtown to the northern suburb of Sandton. The re-branding would have raised customer expectations of performance standards to international levels.

ABN Amro Lease Holding NV, the independently managed subsidiary of ABN Amro, acquired in full the fleet management operation of Investec, a South African bank, at the end of 1997. The cost was ZAR 500 million, and was the 16th largest acquisition in South Africa (Euromoney Sept 1998). In April 2001, this division employed 65 people, an increase of 5 since its acquisition. Like the international leasing division, the South African operation has been run separately from the local banking and securities divisions[43].

The entry into South Africa was a departure from the bank's standard strategy going into a new market, in which local banking expertise was a key resource providing client and business networks as well as local risk management expertise. Perhaps because the bank branch was a greenfield, a large group of ten expatriates was used, who had no South African, and limited emerging market experience. Nonetheless, there were still four expatriates in South Africa six years later, while Werner Stals had been appointed head of the overall operation in June 1999, even though his banking experience was limited to his time with ABN Amro. Early re-branding was also unusual for the bank: for example, several longstanding acquisitions in the US and Europe (including LaSalle bank acquired in 1979) were rebranded only in early 2003 and even then retained their own names (www.abnamro.com).

It is possible that the sophistication of South Africa's financial services sector and the strength of the local institutions (at least in the domestic market) were underestimated at the time of entry and South Africa was treated as 'just another' emerging market. But the lack of local banking experience and business networks was felt later when the bank was forced into the medium-size corporate market in search of clients, and several loans went sour. The local partner – a securities broker – was relied upon for distribution and business networks, a second key resource, but this was inadequate. On the securities side, furthermore, only a single expatriate was brought in, despite a trading skills shortage, and there was little integration with the bank's wider trading culture and systems.

The HS research team was a third key resource for entry, identified (again in hindsight) as a major reason for acquiring an equity broker, which could provide information on local corporations to increase the domestic investment banking market share. But according to a member of the securities research team, there was almost no contact with the local branch of the bank before November 2000, when the two divisions moved into the new building. On the other hand, the South African research team supported global equities research in London, having ongoing contact on resource companies (Kruger). In other words, South African research supported the investment banking operation , rather than either the market-seeking or the market-sustaining activities which had ostensibly motivated entry to South Africa.

ABN Amro's Performance: Progress followed by Retreat

Given the sub-optimal nature of the key resources for entry, it is perhaps unsurprising that, while early entry initially paid off, the local operation faltered badly after 1998. The optimism reflected in the early expansion of the stake in HS and the brokerage's re-branding was not realised.

Tables 8.1 and 8.2 provide indicators of ABN Amro's market penetration and competitive position. Table 1 shows total assets (including domestic and foreign assets) for ABN Amro and a 'peer group' of six other foreign banks: Citibank, Commerzbank, ING Barings, JP Morgan Chase, Credit Agricole and Deutsche.[44] During the first three years, ABN Amro outperformed the peer group, but as the number of foreign banks increased from 1998, ABN Amro grew slower than the others. The table may underestimate the banks' South Africa-based business: according to ING, as much as two-thirds of loans may be booked off-shore, and fee-based income up to 60 per cent of total earnings (FM 25/4/97).

Opinion of ABN Amro in the market was initially favourable: an annual survey of financial directors of 100 large multinationals operating in South Africa placed ABN Amro as the top foreign financial institution in 1997 and 1998, ahead of both Commerzbank and Citibank (PMR Review Dec 1997, Oct 1998). An annual 'peer review' of banks saw ABN Amro improve its ranking amongst foreign banks steadily between 1996 and 1998 in the corporate banking and treasury categories (Price Waterhouse Cooper, various years). ABN Amro's excellent reviews in the latter two functions in 1998 was not matched in securities dealing or corporate finance, a possible indication of the securities division's future difficulties (Table 8.1).

Table 8.1 ABN Amro Total assets in South Africa, compared with peer group

End of	Total assets (ZAR bn)	ABN Amro asset growth (% p.a.)	Peer group asset growth (% p.a.)	ABN Amro rank	No. of banks
1995	102	n.a.	n.a.	3	3
1996	1620	1488	164	3	4
1997	2995	85	76	3	5
1998	3414	14	43	4	7
1999	3300	-3	11	4	7
2000	3851	17	19	4	7
2001	7177	86	133	5	7
2002	5179	-38	-45	4	7

Source: SA Reserve Bank. The figures for 2001 and 2002 partly reflect currency fluctuations as the ZAR was very volatile during these years; these of course affected all banks. The rank in Column 4 is by size of assets.

From 1999, the steady progress slowed and then reversed, and by 2003, the bank was in retreat in South Africa, as reflected in Tables 8.1 and 8.2, notwithstanding the imperfections of the indices.[45] In a separate rating of forex dealers, ABN Amro dropped from 6th in 2002 to 10th in 2003 in the ZAR market (Euromoney May 2003).

Several medium-sized domestic corporates to whom the bank had made loans ran into financial trouble, with associated fraud allegations (BR 14/5/99, 7/7/99, 11/11/99, 30/11/99, 10/01/00, 12/4/00).[46] Though there was no suggestion of any impropriety by ABN Amro, this raised questions about the bank's risk management. In 2003, the (Dutch expatriate) Country Manager acknowledged that there were still "echoes" of these problems, which he argued were a consequence of acquiring the "wrong" equity broker: HS links with "quality" South African corporations were inadequate, pushing the bank into a lowermarket bracket with less rigorous business ethics. In other words, the lack of South African banking experience was telling.

In 2002, ABN Amro management claimed that "30 of the top 50, and 50 of the top 100, listed South African corporations use ABN Amro for the services it offers, together with around 60 multinationals." Nonetheless, in corporate finance, the bank retained "only one or two professionals to source business, flying in their overseas team when necessary" (BD 13/3/02). By 2003 non-core services had been abandoned or outsourced to domestic banks, including local cash management and clearing functions.

Table 8.2 Competitive position ABN Amro's ranking in peer review

	No.	Equities	Bonds	Treasury	Corporate Banking	Corporate Finance	Project Financing
1996	25			3	6		
1997	31			3	3		
1998	28	7	6	2	1	7	5
		Institutional brokerage	Retail brokerage	Money market	Corporate Banking	Corporate finance - M&A	Structured finance - projects
1999	26	10 (6)	7 (4)	11 (4)	6 (2)	13 (8)	7 (2)
2000	30	n.r.	n.r.	n.r.	n.r.	n.r.	n.r.
2001	27	n.r.	n.r.	n.r.	9 (4)	n.r.	n.r.
2002	32	n.r.	n.r.	n.r.	n.r.	n.r.	n.r.
2003	22	n.r.	n.r.	n.r.	n.r.	n.r.	n.r.

Source: PriceWaterhouseCoopers, various years. Respondents were asked to identify the top three banks in each category. From 1999, some ranking categories changed. Before 1999, local and foreign banks were surveyed and ranked independently; after 1999, they were combined. Brackets indicate ABN Amro's rank amongst foreign banks. n.r. = not ranked, ie. none of the respondent banks rated ABN Amro in the top three (local and foreign).

In the bond market, the lack of benefits to dealers started becoming a source of concern in early 1999 (FM 26/2/99, BD 27/7/00), and ABN Amro retrenched its bond team and withdrew from this market in August 2001. In mid-2002, a senior ABN Amro manager wrote this off as part of the "learning process" in South Africa, and insisted the capacity would be rebuilt, though the market view was that this would require a substantial premium on salaries (BD 9/7/02).

Reversal in securities trading was most dramatic. In Dec 2000, just 28 months after the re-branding, the bank withdrew from the South African retail market, selling the private client business (which had 23 000 clients and ZAR2 billion in assets) to Gensec, an offshoot of the largest Afrikaans financial institution (BD 21/12/00). In May 2001, the rest of the division was closed, with the loss of 35 jobs. At the time, there were an estimated 72 brokerages in the South African market, of which only 15 were profitable. The top eight firms, six of them foreign, held 85 per cent of the local market. ABN Amro was outside the top ten (BD 2/5/01, FM 11/5/01). Management argued in 2002 that by 2001 (before the global strategic shift discussed below), 60 per cent of South African equities trading was out of London, making it more efficient to use London-based research. But in closing, the bank lost its local partners: Deon Huysamer resigned when the private client business was sold, and Werner Stals after the securities trading division was closed.

Its reputation as an employer in the domestic financial services industry was severely dented (Kruger). This was most uncharacteristic, given the emphasis previously on being a good employer: "the perception is that ABN Amro is a bank that's good to work for. …That lets us attract good local people…We don't lose many people." (Evans 1997) Employment in South Africa had grown from 30 in 1996 to 75 in 1998 and 320 in 2000, but then shrank to 96 in 2002 and 45 in mid-2003. At this time, most of the ABN Amro building in the heart of Johannesburg's new financial district was rented out.

ABN Amro's profitability in South Africa was low. According to data from then-Country Head Werner Stals, South African (after-tax) profits in 1999 were less than 1 per cent of ABN Amro's global profits. In 2000, this dropped to below 0.5 per cent. The banking and leasing divisions each had profits of around ZAR 4-5 million in 1999, and ZAR 6-7 million in 2000, but the securities division went from profit of ZAR 10 million in 1999, to losses of over ZAR 2 million the following year (before the financial market downturn). These numbers seem extraordinarily low even in local currency terms, given the size of the banking assets (over ZAR 3 billion) and the cost of acquisition of the fleet management division (ZAR 500 million). The contribution to global earnings was further reduced by substantial ZAR depreciation from 1996.

Accounting for the Retreat: Strategic and Systemic Factors

By 2003, the bank's South African operation had limited visibility in the domestic market, its staff was small and earnings were negligible. There is no evidence of the original securities acquisition, or the fixed-income trading presence. Management now present the acquisition of HS as, in effect, part of a brownfield entry, arguing that the equity market link was a useful mechanism for expanding the bank's global network in both investment and corporate banking. But a brownfield implies a conscious strategic choice at entry, whereas ABN Amro South Africa clearly looks very different from what was envisaged in 1995, or even 1998. As already noted, the bank's initial loss of momentum is attributable to its abandonment of its standard entry strategy, which in turn was partly a consequence of regulatory constraints in South Africa on entering foreign banks. The ongoing retreat from the South African market is similarly due to a combination of the firm's global strategic choices and broader developments in the domestic and global financial services industry, in particular intensified competition in the domestic industry and the global financial downturn from mid-2000.

The bank underwent a fundamental strategic re-orientation at the global level from May 2000, when a new chairman – Rijkman Groenink – was appointed. The organisational structure shifted from a geographic to a product basis, with three autonomous divisions established for wholesale clients, retail clients, and private clients and asset management respectively. In addition to the Netherlands, the bank identified the US Midwest and Brazil as 'home' markets for the retail division, and retail operations in 26 countries were closed. Wherever their location, staff now reported directly to division heads in either Amsterdam or London, and the independent authority of country managers was severely downgraded. "The main driver for the re-organisation [was] the external perception of ABN Amro as indicated by the share price, rather than a belief within the bank that the [existing] structure was fundamentally wrong. …compound average total shareholder return of 31.9 per cent per annum has been achieved throughout the last 5 years…[but the price:earnings ratio is] barely more than half of other banks in the sector" (FV 30/05/00).

Characterised by top management as a bigger change than the 1991 merger, the re-structuring aimed to create a network which is investor institution-focussed, (capital) supply-driven, and vertically-integrated, in sum, intensive rather than extensive, and similar to those of banks in the first-tier financial centres. Groenink said that "the bank no longer aimed to be all things to all people …. universal banking is dead within ABN Amro….[He] identified two main weaknesses: no focus on investor value as the ultimate driver….[and] the structure was too complex, [with] fuzzy responsibilities and no accountability." (FT 31/5/00) A group of 20 'peer' banks in the US and Europe was explicitly identified, with the goal of putting ABN Amro's shareholder return in the top five of the peer group by end-2004 (FV 17/8/00). In mid-2003, the bank was at number 12 out of 20, and it had not been in the top 10 since January 2001.

The promotion of shareholder value up the list of priorities inevitably involved a relative downgrading both of customer service and of employee voice and security. ABN Amro management continue to insist that "the total network philosophy remains important ... our clients will decide where we are, not us….[but] if we come to the conclusion that we are number 33 on the banking list of a major global corporate, we think that we would both agree that there is no relationship. In the old days, corporates would have more than a hundred banks. Now they are looking for fewer but closer relationships" (Euromoney October 2001).

The South African securities and bond market divisions were clearly victims of the restructuring and securities trading in all emerging markets except China, India and Brazil is now run directly out of ABN Amro's London offices. Decision-making became much more centralised and country managers with a local orientation found their strategic approach rejected. Stals argued that "value was destroyed by poor decisions at the centre."

According to South African managers more supportive of the shift, the new structure makes it inappropriate to evaluate the bank on a country basis: "the entire concept of a branch is gone…the focus now is on client profitability, and no longer on product profitability". "The bank is not interested in country market share, but in 'client's wallet' share". The South African operation reports to the Wholesale Client Services unit (WCS), which is divided into five sectors on the basis of clients' industrial activity. Capital is allocated to clients centrally, and return per client must clear a globally-defined risk-adjusted hurdle rate. Risk management is done on a client basis, taking country and internal risk into account. As a result, profit earned in South Africa, however small within the overall bank picture, is not relevant, say local management: "South African companies do a lot of varied business [with us] in Europe, though not in South Africa."

It seems that the bank's global service network has lost its 'grounding' in South Africa, and its current operations appear more of a representative office, a "listening post". With local activities barely served, and client service managed abroad, it is hard to assess the value added by activities *in* South Africa. The distinction between direct investment and imports has become blurred, as often the case in services. Nonetheless, the board has decided to maintain the branch, rather than scale back to a representative office, because South Africa represents the bank's last remaining presence in Africa.

ABN Amro's attempt to abandon geographical structure can be contrasted with alternative approaches to vertically-integrated global service networks. A senior South Africa manager of another major (London-based) bank[47] indicated that the South African operation is "one hundred per cent" integrated into the global operations of his institution, which also uses global risk management and capital allocation procedures, which are "very conservative with strict global procedures from which South Africa can't deviate." However, clients are defined on a country basis, so that all services to a South African-based client are evaluated as 'South African product', even if the services were provided (and billed) outside South Africa. The relationship managers for all South African corporations are part of the bank's 'SA team', even if not physically based in South Africa. This bank thus distinguishes its internal market evaluation processes from accounting for tax and regulatory purposes. This bank has introduced many new products into its South African operations, using a thousand-strong international managers group on a short-term basis to train local employees in internal risk and credit procedures.

ABN Amro's strategic decisions were reinforced by the collapse of the 'dotcom' bubble which coincided almost exactly with the bank's strategy change. The added pressure on profitability reinforced the decision to focus on shareholder value, with several major international banks (particularly in Europe) starting to look for fresh capital (FT 27/11/02). Necessary increases in loan loss provisions, tighter management of risk and cutting of costs were much easier to implement in a centralised, vertically-integrated network. Mid-size international banks like ABN Amro, which had tried to break into a range of high-margin, high-cost services in global competition with "bulge bracket" banks like Citibank, Deutsche and JP Morgan Chase, were forced to cut back as the downturn deepened and their volumes could not support the high costs of these services, leaving them over-extended. The impact spread throughout the global network: operations in small markets such as South Africa became expendable early on (BD 9/7/01), but later even large market activities had to be cut, such as investment banking in the US (BT 14/4/02).

In South Africa, foreign banks were caught in a local cost squeeze in relation to the international pressures. The rapid influx of foreign banks from 1995 increased competition dramatically, but market growth failed to meet expectations. GDP growth between 1997 and 2002 averaged 2.3 per cent per annum, and privatisation, FDI acquisitions and 'Black Economic Empowerment' deals all slowed. The result was a heavily overtraded market, pushing margins to low, developed country, levels: South African banking margins of 3.42 per cent are comparable to the US (3.65 per cent), the UK (2.66 per cent) and Australia (2.78 per cent) (KPMG 2002), while brokerage commissions are now at 0.15 per cent for institutional clients, down from 0.35 per cent five years ago (FM 24/01/03). The ZAR depreciation further cut returns in home currency terms.[48]

Modest revenue streams in South Africa are not offset by low costs. The regulatory requirement that foreign branches maintain their own balance sheet imposes a significant cost on South African operations. Externally-supplied capital carries a country risk premium due to South Africa's 'emerging market' rating. Even sovereign South African assets require 'full solvency' capital backing, demanding returns 75-100 basis points higher than margins allow. SA corporate hurdle rates within ABN Amro are at the same levels as US blue chips and 50 basis points higher than competitors for capital such as Central European companies.

Secondly, financial sector depth – part of the attraction for foreign banks – results in high operating expenses. The foreign banks' entry created skill shortages and high labour turnover in the sector and salaries costs rose. By 1998, foreign banks felt that "expatriate employees [were] becoming cheaper than the locals" (Euromoney Sept 1998), though relatively few expatriates seem to have been brought in. A 2001 survey reported that foreign and local financial services salaries were close to par in nominal terms, though living costs are far lower in Johannesburg (FM 25/5/01). Before "9/11", the financial services industry had the highest pay structure in South Africa, even non-professional staff being paid more than elsewhere. According to a sector human resources consultant, banks would headhunt and pay whatever was demanded and the foreign banks tended to poach staff from each other . After "9/11", salaries stopped rising, but Citibank, the only bank still expanding, continued to pay a premium of 30 – 35 per cent to attract staff from rivals.

Facing both global and domestic cost pressures, many second-tier international banks have cut back or withdrawn entirely from South Africa in the past 2 years, though ABN Amro is thought to have retrenched more South African staff than others (BR 14/11/01).The list includes ING Barings, International Bank of Southern Africa (the local arm of Banque Paribas), CSFB, Societe General, Credit Lyonnais and Merrill Lynch, which sold its bond dealing and private client business in November 2001, reducing employment from 230 to 90, even though it was in the top six South African brokerages. The top-tier banks – Citibank, JP Morgan Chase, Deutsche and HSBC – have been able to raise their global market shares in investment and corporate banking by maintaining high-cost international operations, and have maintained a strong presence in South Africa, though they have also come under some pressure (FM 24/01/03).

The major domestic banks have re-asserted their dominance in the sector, and are now in a very strong position competitively. The top five South African institutions controlled 86 per cent of total banking assets and 88 per cent of corporate loans at end-2001, after slipping back to 76 per cent of assets in 1998 (KPMG 2002). All but one second-tier domestic banks have either been absorbed or collapsed over the past 2 years, the number of South African banks dropping from 44 to 33 during 2001. Though the "big five" domestics remain worried, about Citibank in particular, they believe they have "seen off the foreign competition" (Euromoney Sept 2002) and that they are relatively invulnerable to foreign takeover (BR 29/5/2003). Because they are relatively small in the international arena (ranked between 146 and 331 globally on Tier 1 capital at end-2001), they have been protected from the gales of the global financial market downturn. Furthermore, the country and currency risk premium offer them some degree of protection in the domestic market, where their dominance of the local interbank market allows them to obtain funds cheaply. They have addressed high cost -income ratios by cutting back in the retail market via branch closures, and have thus far avoided the costly investments required to extend financial services to South Africa's large mass of poor people. However, they remain relatively unprofitable - average after-tax return on equity for the three years 2000-2002 was 9.2 per cent, while the CPI averaged just over 7 per cent - and concerned about slow market growth.

Impact on Development

Spillovers of technology, productivity and skills from foreign firms to local competitors, suppliers, customers and employees are generally used to motivate foreign investment, but it is notoriously hard to find strong empirical justification for their existence, and especially difficult when considering a single firm. However, ABN Amro have undertaken some specific training activities, and skills transfer would also have occurred in the context of ongoing operations. Research staff in ABN Amro's securities trading division participated in workshops and conferences with bank staff and were sent on at least one internal training course per annum in Europe. As part of the global research team, they also participated in joint projects with internationally-experienced colleagues (Kruger). On the banking side, ABN Amro worked to familiarise South African corporate treasurers with new products and approaches by holding training courses for clients run by ABN Amro staff brought in from abroad. In addition, local banks have drawn on ABN Amro expertise by seeking co-operation on projects in specific sectors where the Dutch bank is known to be strong, such as energy and telecoms.

More generally, it is argued that the entry of foreign banks and brokerages has improved efficiency in the banking and securities markets, by importing standards and quality measures from parent companies and developed-country markets in research, regulation and risk management. Foreign banks have also introduced new products to South Africa, such as warrants (introduced by the local Deutsche branch), derivatives in interest rates and currencies and asset securitisation. These have led to marginal reductions in the cost of capital. Though foreign bank pressures on the "big 5" domestic banks led to reduced costs and increased efficiency, the level of competition now is arguably lower than five years ago. Cost-cutting was in part at the expense of domestic consumers, so the net welfare impact is unclear. As already noted, foreign bank entry led to a skills shortage and a 'once-off' rise in wages and salaries in the sector, even for non-professional staff. Again the consequences for overall costs and efficiency are unclear.

Conclusions

Several conclusions can be drawn. First, the standard distinction between market-seeking and resource-seeking motives for entry into foreign markets does not always apply in services, particularly producer services. There is often a more complex mix of motives between market-seeking and 'market-sustaining', that is, establishing a presence both to acquire new domestic clients in a target country but also to consolidate the firm's *existing* base of foreign clients trading with or operating in the target country.[49] As the foreign firm aims to create a global network, market conditions and growth of market share amongst domestic customers may not be the only consideration in the firm's strategic approach.

For these reasons, the drive to expand the network can dominate other considerations in the corporate entry strategy, leading to costly errors even in large corporations. This is illustrated by ABN Amro's abandonment of its emphasis on selecting the right management and ensuring a cultural fit. ABN Amro has not established the intended presence in South Africa, but it has expanded its customer base in existing European markets by picking up South African corporate clients, and has sustained its existing customer base of large multinational clients by offering services in South Africa.

Secondly, the case illustrates the limits of the 'global service network' model. An extensive network is extremely costly, requiring a presence in many small markets, and this cost structure pushes firms towards more intensive, centralised, structures. Furthermore, when service corporations with global networks face competitive pressures in major markets, the firm is able to cut back in less important markets, rather than where the pressures actually appeared. Thus, market-focussed service corporations can react in similar 'footloose' fashion to resource-seeking manufacturing investors with commodity value chains. Incorporation into global networks is not an unambiguous benefit to the host country, notwithstanding improved access and efficiency.

Third, although foreign entry has further integrated South African *markets* into global financial markets, local financial institutions are not fully integrated: the domestic banks are still protected by country risk and by regulation, and competition in financial services has declined. The case study also confirms evidence from the FDI survey (chapter 7), which suggests that South African service firms have reacted vigorously to the threat posed by foreign entry.

Fourth, the domestic response is linked to the regulatory environment: an effective regulator shapes entry strategies of foreign investors and influences their prospects for success. But is the regulatory focus 'development', or simply the protection of domestic firms? In South Africa, foreign entry has contributed to an 'overdeveloped' financial services sector, that is, a sector where the top end of the market is high-tech, efficient and competitive, but at the bottom end services are underprovided and very costly to consumers.

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