# chairman's report

ROGER JARDINE
*Chairman*

***"Extraordinary measures are required to return us to a path of sustainable growth. Central to this effort is infrastructure construction and maintenance, which is the flywheel for economic growth and large-scale job creation."***

~ Cyril Ramaphosa, July 2020

President Ramaphosa made this statement over two years ago and has regularly acknowledged the criticality of South Africa's infrastructure programme as a key driver of his economic recovery strategy. Yet, it is hard to identify one government-led infrastructure project of any significance that has actually been executed. Progress, in other words, has been to date, glacial. The pace does not correlate to the stated "extraordinary" nature of the measures required. Extraordinary suggests urgency, immediate action and focus.

Whilst the need for the infrastructure programme rollout and other economic reforms is widely accepted, implementation has been painfully slow. So, what is the disconnect between the President's plea and the lack of delivery?

It is true that post the state capture years, closely followed by the Covid-19 pandemic, there remains massive strain on government finances. This may be a small part of the reason.

My view on the primary reason for the slow pace of change – and this is something I have covered in previous statements – is the historical unwillingness to crowd in the private sector. I do acknowledge that there is some evidence of a shift in this thinking in some parts of government, which is welcomed, but we have a long and difficult road to travel together.

There have been some promising developments, particularly in the energy space. Again, government was slow and the electricity grid was, and remains, on its knees before they embraced partnership with the private sector. The raft of new measures announced by the President in July could be game changing for the country. These measures, however, remain high level and there are some crucial actions required to fix Eskom's capital structure, revise the National Energy Regulator of South Africa's (NERSA's) regulatory and pricing powers, amend the Electricity Regulation Act, and deliver grid expansion. In addition, the government must urgently accelerate the procurement of new generation capacity through increased private investment. This has been achieved at scale in other markets.

The reforms in the logistics sector are helpful first steps in ensuring that the country is investing in infrastructure that has a multiplier effect on economic growth, and positions South Africa as a strategic trade corridor on the continent.

It is most unfortunate that thousands of kilometres of rail are inefficient or simply not functioning at all anymore. Industry estimates put the export revenue forgone due to ailing Transnet infrastructure and operations, rampant crime on its railways and a shortage of locomotive spares, at around R40 – R50 billion annually (coal, iron ore, chrome and manganese). This represents a material loss of foreign exchange, corporate income tax payments and potential jobs, and unfortunately does not portray the country as a reliable supply destination for buyers seeking these commodities. The 16 rail slots that have become available for the private sector to run, manage and invest in fall well short of what is required to fundamentally overhaul logistic infrastructure and notably improve efficiencies.

Equally, it's well known that South Africa's ports are among the most inefficient and costly in the world. This must change. The longer port authorities take to establish partnerships with

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the private sector to help improve operations and address bottlenecks arising from old technology, ageing (and worn-out) infrastructure and inadequate container capacity, the bigger the risk that the market share recently lost to the likes of Maputo Port Development Company in Mozambique becomes permanent.

The GDP growth sacrificed by the neglect of the country's infrastructure assets has been enormous. Investment to GDP in South Africa is stuck at 14% – a paltry number compared to other emerging markets. It is to be hoped that the commitments made by Operation Vulindlela start to have an impact and scale that 14% to at least 25% over the next decade. It is definitely achievable.

FirstRand is committed to deploying its financial and human capacity to support the government in its endeavours. The group is proactively engaging to support systemic state-owned entities that own and control network infrastructure and industries that are critical to the economy and its recovery, and this extends to agencies responsible for the procurement of projects. Our support for these entities continues to be targeted and aimed at sustainable development. We are committed to assisting government in capacity building within its institutions to enable the delivery of critical infrastructure.

Delivery also hinges on the procurement regimes that follow these reforms and the degree of liberalisation that is introduced. Government has an established track record in the renewable energy sector. It is imperative that this is now carried into other network industries as the country does not have time to waste.

One reason we do not have time to waste is that South Africa is currently enjoying the benefits of a strong, albeit fading, commodity cycle. This has boosted our terms of trade, which in turn created welcome fiscal and balance of payments capacity. However, given the cyclical nature of the commodity cycle, it is highly unlikely that this temporary revenue boost will present a long-term windfall. Therefore, it must be urgently utilised to assist the transformation of the economy's production capacity.

The revenue windfall that South Africa is enjoying cannot be underestimated. At the start of fiscal year 2021/22 the fiscal deficit was projected to be around 9% of GDP. In the event it registered closer to 5% (representing a windfall of around R200 billion relative to expectations). Similarly, the Minister of Finance forecast a deficit of 6% for 2022/23. This estimate already seems conservative in the face of tax revenue overruns. Forecasters are putting the deficit for this year below 5% – presenting another sizeable windfall relative to expectations. These positive surprises supported a stabilisation of the government debt trajectory over this period, paving the way for rating agencies such as S&P Global Ratings to acknowledge the improvement in government finances by shifting their outlook for South Africa's sovereign debt rating from stable to positive.

It is encouraging that National Treasury is not extrapolating the commodity-induced fiscal windfall into the future and is viewing it as temporary, reflected in its low nominal GDP growth estimates, particularly for the 2022/23 fiscal year. It is clearly determined not to repeat the mistakes various emerging economies have made in the past. Also, by explicitly stating that funding for new large permanent increases in expenditure must come at the expense of spending elsewhere, it's clear National Treasury is of the opinion that tax revenues associated with future commodity price windfalls should be reserved for ways to lift the county's potential growth rate.

The improved fiscal position could also be used to decrease the potential negative social impacts that often comes with change. If real structural reform gets traction, it must be accompanied by investment agendas covering youth employment, tax incentives and public works programmes. Retooling, reskilling and additional training plans should also be part of the mix. Some of these initiatives have already been put on the policy table in one form or another, and implementing them would result in providing a socioeconomic transition as part of the potential higher growth rate. Again, crowding in the private sector will be key to success.

The combination of the push from the Presidency and an improved fiscal position is a gift to execute the necessary reforms. It could deliver some profound outcomes and a common purpose for all stakeholders determined to improve the living conditions and prospects of all South Africans.

Now, more than ever before, South Africa requires a decisive approach to its national growth strategy. There is no room for interminable processes that only serve to delay the implementation of policies that are urgently required to kick-start our economy. In my view, a government is elected to govern and take tough policy decisions. In this regard, the government must abandon the notion that the process of social compacts will guarantee the efficacy of moving ahead with key programmes that will stimulate economic growth. Given both the scale and urgency of the projects or programmes I have described earlier, it is clear the road to success requires strong private sector collaboration. To this end, the government and the private sector should meet to agree on priorities and a plan to implement them. Indeed, this approach would be a powerful catalyst for the "extraordinary measures" that the President believes will place us on a path of sustainable growth. There is no plausible plan for South Africa to prosper without the private sector playing a strong role.

Although there still appears to be support among some policy makers for a state-led approach to economic development, it is undeniable that only a functional, capable state will be able to deliver on a growth agenda. The state currently possesses neither the financial nor human resources to meet the social and economic needs of South Africa. This is demonstrated by the fact that the country is struggling with the most basic underpins to economic growth and development, namely effective basic public services, an investor-friendly operating environment (also important for supporting small business development), appropriate investment initiatives, and skills and technical capacity. High-quality and reliable government services, such as a constant supply of electricity generation, reliable transport, and functioning healthcare and education systems are not features of our daily lives.

I have previously said that the time has come to acknowledge that a developmental state (which some take to mean state-led growth and employment initiatives) for the twenty-first century must implicitly position the private sector appropriately as the engine for economic growth, investment and job creation. It is for government to create an enabling environment to make this happen.

Circling back to FirstRand, the consistent feedback that we get from investors, domestic and international, is the urgent need for structural reform in South Africa. The country has many world-class companies with highly respected management teams and, compared to other emerging markets, strong corporate governance credentials. However, many are trading at low valuations. The drag on economic growth is a massive obstacle for investors, and until they see real commitment and action on structural reforms, they will not change their position. Macros always matter.

More importantly, the slow pace of the implementation of structural reform is severely constraining the ability of South African companies to grow and create much-needed employment. It is well known that the structure of the South African economy needs to undergo changes that will lift the potential growth rate well above the anaemic level that is keeping our country from fulfilling its potential and promise to all citizens.

FirstRand's businesses continue to navigate this low-growth environment with remarkable resilience, as demonstrated in its latest set of results for the year ended 30 June 2022. In the *CEO's report*, Alan Pullinger unpacks the strategies that the group executed on both during and immediately after the pandemic. These strategies were particularly focused on strengthening the balance sheet, building available financial resources and positioning the group to grow into a post-pandemic recovery.

The results themselves were excellent and in the *CFO's report*, Harry Kellan provides a detailed unpack of the performance. The 23% increase in the group's normalised earnings was driven by the materially lower cost of credit, which reflects origination strategies and the continued post-pandemic recovery across the jurisdictions in which the group operates.

Topline growth was healthy, driven in particular by the rebound in non-interest revenue (NIR), and costs were well managed. Pleasingly, at 20.6%, the normalised ROE remains well situated in the target range of 18% to 22%. The group produced R10.1 billion of economic profit (2021: R4.9 billion), or NIACC, which is its key performance measure.

The Common Equity Tier 1 (CET1) ratio increased to 13.9% (2021: 13.5%) and, given this strong capital level, the board was comfortable with materially increasing the payout to shareholders. The combination of a drop in cover to 1.7 times and a special dividend of 125 cents per share resulted in a total payout of 467 cents per share (the highest payout level in the history of the group at R26.2 billion). Despite this high level of payout, FirstRand remains capital generative and has the necessary financial capacity to increase momentum in risk-weighted asset (RWA) growth in the 2023 financial year.

I would like to congratulate the FirstRand management team on delivering these outcomes for our shareholders. The group continues to outperform its local peers and many other banks in

the world in its ability to deliver superior returns to shareholders in the form of economic profit and growth in net asset value – which now leads me to comment on the topic of executive remuneration.

In the group's remuneration report for the year the chairman of the remuneration committee has unpacked in detail how we continue to evolve our approach to reward based on shareholder feedback. I would like to extend my thanks to our shareholders who continue to engage proactively with us on this very important topic.

Last year we made wholesale changes to our policies and practices. I believe this was acknowledged, given that the majority of our shareholders supported our remuneration policy. One large shareholder voted against the policy, which meant we fell marginally short of the required 75% threshold.

It is not possible or sensible to separate remuneration outcomes from the company performance and default to a tick-box approach. Operational and financial outperformance does not happen by chance. The fact that the group's performance targets of earnings growth combined with a return above cost of equity have to be met for short-term remuneration to be paid and long-term incentives to vest, ultimately results in a better outcome for shareholders.

Our philosophy that remuneration must align with shareholder value creation and that management must not do better than shareholders is a deeply embedded principle fully controlled by the group's key performance measure, the delivery of economic profits or NIACC. This means that employees only receive variable pay after first "paying" shareholders a minimum return for their equity.

I would also like to acknowledge the ongoing constructive dialogues we have had this year with shareholders on our responsibilities with regards to climate change. We continue to improve our efforts in this space from both a risk, strategy and disclosure perspective and I believe the group's soon to be published TCFD report for the 2022 financial year will demonstrate the good progress against our climate roadmap and approach, as well as short-, medium- and long-term targets.

FirstRand continues to extensively engage with industry experts and think-tanks to better understand the nuances of the overall transition process, and government departments and regulators on envisaged policy approaches. The group is particularly active in engaging with our clients to better understand their transition plans and needs.

In closing, I extend my gratitude to my fellow board members who continue to provide steady guidance and oversight at a time when the group has been navigating a difficult operating

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environment, full of uncertainty. Most developed economies are facing the prospect of outright recession, together with a mix of rising inflation and interest rates, and the Russian-Ukrainian war-induced energy crisis. It is, therefore, completely unnecessary that the South African economy, whilst having to deal with a myriad domestic as well as global headwinds, also has to suffer under the weight of poor implementation of policy reforms and the resultant constraints to growth and employment.

In terms of changes to the board during the year, I would like to welcome Ms Shireen Naidoo, who was appointed on 1 April 2022. Ms Naidoo brings significant climate and sustainability skills to the board, as well as important perspectives on the environmental, social and governance (ESG) universe.

My thanks go to Faffa Knoetze, who retired as a director effective 1 December 2021, for his valuable contribution to the board over the duration of his tenure.

I would like to acknowledge the immense efforts by the FirstRand leadership team, which has been instrumental in delivering the group's strong recovery in earnings and superior returns for shareholders.

Finally, I thank each and every employee for their commitment and hard work, our customers for continuing to trust us with their financial services needs, and our shareholders for engaging with us in a rigorous and honest manner.

ROGER JARDINE ~ Chairman