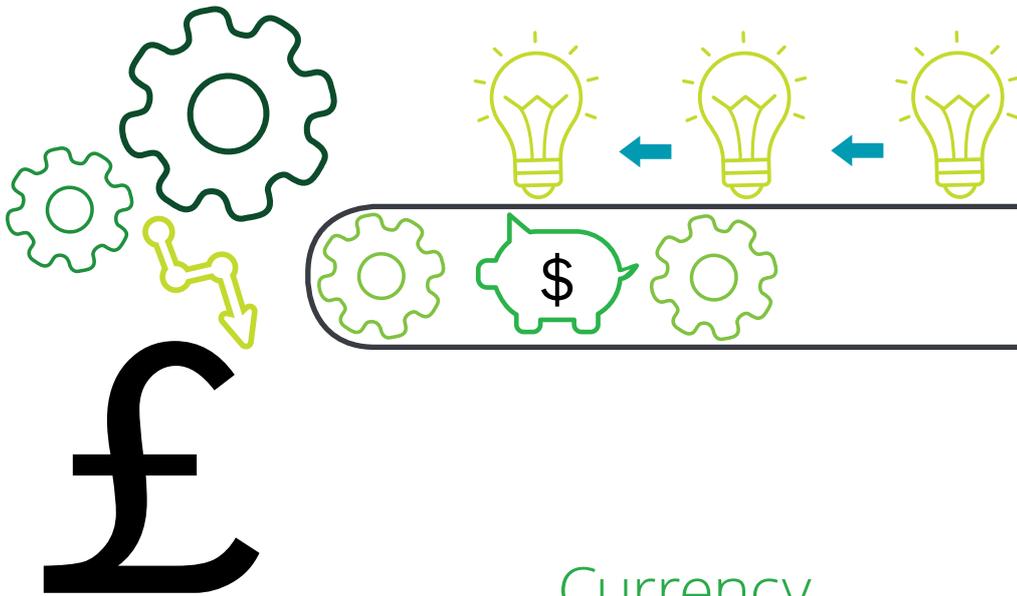


Rand *depreciation*

A boon for South African outsourcing industry





Continued weakening of the Rand and a grim recovery outlook in the short- to medium term, could help the local South African outsourcing industry establish itself as a cost-effective destination for outsourcing contracts and, subsequently, attract more engagements to the country.

Currency depreciation has positive as well as negative impacts on the country's economy. It makes exports cheaper, and imports dearer, increases inflation and drives foreign direct investments (FDI) away from the country.

Rand depreciation

In the last two years, the South African Rand has been on a constant decline against the USD. This decline has peaked since 2014/15. The Rand closed at a level of ZAR15.98 to the USD for the week ending February 5, 2016. During the same month in 2015, the currency was trading close to ZAR11 to the USD.

One of the major factors affecting Rand valuation is the improvement in the US economy and expectations of rate hikes in the coming quarters by the Federal Reserve. Any rate hike implementation will have a negative impact on emerging economies as the investors tend to look at developed western economies that will result in an outflow of money towards the developed economies.

Another factor for the depreciation is the Chinese flexible foreign policy. The Rand is one of the currencies most exposed to China, hence any adjustments to Chinese foreign policy has a direct impact on the Rand. After People's Bank of China devaluated the Yuan by 2% in mid-2015, the Rand lost close to 26% of its value during the next six months.

Since South Africa relies more on mineral exports, low commodity prices have also led to a weakening of the Rand. Due to low economic growth, China's demand for commodities have gone down resulting in lower global commodity prices.

Investor confidence is yet another factor affecting the value of currency. The South African government has been making ministerial level changes that have affected investor confidence. The replacement of Finance Minister Mr Nene by Mr van Rooyen as South Africa's finance minister – despite government's attempts to establish the lost confidence by appointing Mr Pravin Gordhan to the post soon after – dealt a further blow to the Rand.

To make matters worse, the monetary policy has not provided much support to the falling Rand. A 25 basis point (bps) hike in November 2015 failed to help much. The reserve bank is expected to adopt an aggressive monetary policy and come up with bigger rate hikes to prevent the Rand from declining further. The expectations are that through 2016, a 125 bps hike will be executed in three phases (50 bps, 50 bps and 25 bps towards the end of the year).

As per Deutsche Bank estimates, the Rand will depreciate further and reach a low of ZAR17.50 to the USD in 2016 and ZAR18 to the USD in 2017; however, the currency is expected to gain against the US dollar in 2018 and trade at better R/USD rates. The continued depreciation of the Rand has already led to inflationary pressure, which is expected to reach 8% YOY in 2016. As if these were not enough reasons, South Africa now faces huge implications of one of the most devastating droughts in the past 20 years; given the current agricultural output, expectations are that the country might need to import up to 5 million tons of maize, and wheat to the tune of 2 million tons this year. Maize prices are already high, having increased by 50% since December 2015. The only relief has been the low Brent oil price regime, which is expected to continue in 2016 (USD37/barrel) as well as 2017 (USD44/barrel).

Parameter	2014	2015E	2016F	2017F
Goods export (FOB)*	93	83	88	90
Good import (FOB)*	-99	-85	-89	-93
Trade balance*	-6	-2	-1	-3
Current account balance*	-19	-13	-12	-13
Foreign reserves**	48	45.8	47	47
ZAR/USD**	13.9	15.6	17.5	18

(Source: EIU*, Deutsche Bank** (Figures in USD billion, except ZAR/USD rates))

Impact of Rand depreciation on industries

The story is not all grim when it comes to impact on industries though. One of the industries at an advantage of the depreciating Rand is tourism. The weakening of the Rand has, to a certain extent, countered the impact of new visa laws introduced in May 2014. As per these laws, tourists from countries such as China, India and Russia were required to apply for visas in person, and visitors accompanied by children were required to have valid birth certificates for each child. The new visa laws were anticipated to result in a loss of R7.5 billion per year for the South African economy; however, as per the data collected from entry points, the number of tourists during the holiday season in 2015 had gone up by 7% compared to 2014. Close to 2 million tourists visited the country during the five-week period from 1 December 2015 to 7 January 2016. Asia accounted for the maximum percentage of these visitors (15%).

The weakening of the Rand has also helped the wine industry. The seventh-largest wine producer globally, South Africa attracts a large number of wine tourists. As per Rico Basson, Managing Director, Vinproa – a service organisation with 3 600 wine producers and cellars as members – the wine tourism market has the potential to reach R15 billion by 2025 from R6 billion in 2015 if the Rand continues to drop against the US dollar.

Business Process Outsourcing (BPO), too, has been a beneficiary of the Rand's depreciation. The weakening of the Rand has positioned South Africa as a cost-competitive outsourcing destination for companies based outside of the US and Europe. It is an added boost that the country also enjoys time zone and cultural similarities with these geographies.

Currency depreciation and outsourcing

Currency depreciation has always been a positive factor for the outsourcing industry as it makes the outsourced services cheaper for buyers of the service. A stable lower currency value of the country where the service provider is based usually warrants a higher return on investment (ROI) to the service buyer making the outsourcing decisions. A strong local currency has negative impacts on tourism and mining, and also makes local hiring costly, forcing companies to outsource to a location that has steady lower currency value. India, an established outsourcing hub, has been benefitting due to its lower currency value against the US dollar. The Indian Rupee has depreciated from INR39.36 to the USD in January 2008 to INR67.94 to the USD in January 2016.

Similar has been the case for major outsourcing hubs, both established and emerging. In South Africa, a number of factors similar to India can boost the local outsourcing industry. These factors include the pool of English-speaking talent (the country also has Spanish, Portuguese and French-speaking capabilities), cultural similarities with the UK, Australia and even the US, as well as time-zone similarities with European nations.

The South African government along with Business Process Enabling South Africa (BPESA), a South African BPO investment and networking body, is working towards establishing outsourcing as a major job creator for the country. Government has also come up with numerous initiatives for promoting outsourcing within South Africa. The government has even eased regulations to attract foreign companies.

Continued weakening of the Rand is expected to help outsourcers looking for new contracts, or even a renewal of existing contracts, from the UK and Australia, which are the priority markets for BPESA.

Companies that are already providing BPO services and have proven their worth will be better placed to exploit the Rand's depreciation by providing cheaper contract terms to their clients.

Indeed, the new cost differential may prove to be a deciding factor before any contract is awarded, as cost still remains one of the major factors in outsourcing contracts. Outsourcing services providers should look at getting in long-term contracts with the buyers through diligent negotiations as buyers prefer not to get into new pricing contracts beyond one to two years in a weak currency regime.

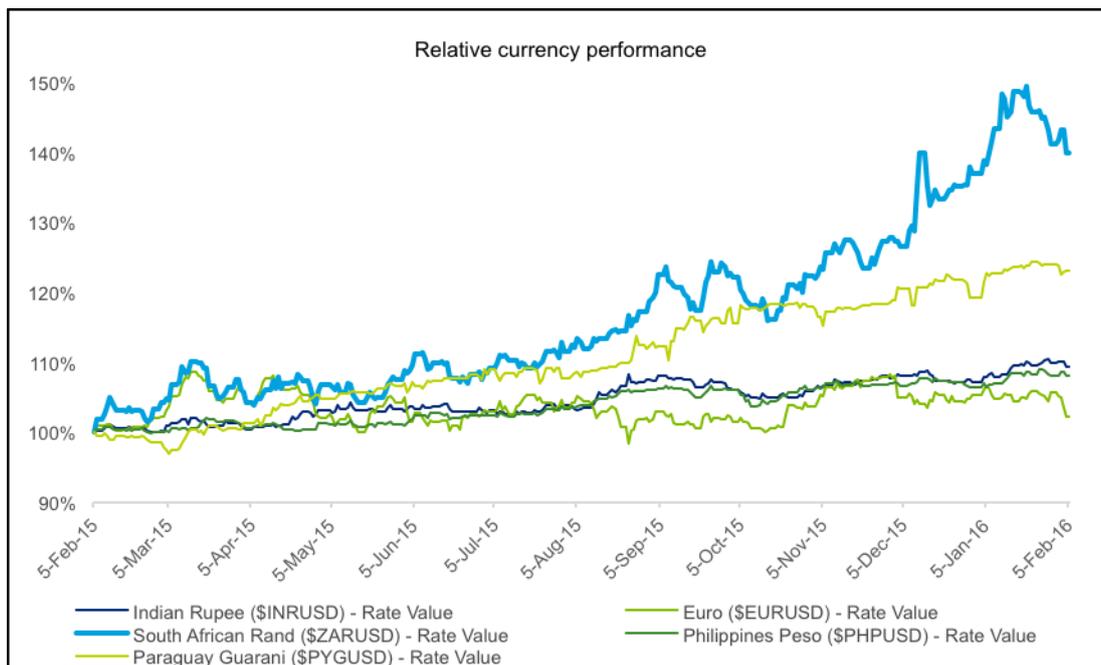
Long-term contracts at same price level and movement towards outcome based pricing instead of FTE based pricing will also help providers avoid risks of Rand stabilisation or appreciation in the short- to medium term.

Added to these advantages is the fact that South Africa has a large number of law graduates, much higher, in fact, than in India, Philippines and Ireland. This is crucial for the evolution of Legal Process Outsourcing (LPO). Outsourcing the legal processes to low-cost countries is the new normal. LPO to South Africa is rising as a result of similarities in the legal framework with many of the European countries including the UK, quality of legal skills and effective regulatory and compliance environment. South Africa's LPO industry is also boosted by the supply of legal graduates. As per the Law Society of South Africa, there is an oversupply of legal graduates to a tune of 2 000 graduates every year, hence, in terms of resources South Africa is better placed than other offshore destinations. Law firms such as Hogan Lovells, Norton Rose, Fulbright, Cliffe Dekker Hofmeyr (DLA Piper Group) and Bowman Gilfillan already have presence in South Africa. LPO providers such as Integreon, Exigent, BPO Global and Cognia Law have also established themselves in South Africa.

Rand and other currencies' performance against the US dollar

For the last year (January 2015 to January 2016), the Rand has weakened more than 40% against the dollar – the biggest fall compared to currencies of other outsourcing countries. The Paraguay Guarani has depreciated about 20%, while the Indian Rupee has gone down by close to 10% during the same time period.

As the Rand has depreciated the most among the currencies of established and emerging outsourcing hubs (during 2015/16), companies outsourcing to South Africa will enjoy the cost differential and can expect more savings out of their outsourcing engagements.



(Source: CapitalIQ, Exchange rate with USD in February 2015 = 100%)

The weakening of the Rand has had a positive impact on industries such as tourism, wine and outsourcing.

Conclusion

Looking ahead, the outlook around the Rand's recovery in the medium term remains grim till the end of 2017. While the importance of rand depreciation is a temporary advantage for South Africa, just like most short-term incentives, those service providers that are capable of retaining clients, expanding scope and automating a number of processes, this depreciation could be a critical attraction for the next 30-month period until 2018.

These are opportunities that should not be missed by opportunistic entrepreneurs. In the wise words of Lisa Weedn, "Every unexpected change is an opportunity for something wonderful". Multinational companies wanting to take advantage of growing their markets in the African continent stand a far better advantage now to set up centres of excellence in South Africa and reap the cost advantage on the current services they might already be providing in Europe or America, such as consolidation of management reporting on Africa operations, tax compliance, data analytics, etc.

Outsourcing service providers might also do away with the FTE costing and move towards outcome-based pricing to counter the risk of the Rand's stabilisation or appreciation. While eliminating FTEs might look like negative job elimination, technology and automation for imported jobs could be very attractive in South Africa and would result in a number of knowledge-based jobs being created locally, resulting in more FTEs being hired locally. The combination of South Africa's technology innovation, well trained professionals in accounting, legal, engineering, etc. who can be supported by an abundant number of unemployed graduates – this could elevate South Africa further than where it is currently rated.

The South African outsourcing industry should make utmost use of the weak Rand regime to establish itself as a cost-effective destination and to raise its service contribution to the global outsourcing industry.

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