

The performance of family controlled companies on the JSE: A financial and investment evaluation

Introduction

In recent years stock market researchers have directed considerable attention to obtaining greater insights into the agency relationship which exists between management and the shareholders of listed companies. For example, it has been argued that the tax disadvantages of dividends are outweighed by the increased control returned to the shareholders (Rozeff, 1981). This has emerged as a major factor in the contentious dividend controversy. Also, the rise of conglomeration and the waves of merger activity can be explained in terms of agency theory. For example, it has been argued that since management's human capital is concentrated in the company, and is thus not diversifiable, it is in their interests to diversify the company (Jansen and Meckling, 1976). It is indeed fair to say that agency theory has been one of the major developments in the theory of finance in the last decade.

On the Johannesburg Stock Exchange ("the JSE") several companies are controlled by individual families which hold a controlling interest of more than 50% of the issued shares. These companies constitute an interesting sample in the sense that the usual problems which exist between the objectives of management ("the agent") and the shareholders ("the principal") are less pronounced. This is especially true in those cases (the majority) in which the family is not only the major shareholder but also fulfils the management function. In such cases, the policies adopted by management might be chosen to suit their objectives (eg tax planning considerations) rather than those of the minority investors. For this reason, the group of family controlled companies comprises a subset of the JSE which is worthy of further investigation.

In this paper the performance of family controlled companies is examined from two perspectives – a financial management perspective and an investment performance perspective. The financial management aspect is investigated by means of an analysis of several key financial ratios computed from the annual financial statements of a sample of family controlled companies. This analysis reveals trends in the way in which family controlled companies are both financed and managed. As such it reveals certain opportunities which may exist for the owners of family controlled companies to improve their financial performance.

As far as the investment performance is concerned, this paper seeks to determine whether the unique agent-principal relationship which exists in family controlled companies leads to differential stock market performance when compared to non-family controlled companies.

Data and methodology

For the purposes of this study, a family controlled company has been defined as a company which is controlled by a majority shareholding of a particular family or family members or through their control via a pyramid holding company. The study was confined to the Financial and Industrial sectors of the JSE and,

therefore, was limited to the 373 companies listed in these sectors on 31 December 1984. A breakdown of the number of family companies per sector is given in Table 1 below. Examination of this table shows that 131 companies were identified as family controlled companies. This constitutes 35% of the population.

Table 1: Proportion of family controlled companies per sector

Sector	Number of companies listed (Note 1)	Number of family controlled companies	% of FCC to number of companies listed in sector
Financial			
Banks	15	1	7
Cash Assets	12	–	–
Insurance	14	–	–
Investment Trusts	12	2	17
Property	18	8	44
Property Trust	9	–	–
	80	11	14
Industrial			
Industrial Holding	60	23	38
Beverages and Hotels	7	2	29
Building	18	4	22
Chemicals	14	5	36
Clothing	24	19	79
Electronics	13	7	54
Engineering	33	9	27
Fishing	5	1	20
Food	10	–	–
Furniture	15	8	53
Motor	21	14	67
Paper and Packaging	13	1	8
Pharmaceutical and Medical	5	–	–
Printing and Publishing	6	1	17
Steel and Allied	3	–	–
Stores	32	20	63
Sugar	3	1	33
Tobacco and Match	6	2	33
Transportation	5	3	60
	293	120	41
Total	373	131	35

Where: FCC = Family controlled companies

Note 1: Figures obtained from The Johannesburg Stock Exchange, Quarterly Statistics: December, 1984.

From these 131 family controlled companies a sample of 57 companies was selected for analysis. This sample is based on a list of family controlled companies published by Kilalea (1985: 61–62). This list was amended to exclude companies which had not been quoted for the full period 1975–1984. In addition, the list was further amended to include quoted subsidiary companies for those cases in which the holding company had not been quoted for the full period. This resulted in the final sample of 57 companies (Appendix 1).

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The period of analysis was from January 1975 to December 1984 and all tests were carried out over this period. In addition, the period was divided into two subperiods. This was done because economic conditions varied considerably within the ten-year period. It was, thus, possible to examine the behaviour of family controlled companies not only over the entire period but also in times of economic recession (1975-1978) and economic boom (1979-1981). Hence all tests were performed over three periods.

Financial performance: Methodology

One of the principal means of financial analysis adopted by companies and financial institutions takes the form of ratio analysis. Such financial ratios provide managers of the company, analysts, prospective investors and creditors with a means of making meaningful comparisons of a firm's financial data at different points in time and with other firms or against standards or norms (Anthony and Reece, 1983: 426). The most common standards of comparison are trend analysis and industry average ratios. Trend analysis comprises a comparison of the same ratio for the individual firm at different points in time. Industry average ratios comprise ratios of other firms that are comparable in terms of the general characteristics of the firm (Keown, Scott, Martin and Petty, 1985: 44). These comparisons have also been aptly described respectively as ratio analysis "on a time-series basis" and "on a cross-sectional basis" (Boy, 1976).

Generally, analysts categorise financial ratios into four classes, each representing an important aspect of the company's financial position. Those four classes comprise liquidity, leverage, efficiency and profitability ratios and it is these four classes which will be evaluated below.

Much debate exists about which are the most appropriate financial ratios for each of the four classes discussed above. Thus, for the purpose of this study, several financial ratios from each class were examined in an attempt to overcome the criticisms which may have been levelled at the use of a single ratio. The ratios used in this study and their definitions are presented in Table 2 below.

Table 2: Financial ratios and definitions

1. Profitability ratios

Return on common equity:

$$\frac{\text{Profit ordinary shareholders}}{\text{Average ordinary shareholders' interest}} \times 100$$

Return of total assets:

$$\frac{\text{Profit before interest and tax}}{\text{Average total assets}} \times 100$$

Net profit margin:

$$\frac{\text{Normal profit before interest and tax}}{\text{Turnover}} \times 100$$

2. Efficiency ratios

Fixed asset turnover:

$$\frac{\text{Turnover}}{\text{Average total fixed assets}}$$

Inventory turnover:

$$\frac{\text{Turnover}}{\text{Average total stock}}$$

3. Leverage ratios

Debt ratio:

$$1 - \frac{\text{Ordinary shareholders' interest}}{\text{Total funds}}$$

Long-term debt to total debt:

$$\frac{\text{Total long-term loan capital}}{\text{Total borrowed funds}}$$

4. Liquidity ratios

Current ratio:

$$\frac{\text{Total current assets}}{\text{Total current liabilities}}$$

Acid test ratio:

$$\frac{\text{Total current assets excluding total stock}}{\text{Total current liabilities}}$$

Source: Bureau of Financial Analysis, 1977

To examine the financial performance of the family controlled companies, the financial ratios defined in Table 2 were calculated for each of the 57 companies in the sample. For each year, the mean ratio of all family controlled companies within each sector of the JSE was then calculated. This was repeated over all years (1975-1984) and all sectors. While such means are of some interest, they have limited value due to the fact that certain ratios will be higher in some sectors than in others. Thus, in order to compare the performance of the group of family controlled companies with the market as a whole, the mean ratio for each sector for each year was compared with the overall sector averages provided by the Bureau for Financial Analysis (BFA) (1984). The significance of the ratios of the family controlled companies can then be tested using the following methodology.

Let X equal the number of times (across sectors and years) that the mean ratio of the family controlled group is less than the BFA industry average for that year and that sector. Then, under the null hypothesis of no difference between the mean ratio of the family controlled group and the sector average, X will be binomially distributed with parameters n (the number of sectors times the number of years examined) and p (the probability that the family controlled company mean is greater than the sector average), which is equal to 0,5.

Since n will be fairly large (well above 100), it follows that X is approximately normally distributed with mean np and variance npq, where q equals (1-p). A suitable test statistic for the hypothesis that the mean ratio of the family controlled companies is equal to the industry average is then

$$Z = \frac{X - np}{\sqrt{npq}} = \frac{X - n(0,5)}{\sqrt{n(0,5 \times 0,5)}}$$

since p = 0,5 under the null hypothesis.

The Z value obtained for each ratio examined can be compared to the value of Z obtained from the standardised normal tables in order to test the null hypothesis. Note that significant negative values of Z indicate that the mean ratio of the family controlled group is less than the sector average, while significant positive Z values indicate the mean ratio of family controlled companies is greater than the industry average.

Finally, in concluding this section on methodology, it must be pointed out that while financial ratios provide a basis for assessing companies, there are a number of

general limitations to both financial statements and to the computation of the ratios. These limitations are well documented and may be found in a number of standard texts (for example: Keown et al, 1984; Weston and Brigham, 1981 and Anthony and Reece, 1983). However, in addition to these general limitations, this research encountered other limitations. Two of these are briefly mentioned below:

- many companies complied with only the minimum disclosure requirements of the Fourth Schedule of the Companies Act, 1973, with the result that, in many instances, actual turnover, income and expenditure figures were not disclosed. This restricted the calculation of a number of profitability and activity ratios;
- there were a limited number of family controlled companies listed in particular sectors of the Johannesburg Stock Exchange and limited disclosure reduced the sample size further.

Financial performance: Results

In this section the methodology presented in the previous section is used to evaluate the financial performance of family controlled companies. This evaluation is repeated for three distinct periods: the entire period 1975 – 1983; a recessionary period 1975 – 1978; and a period of economic boom, 1979 – 1981. Note that the tests of the entire period are only done until the end of 1983 because industry averages were not available for 1984. The results are summarised in Table 3 below.

Table 3: Financial ratio evaluation

Ratio	Z-values*		
	1975–1983	1975–1978	1979–1981
Profitability			
Return on equity	-0,583	-1,155	0,507
Return on total assets	-2,525	-1,896	-1,667
Net profit margin	-0,583	-0,289	-1,183
Leverage			
Debt ratio	-2,997	-2,021	-2,000
Long-term debt to total borrowing	-3,384	-1,433	-2,667
Efficiency			
Fixed asset turnover	4,001	2,771	2,197
Inventory turnover	1,648	0,866	1,333
Liquidity			
Current ratio	0,503	0,152	0,686
Acid test ratio	4,724	2,412	3,656

*Critical value at 10% level is 1,645.

On analysing Table 3 it is immediately apparent that there is general consistency over all three periods examined. Thus, in general, the sign of Z does not change from boom to recession. In addition, the significance or lack of significance does not vary with differing economic climates. It can, therefore, be concluded that there is a high degree of consistency in the results presented.

As regards profitability, the results indicate that, on average, the return on assets is significantly lower for the family controlled companies when compared to the sector average. However, there is no significant difference between the family controlled companies and the

sector average as regards return on equity and net profit margin. Nevertheless, it is interesting to note that while these differences are not statistically significant, they are predominantly negative, which would indicate some degree of inferior performance on the part of family controlled companies. Thus, the overall conclusion is that family controlled companies perform less well than the industry average in terms of profitability.

As regards the leverage ratios, it is interesting to note that family controlled companies have significantly less gearing (as evidenced by the debt ratio) than do the industries on average. In addition, they have less long-term debt relative to total borrowings. These results are consistent across both ratios examined and in almost all periods examined. They, therefore, indicate that family companies are far more conservative in their capital structure decisions than are the industries on average. Although not examined directly in this study, it is possible that this means that family controlled companies tend to use more internal funds for growth rather than external funds.

The efficiency ratios examined indicate that, in general, family controlled companies tend to be more efficient in the utilisation of the assets at their disposal. This is evidenced by the highly significant fixed asset turnover. The fact that this difference is positive indicates that on average the family controlled companies have higher fixed asset turnover than the industry average. In addition, the inventory turnover is significantly higher for the family controlled companies over the entire period 1975–1983. Although the difference is not significant in the individual subperiods, it is, nevertheless, positive which does indicate some tendency for family controlled companies to have higher inventory turnover.

The two liquidity ratios examined provide very interesting results. As far as the current ratio is concerned, there appears to be no significant difference between the family controlled companies and the sector average. Once again, however, the ratios are consistently positive which would indicate some degree of support for the assertion that family controlled companies are more liquid than the industries on average. This is confirmed by the acid test ratio which is statistically significant in each of the periods examined. This may be interpreted as family controlled companies being more conservative in maintaining liquid current assets to meet maturing short-term obligations. Although there was no significant difference in the current ratio, the preponderance of positive Z values and the maintenance of a significant acid test ratio leads to the conclusion that, in general, the family controlled companies are more conservative than the market; that is, they tend to have a higher degree of liquidity.

The general results of this section are summarised in Table 4 below.

Table 4: Financial performance of family controlled companies vs market

Profitability	Lower
Leverage	Lower
Efficiency	Higher
Liquidity	Higher

The summary presented in Table 4 indicates that family controlled companies are, on average, more conservative than the industry as a whole. This is evidenced by their lower leverage and higher liquidity. In addition, they make more efficient use of the assets at their

disposal in terms of the activity ratios. In terms of profitability, however, family controlled companies do not perform as well as the market as a whole.

The relationship between profitability, efficiency and leverage is explained by the du Pont Model (eg Weston & Brigham, 1981: 152). The results obtained thus indicate that the lower profitability is due to the lower use of leverage which is not sufficiently compensated for by the greater efficiency of family controlled companies.

From the modern portfolio perspective, it could be argued that the lower use of leverage and the greater liquidity render the family controlled companies less risky and, therefore, a lower return should be expected. The results obtained are, therefore, both explainable and consistent with modern financial theory.

In conclusion, it can be said that family controlled companies are more conservative in financing and liquidity, more efficient in utilising their assets but derive a lower return than the market. Moreover, economic conditions of recession and boom do not appear to have a significant effect on these observations.

Investment performance

In recent years, many deviations from Sharpe's (1964) capital market theory have appeared in both the local and international literature. In particular, several researchers have found evidence of superior performance by groups of securities. For example, Reinganum (1981) and Banz (1981) found evidence of a small firm effect, Arbel, Carvell & Strebel (1983) found evidence of a neglected firm effect, Basu (1977 and 1983) found evidence of a P/E ratio effect and Rozeff and Kinney (1976) identified a January effect.

In this study, the possibility of a family controlled effect is examined. In order to do this, the performance of the portfolio of 57 family controlled companies examined in the previous section is investigated. Initially, the performance of this portfolio is compared with that of a group of 57 non-family controlled companies (Appendix 2) and with the JSE Actuaries industrial index.

In order to measure share performance of the family controlled companies vis-à-vis the market, the returns were computed and compared. The return for each share was computed using log normal returns:

$$R_t = \ln((P_t + D_t)/P_{t-1})$$

where R_t = return on the share in year t

\ln = natural logarithm

P_t = price of share at end of year t

D_t = total dividend paid during t.

Two investment strategies were applied in assessing the stock performance of the family controlled and non-family controlled portfolios. They are:

- (i) equal rand amounts in each company; and
- (ii) equal number of shares in each company.

The results are presented in Table 5 below. This table also reports Sharpe's reward to variability ratio (RV) (Sharpe, 1970), which provides a measure of the risk adjusted performance. This ratio is calculated as:

$$RV_p = R_p/S_p$$

where RV_p = the reward to variability ratio for portfolio p;

R_p = the return on portfolio p; and

S_p = the standard deviation of the return on portfolio p.

Table 5: Investment performance of family controlled companies

	Average return (%)	Standard deviation	Sharpe's RV ratio
"Equal rand amounts" investment strategy			
Family controlled	24,85	25,63	96,96
Non-family controlled	19,45	19,07	101,99
Industrial index	20,86	16,76	124,46
"Equal number of shares" investment strategy			
Family controlled	21,91	23,10	94,85
Non-family controlled	18,44	18,29	100,82
Industrial index	20,86	16,76	124,46

Inspection of Table 5 reveals that family controlled companies tend to yield higher returns on average. These higher returns are, however, commensurate with higher risk. In fact, the larger standard deviations result in family controlled companies having lower RV ratios. Thus, on a risk adjusted return basis, family controlled companies performed below non-family controlled companies and the industrial index.

However, it is important to note that the differences between both the average returns (t-test) and the standard deviations (F-test) are not significant at the 5% level. These test statistics are shown in Table 6 below.

Table 6: Statistical results – family vs non-family/ industrial index

	F statistic *	t statistic†
"Equal rand amounts" investment strategy		
Family vs non-family	1,81	0,53
Family vs industrial index	2,34	0,41
"Equal number of shares" investment strategy		
Family vs non-family	1,60	0,37
Family vs industrial index	1,90	0,12

*Critical value at 5% level is 3,18.

†Critical value at 5% level is 1,73.

Thus, at the 95% confidence level it must be concluded that there is no statistical difference between the mean return of family controlled companies and that of non-family controlled companies or the industrial index.

As a final test, the performance of the family controlled portfolio was compared to that of the non-family controlled portfolio and the industrial index under conditions of boom and recession. The results are summarised in Table 7 overleaf.

Examination of Table 7 shows that in absolute terms family controlled companies, on average, underperform non-family controlled companies in periods of recession and outperform non-family controlled companies in boom periods. Indeed, the performance of family controlled companies is statistically significantly higher than non-family controlled companies for the period 1979–1981. These conclusions appear equally valid on a risk adjusted basis.

In conclusion, therefore, it must be stated that the results presented do not provide strong support for the assertion that a family controlled factor exists on the

JSE. Rather, it must be concluded that as a group the family controlled companies tend to provide higher returns to investors but at higher risk. This higher risk is evidenced by higher volatility or standard deviations of return. As a result, family controlled companies outperform non-family controlled companies during boom periods but underperform these companies during recessions. Overall, no evidence has been presented which indicates either superior or inferior performance by family controlled companies.

Table 7: Investment performance under different economic conditions

	Average return (%)	Standard deviation	Sharpe's RV ratio
"Equal rand amounts" investment strategy			
<i>1975-1978 (recession)</i>			
Family controlled	19,71	19,23	102,50
Non-family controlled	22,47	23,12	97,19
Industrial index	16,98	12,41	136,83
<i>1979-1981 (boom)</i>			
Family controlled	43,46	13,58	320,07
Non-family controlled	24,63	17,51	140,68
Industrial index	34,89	18,29	190,76
"Equal number of shares" investment strategy			
<i>1975-1978 (recession)</i>			
Family controlled	15,67	21,62	72,48
Non-family controlled	19,31	22,37	86,32
Industrial index	16,98	12,41	136,83
<i>1979-1981 (boom)</i>			
Family controlled	38,29	10,03	381,91
Non-family controlled	24,69	17,70	139,16
Industrial index	34,89	18,29	190,76

Conclusions

In this paper, an attempt has been made to evaluate the performance of family controlled companies from both a financial and investment point of view. The results obtained indicate that significant differences do exist between family controlled companies and the market as a whole, in terms of financial performance. However, in terms of investment performance, no significant differences were found.

The financial analysis of family controlled companies revealed that, in general, family controlled companies performed worse than the market, in terms of profitability. In addition, they had, on average, lower leverage. The traditional approach to the theory of capital structure asserts that the firm can increase its total value through judicious use of leverage (van Horne, 1980: 261-292). Consequently, were family controlled companies to have a less conservative leverage policy, profitability may improve to the extent that no significant difference would exist between the family controlled companies and the market. Family controlled companies performed better than the market as regards the efficient use of fixed assets and this could be due to the personal stake of family management. This has interesting implications in terms of agency theory.

The results obtained from the financial analysis over the periods of economic recession and boom do not reflect any overall change from that obtained over the full period. Profitability is below that of the market both in periods of recession and boom, as is leverage. On the other hand, the family controlled companies appear to

have greater liquidity than the market as a whole. Thus, in recessionary periods, by maintaining higher liquidity, as suggested by the acid test ratio, the family controlled companies are more prepared to meet a cash flow crisis. Contrary to this, the maintenance of higher liquidity during economic boom periods means that the family controlled companies are not fully utilising their resources. Finally, during these economic extremes, family controlled companies continued to use fixed assets more efficiently in producing turnover.

The research conducted on stock market performance indicates that, both in the case of the "equal number of shares" investment strategy and the "equal rand amounts" investment strategy, family controlled companies tend to provide higher returns than non-family controlled companies and the industrial index. These returns are, however, at the expense of higher risk. The riskiness attached to these securities may be attributable to the small number of shares available to "outside" shareholders, thereby creating a liquidity problem for larger investors.

Finally, it is interesting to note that while the family controlled companies are financially more conservative and less profitable than the market as a whole, the reverse applies in terms of investment performance. As an investment medium, family controlled companies yield higher returns but have commensurately higher risk than non-family controlled companies. Why this distinction between financial performance and investment performance should exist remains an open question which requires additional research.

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Appendix 1

The sample of family controlled companies used in this study

Security	Sector
Suncrush	Beverages and Hotels
Yorkor	Building and Construction
Nat Veneer	Building and Construction
Adonis	Clothing, Footwear and Textiles
Silverton	Clothing, Footwear and Textiles
Progress	Clothing, Footwear and Textiles
TEJ	Clothing, Footwear and Textiles
Genrec	Engineering
Montays	Furniture and Household
Duros	Furniture and Household
Eureka	Industrial Household
Amal Indus	Industrial Household
Nictus	Industrial Household
Micor	Industrial Household
SA Bias	Industrial Household
Rentmeester	Industrial Holdings
Welfit	Motor
Schus	Motor
Math Ash	Printing and Publishing
Hepworths	Stores
Spitz	Stores
P'n P	Stores
Grand Bazaars	Stores
Sterns	Stores
Putco	Transport
African & Overseas	Clothing, Footwear and Textiles
Rex Tru	Clothing, Footwear and Textiles
Seardel	Clothing, Footwear and Textiles
Bivec	Engineering
E L Bateman	Engineering
Beares	Furniture and Household
Porter Holdings	Motor
PEP	Stores
Crookes	Sugar
Triomf	Chemicals and Oils
Bromain	Industrial Holdings
Picardi Beleg	Industrial Holdings
Suiderland	Industrial Holdings
Garlick	Stores
John Orr	Stores
Frasers	Stores
Natal Cons Inv	Clothing, Footwear and Textiles
Natal Can	Clothing, Footwear and Textiles
Cons Textile	Clothing, Footwear and Textiles

SA Wool Mills	Clothing, Footwear and Textiles
Placor Holdings	Industrial Holdings
Curfin	Industrial Holdings
Plateglass	Industrial Holdings
Currie	Motor
Metair	Motor
Sakers	Motor
Saficon	Motor
Wesco	Motor
Foschini	Stores
Lefic	Stores
Mobile	Transport
Trencor	Transport

Appendix 2

Sample of non-family controlled companies

Company	Sector
Abercom	Engineering
Aberdare Cable	Electronics
AECI	Chemicals and Oils
Afcol	Furniture and Household
Afri Pers	Printing and Publishing
Afrox	Engineering
Amic	Industrial
Anglo Alpha	Building and Construction
Argus	Printing and Publishing
Assoc Eng	Motor
Barlow Rand	Industrial
Berkshire Int	Clothing, Footwear and Textiles
C G Smith	Industrial
Cad Schwep	Stores
Cementation	Engineering
Chubb Holdings	Engineering
CNA Gallo	Stores
Darling Hodgson	Industrial
Dorbyl	Engineering
Dunlop	Motor
Edgars	Stores
Ellerines	Furniture and Household
Everite	Building and Construction
Fed Volks	Industrial
Globe Eng	Engineering
Gresham	Stores
Group 5	Building and Construction
Hiveld Steel	Engineering
I & J	Stores
ICS	Stores
Jabula	Food
Kohler	Paper and Packaging
Malbak	Industrial
Metal Box	Paper and Packaging
Murray Roberts	Building and Construction
NFS Motors	Motor
OK	Stores
Plascon Evans	Chemicals and Oils
Premier Group	Stores
Protea	Industrial
Quinton Haz Sup	Motor
Rembrandt Group	Tobacco
Reunert	Electronics
Romatex	Clothing, Footwear and Textiles
S Atlantic Holdings	Industrial
SA Breweries	Beverages and Hotels
SAAN	Printing and Publishing
Sappi	Paper and Packaging
Scottish Cables	Electronics
Sentrachem	Building and Construction
Stewarts & Lloyds	Engineering
T W Beckett	Stores
Tiger Oats	Stores
Tongaat	Sugar
Unisec	Industrial
Utico	Tobacco
Woolworths	Stores