

Highlighting trends in the South African construction industry

December 2013

SA construction

1st edition



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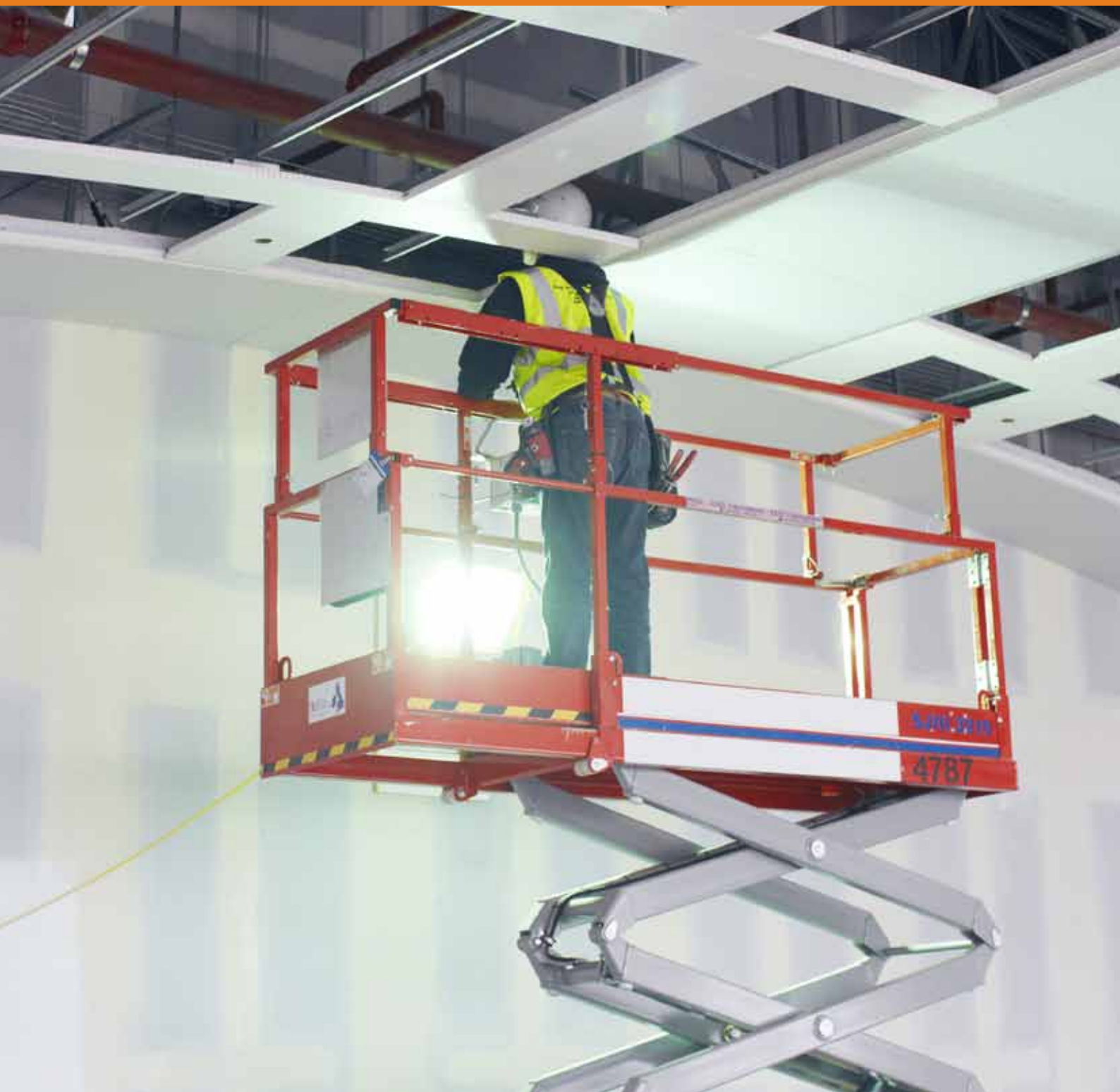


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1. Executive summary



Highlights

	Current year R 'millions	Prior year R 'millions	Difference R 'millions	% Changes
Total revenue	145 793	120 828	24 965	21%
Net profit	3 085	1 266	1 819	144%
Net operating cash flows	5 375	576	4 799	833%
Distributions to shareholders	790	1 695	(905)	(53%)
Total assets	96 466	86 765	9 701	11%
Secured order book	160 630	159 193	1 437	1%
Employees*	429	433	(4)	(1%)

* Thousands

Welcome to the inaugural edition of our SA Construction publication, which highlights trends in the South African construction industry.

The 2013 year has seen the construction industry in the headlines for all the wrong reasons. Most notable has been the finalisation of the Competition Commission enquiries as well as significant delays at Eskom power plant projects. These have highlighted the importance of the industry for the country's development and the challenges of the environment in which it operates.

We hope that this publication will provide meaningful information to industry participants in evaluating performance and addressing risks.

Scope

Our findings are based on the financial results of the top 10 construction companies by market capitalisation on the Johannesburg Stock Exchange (JSE). Section 11 provides a list of all construction companies included in this report.

The findings of this report are based on publicly-available information, predominantly annual reports, for financial years ending no later than 30 June 2013. Where annual reports were not available, we have used preliminary reviewed results.

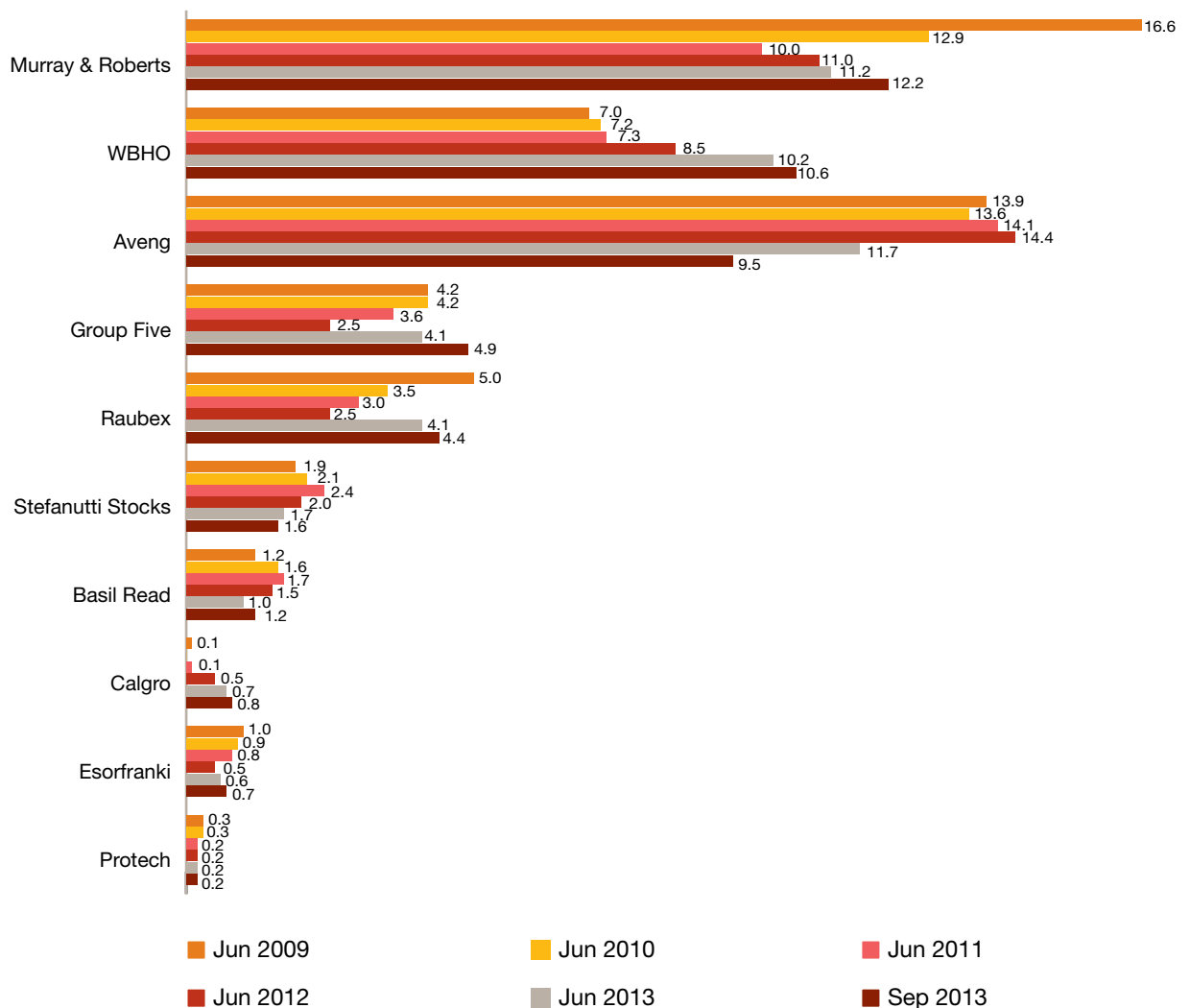
2. The South African construction industry



Market capitalisation

There is little doubt about the cyclical nature of the construction industry, as reflected in the market capitalisation graphs. Market capitalisation reflects the organic growth or regression, merger and acquisition activities and market expectations about the future.

Figure 1. Market capitalisation of the Top 10 construction companies (R 'billions)

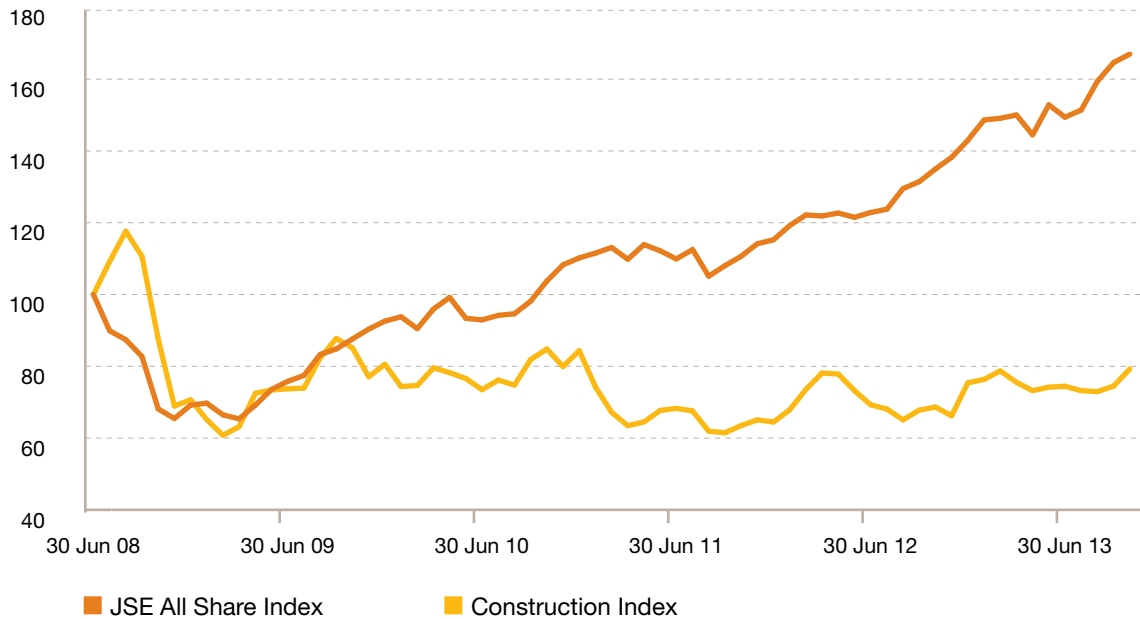


Source: I-Net Bridge

The South African construction industry was particularly hard hit when the infrastructure development highs leading up to the 2010 FIFA World Cup were followed by a global recession and/or depressed growth. Statistics detailing the decline of the industry over the last three years have been well publicised.

The discrepancy between the performance of the construction index and the JSE all-share index is stark. Not only has the industry been punished for its lacklustre financial performance in the down cycle, but also because of public perception following the Competition Commission process, findings and settlement.

Figure 2. Market capitalisation: JSE vs construction



30 June 2008 = 100

Source: I-Net Bridge

It would appear that the cycle has bottomed out with a number of encouraging signs from the financial performance of individual companies, order book growth and public infrastructure commitments. However, there are still a number of risk factors that could impact the industry.

Public-sector infrastructure spending is normally a good indicator of the industry's performance. The South African Government's infrastructure development plan and the 'new' Presidential Infrastructure Coordinating Commission (PICC), set up to coordinate infrastructure expenditure between the three different spheres of government, are positive signals for future growth in the industry.

Public-sector spending

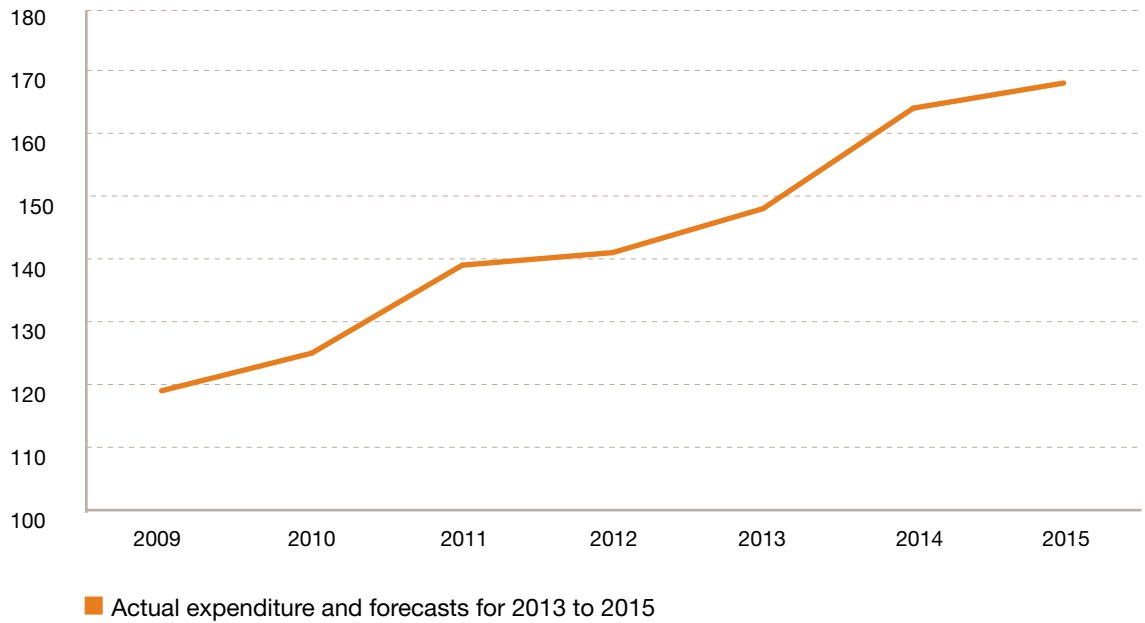
After remaining fairly flat from 2009 to 2011, capital expenditure by public-sector institutions has increased by 11.7% since 2011, with total expenditure in 2012 amounting to R202 billion. The scale of this increase may be misleading, as new construction work only increased by 3.5% to R137 billion while plant, machinery and equipment purchased increased by 55% to R38 billion. Nevertheless, when one takes into account that the 2011 increase from 2010 was 16.1%, the increase in new construction over the last three years has been real.

Figure 3 summarises the capital expenditure relating to new construction, cost of development of properties and major rejuvenation projects actually incurred by the public sector for the financial year up to and including 2012 together with estimates for the 2013 to 2015 period. The graph shows a good growth trend over the last few years and positive expectations for the next three years.

However, it needs to be borne in mind that construction input cost inflation was also well above CPI inflation and that the effective growth rate from 2009 to 2015 shown on the graph is less than 6%.

With the pressure on margins experienced by the industry, it should be noted that the graph reflects real growth for buyers of construction services, but not for the construction companies themselves.

Figure 3. Construction-related public capital expenditure (R 'billions)

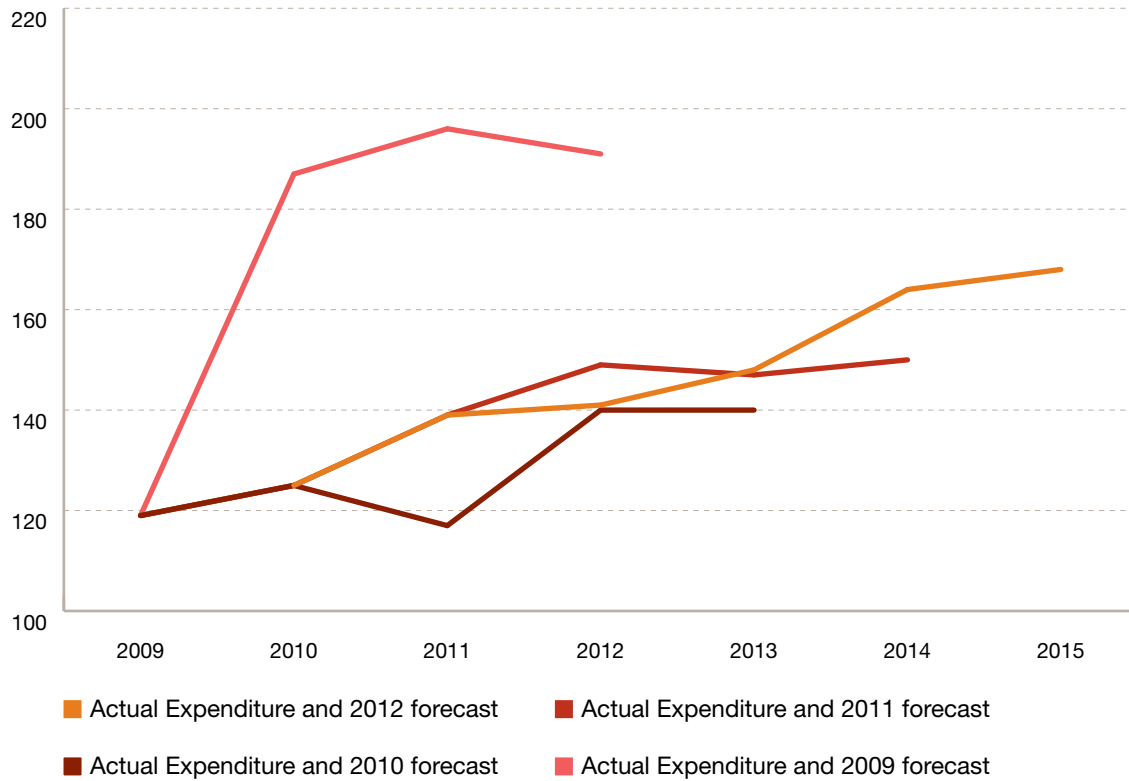


Source: Stats SA

Concern has been aired from various quarters about the Government's ability to roll out capital and infrastructure programmes as well as the accuracy of capital forecasts. A comparison of actual construction expenditure with forecasts made in the last three years shows that apart from the pre-credit crises 2009 forecast, actual expenditure has been reasonably in line with forecasts.



Figure 4. Comparison of actual construction expenditure with forecasts (R billions)



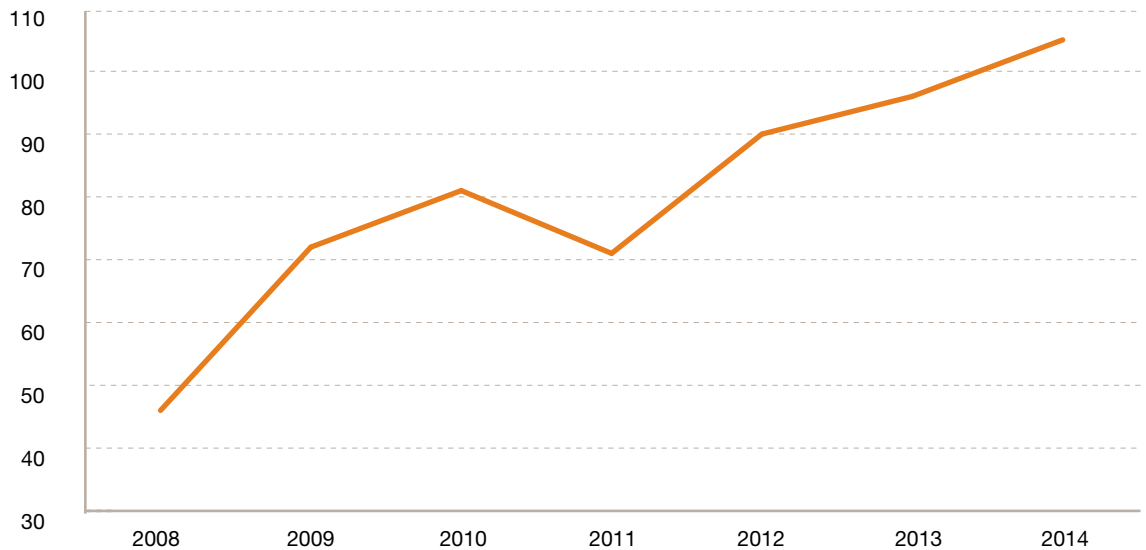
Source: Stats SA

Actual construction expenditure in 2012 was R7.3 billion below the 2011 forecast.

For new construction expenditure, the difference was only R1.5 billion with the R6.5 billion and R8.5 billion underspent by municipalities and extra-budgetary accounts respectively partially offset by higher expenditure by public corporations (R11.3 billion) and National Government (R2.0 billion). The remainder of the difference is explained by delays in major renovation projects.

The bulk of the public corporation capital spending is done by Eskom, Transnet and SANRAL as well as ACSA in the run up to the 2010 FIFA World Cup. As the data shown in Figure 4 is a year old, we also show the aggregated capital expenditure and expected capital expenditure by these four entities.

Figure 5. Capital expenditure by Eskom, Transnet, SANRAL and ACSA (R 'billions)



**Capital commitments for 2014*

Source: PwC analysis, annual reports for Eskom, Transnet and ACSA

The South Africa National Roads Agency Limited (SANRAL) has been a reliable source of work for the construction sector and we expect it to remain so. We are encouraged that local governments are working more closely with SANRAL and we expect this to result in a gradual improvement in project delivery, although we note that National Treasury is yet to reallocate funds for the affected roads from the provinces to SANRAL.

Over the period of National Treasury's 2013 Medium-Term Expenditure Framework (MTEF), R845 billion has been approved and budgeted for public-sector projects, with R296 billion in the energy sector and R262 billion allocated to transport and logistics projects.

Converting budget into action will be the challenge for the next few years. Although the realisation of the need for this infrastructure development is clear, the awarding of tenders has been slower than initially hoped.

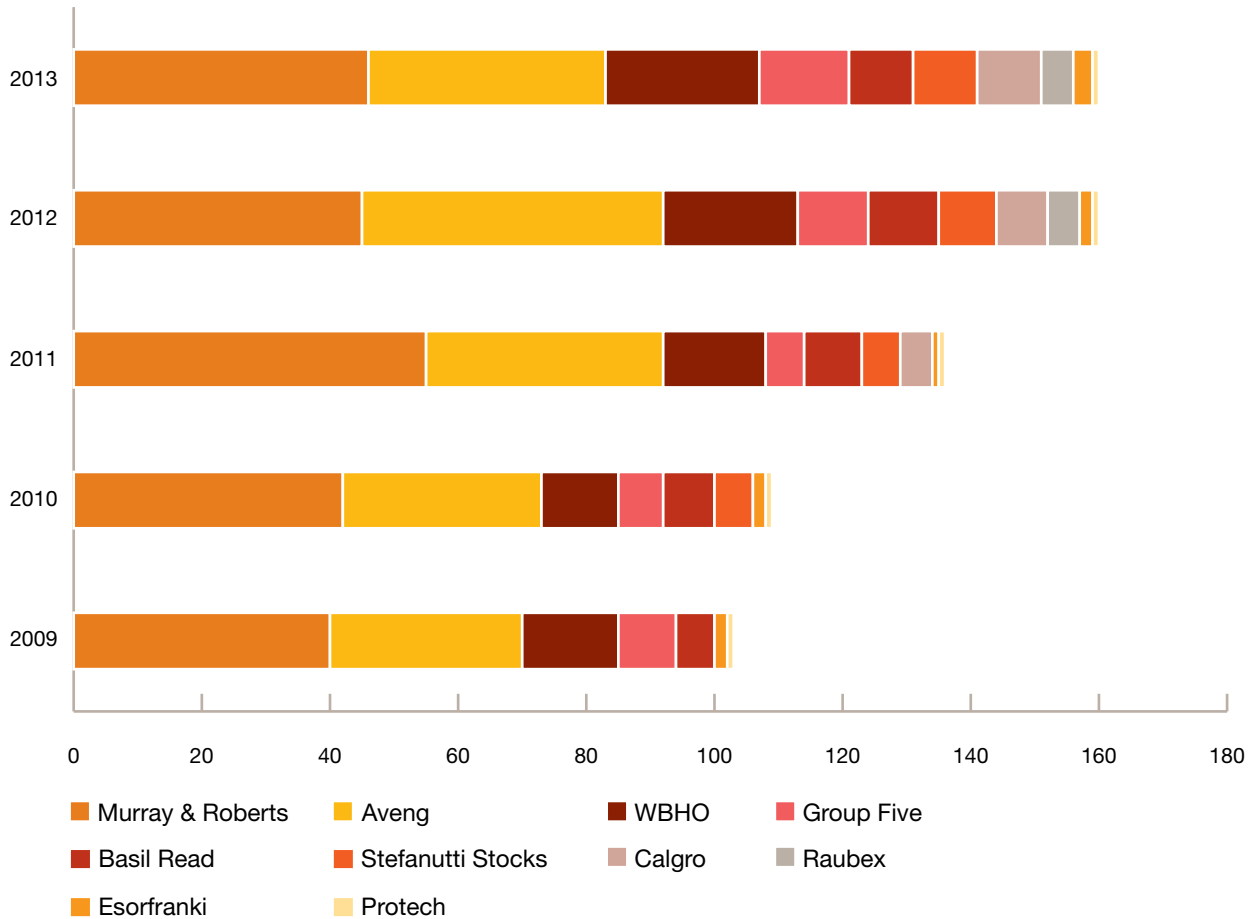
The public sector is by no means the only player in the industry. The private sector, often led by the mining industry, has been a significant contributor to total construction expenditure. The severe pressure experienced by this industry, with shrinking margins and labour unrest, will no doubt have an impact on future demand. For example, Aquarius Platinum cancelled a R7.5 billion order from Murray & Roberts, negatively impacting the order book. The reassessment of capital projects by mining companies is also bound to influence future demand.

Order book

Although various definitions are applied, and the information disclosed is not necessarily comparable, there seem to be good signs of growth. The current-year order books reflect the negative impact on the South African economy of recent labour unrest and rating agency downgrades. The offsetting impact of the potential weakening in private-sector demand and the growth in public-sector expenditure will only become evident in 2014.

The growth in the order book during 2013 was 1% (2012: 16%). The secured order book now only covers 1.2 times current-year revenue as opposed to the 1.5 of the prior year. Companies indicate that a major factor contributing to this depressed growth has been the failure of the Government's infrastructure spend to materialise, which is a critical driver for recovery within the construction industry.

Figure 6. Secured order book (R' billions)



Source: PwC analysis

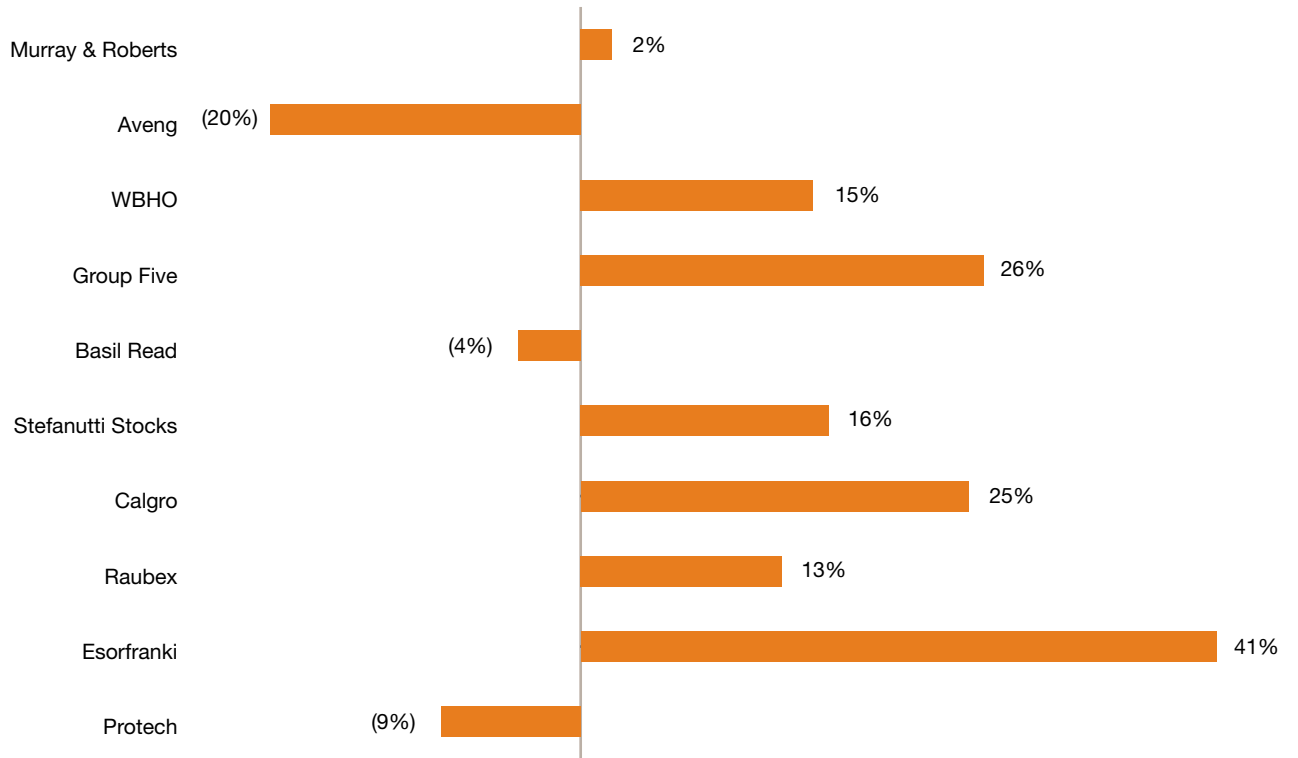
Aveng's order book decreased by 20% mainly as a result of a reduction in the mining order book as well as the softening infrastructure market experienced by the Construction and Engineering: Australasia and Asia operating segments.

Basil Read and Protech showed marginal decreases.

The remaining companies experienced growth in excess of 10%, most notably Esorfranki, which saw year-on-year growth of 41% as a result of a number of longer-term contracts within the civils segment.

The Group Five and Calgro order books also experienced healthy increases of 26% and 25% respectively.

Figure 7. Secured order book growth

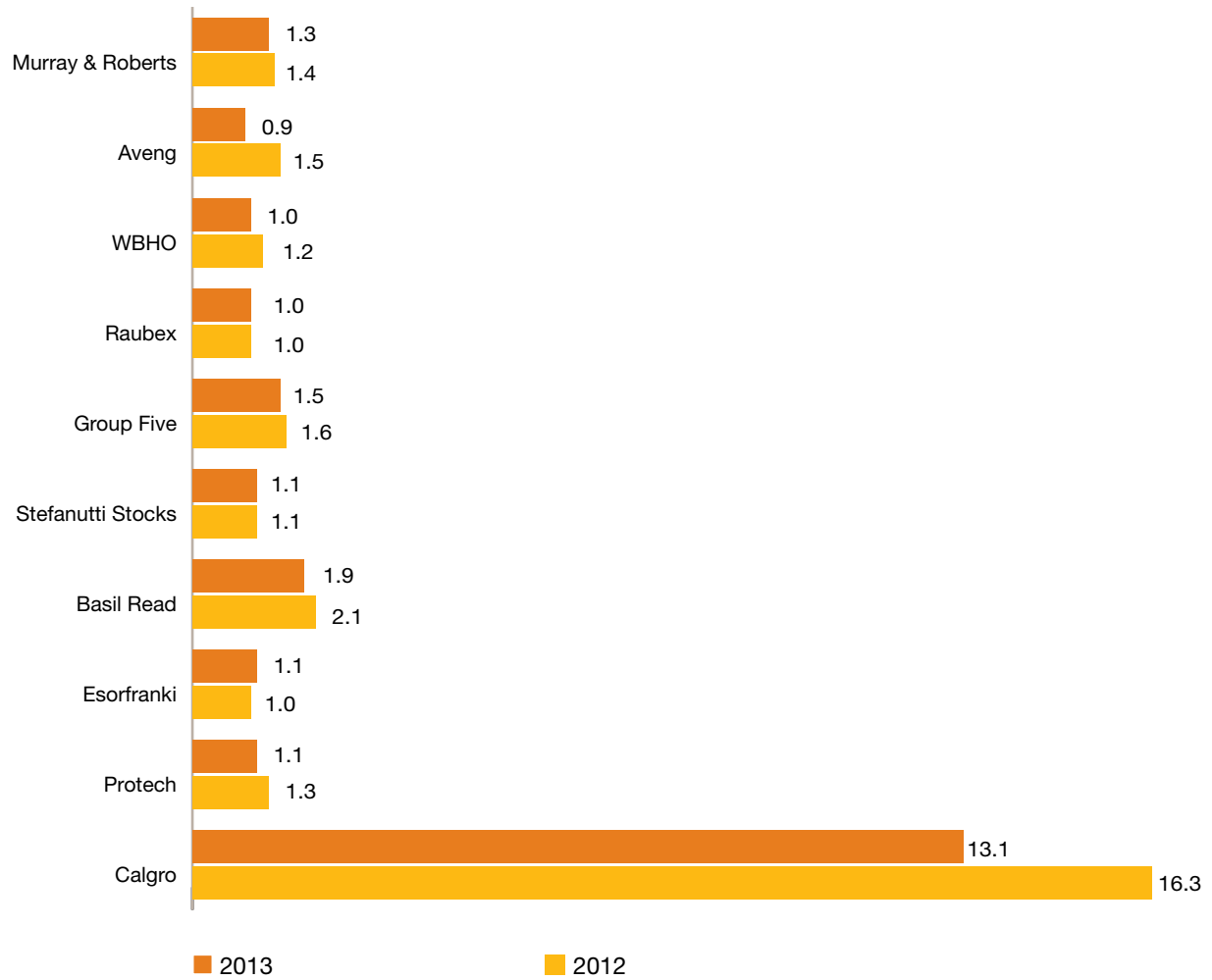


Source: PwC analysis

Apart from Calgro with a secured order book to construction revenue multiple of 13, all other companies' secured order books were between 0.9 and 1.9 of construction revenue. Only Esorfranki and Raubex showed marginal increases in their multiples, while the rest reflected decreased multiples mainly on the back of increased revenue in the current year.



Figure 8. Secured order book as a multiple of construction revenue



Source: PwC analysis



3. *Integrating risk for performance*



It is imperative that construction companies focus on risk and the risk landscape within which they operate. Companies now need to integrate risk and performance management, and they need to evolve risk management to be more predictive in order to anticipate and plan for negative potential events.

The common key risks identified by the top-10 South African construction companies include risks to transformation, health, safety and environmental sustainability, followed by growth and expansion, and compliance with laws and regulations.

Top risk categories disclosed by construction companies

Construction industry challenges	Impact on and required actions by the industry
Margin pressure and competition	
<p>Net profit margins of 5% to 6% were achieved on the back of the global economic boom and the run up to the 2010 FIFA World Cup.</p> <p>The contraction in the global construction industry and in particular in South Africa post 2010, has increased competition and eroded margins to the longer-term average of between 2% and 3%.</p> <p>The anticipation of significant capital expenditure by governments to support the country and the continent's development goals meant that construction companies retained capacity, but at a significant cost.</p>	<p>The low-margin environment has placed extra pressure on strategic decisions relating to capacity, tender activity and pricing. It also highlights the importance of excellent project execution and close out.</p>
Market volatility and impact on order books	
<p>The market volatility experienced by developing economies and commodity-based economies has resulted in delays in foreign-backed, state-owned and large-scale mining projects.</p>	<p>Foreign exchange movements have a direct impact on the international businesses of South African construction companies, mainly in Africa and Australasia.</p> <p>Mining commodity price movements impact directly on demand from mining companies, which support a significant portion of the construction industry.</p> <p>The South African Government's delay in rolling out its substantial infrastructure programme has resulted in delays in the award of tenders and available work.</p>
Liquidity risk	
<p>In addition to the decline in cash generated from operations as a result of lower profitability or project losses in the tough trading conditions, the following also have an impact on liquidity:</p> <ul style="list-style-type: none"> • The global economic slowdown has resulted in increased counterparty credit risk and delayed payments. • Complexity of contracts and perceived red tape from state-owned enterprises results in late certifications, aversion to agree valid scope changes and other unresolved commercial issues. • Cost of initial investment in new territories. • Suspension or termination of projects. 	<p>Cash flow implications should be considered in all phases of the construction life cycle.</p> <p>It is essential that good execution of contracts is complimented by good commercial management of the contract.</p>

Construction industry challenges	Impact on and required actions by the industry
Growth and expansion into new markets	
<p>In an attempt to improve margins, construction companies are taking on projects in the higher-growth economies in Africa and elsewhere.</p> <p>Entry into new markets increases a company's risk profile due to the additional investment required in communication, systems and resources to penetrate new markets and establish local capabilities. The risk associated with regulatory compliance also increases.</p>	<p>Entering a new market requires an in-depth understanding of the local culture, and specific risks and compliance requirements for that territory.</p> <p>Companies also have to improve their systems to monitor performance adequately on a contract-by-contract basis, no matter where the project is located.</p>
Legislative and regulatory compliance	
<p>There is a risk of non-compliance given the myriad local legislation and regulations relating to corporate governance, labour, taxes, health and safety, the environment, indigenisation, performance and contract-specific requirements.</p> <p>As the outcome of the Competition Commission investigation highlights, non-compliance could lead to reputational damage to companies, penalties and the inability to tender on large contracts.</p>	<p>The inherent risk associated with compliance increases significantly in respect of expansion into new territories. Embedding compliance behaviours into standard processes and procedures is imperative.</p>
Socio-economic impact	
<p>Mining developments and large-scale construction projects have led to an influx of people into surrounding communities, attracted by the hope of securing direct employment, or indirect employment in providing goods and services to project employees.</p> <p>Considering the scale of the influx of migrants, the perceived lack of service delivery by local governments, the use of housing benefits for other purposes and the apparent inability of stakeholders to agree on social upliftment projects, the limited resources of individual projects fall well short of community expectations.</p>	<p>Construction companies operate in a number of remote locations where their construction projects are subject to the risk of local social unrest, which can lead to project delays, lower production and damage to equipment.</p>
Transformation	
<p>Transforming the construction industry and with it the country is seen by the industry as a business imperative.</p> <p>A lack of transformation and a low Broad-Based Black Economic Empowerment (B-BBEE) score could negatively impact construction companies in the following ways:</p> <ul style="list-style-type: none"> • Being unsuccessful in securing public-sector tenders; • Possible client sanctions and penalties if contractually-agreed B-BBEE obligations are not met; and • Sanctions being placed on a company by the Department of Labour. <p>The limited pool of experienced engineers suitable for management positions and the steep learning curve and time frame required to equip graduates with management capabilities, remain a significant barrier to transformation.</p>	<p>We see skills development and resulting employment equity component as one of the biggest challenges facing the industry.</p> <p>Construction companies have to invest in their own and prospective employees. Up-skilling subcontractors also creates additional empowerment opportunities.</p>

Construction industry challenges

Impact on and required actions by the industry

Talent management and retention

Sourcing and retaining appropriately skilled professionals remains a key challenge in the construction industry.

A lack of expertise affects a company's ability to complete contracts and also poses a risk to company growth. Staff retention is critical to the sustainability of a company.

Recent senior management changes at some of the leading construction companies highlight the challenge of finding the right person for the job and retaining appropriately skilled people to ensure effective and efficient project execution.

Labour force and trade unions

The labour unrest and unfortunate associated violence experienced at various significant project sites, such as the Eskom power plants and at various other clients, notably in the mining sector, can result in contract delays, equipment and project damage as well as injuries to employees.

The negative impact of these events on the country's reputation has already resulted in the cancelling or delaying of foreign direct investment, removing potential construction projects from the market.

Open communication channels with own and subcontractor labour is essential for proactive monitoring and resolution of labour issues.

Failure to achieve these objectives can result in lengthy labour unrest and project delays.

Health, safety and environmental sustainability

The construction industry poses an inherent risk to the health and safety of employees and subcontractors. A threat to employees can negatively impact employee morale, resulting in a loss in productivity and reputational risk.

Construction companies also have a moral and legislative obligation to protect areas of the environment where they have an impact. Non-compliance with environmental regulations could lead to reputational risks for the company and possible legal consequences.

Despite an overall improvement in health and safety statistics over the last few years, the industry still needs to go further to embed the desired culture.

There is also ongoing improvement in the number of environmental key performance indicators (KPIs) and their monitoring.

Unfortunately, the limited KPIs assured indicate a number of challenges for the management of health, safety and the environment. An appropriate control environment with regular reporting is essential.

Companies will need to ensure that the KPIs are relevant and that they are closely monitored and reported on.

Tender risk

The difficult construction environment results in the risk that tenders are submitted at less than optimal terms under pressure to chase revenue instead of considering strategically decided long-term growth areas with sustainable margins.

Over-optimistic long-term investment assumptions could result in inadequate cash flows to redeem debt, maintain equipment and reinvest in the business. A balance is required between cash preservation and strategic positioning for the future.

Subsequent agreement of onerous contractual terms after the award of tenders is equally risky.

It is of paramount importance to have a comprehensive understanding of the risks relevant to a specific project and its environment for appropriate pricing of a tender.

Implementing key controls over the tendering process, including an appropriate authorisation and review matrix, operational and territory risk framework and commercial assessment is required.

Project execution

Project execution issues are normally the culmination of all the other risks reported. However, the significant public scrutiny of national infrastructure priority projects brings added reputational risk and impact on profitability if projects are not well executed.

The increased complexity of large-scale construction projects requires exceptional project management and discipline at all levels.

Failure in these disciplines can result in material effects on project profitability.

Construction industry challenges	Impact on and required actions by the industry
Scarce resources and cost management	
<p>The construction industry is highly dependent on the supply of electricity and water to construction sites. The cost of these resources has increased significantly in recent years and prolonged power outages and water shortages translate into lost production, which affects project deadlines.</p> <p>In 2013, skills shortage resulted in average wage increases of 9.5% across the construction industry. This is well above inflation and increases seen in other industries.</p> <p>However, the most concerning cost increases relating to the skills shortage are evident in the ineffective and inefficient cost associated with rework, poor productivity and waste and, in particular, the risk for potential subsequent claims.</p> <p>The recent bitumen shortage and resultant cost increases highlighted the need for proactive management of input material needs.</p> <p>Substandard material can be extremely costly if quality control is insufficient.</p>	<p>Companies will be required to implement smart procurement strategies, including the reduction of general overhead costs, formal quality assurance processes, the monitoring of production efficiencies and enhanced productivity initiatives.</p>

Competition Commission investigation

The risk of reputational damage from non-compliance relating to anti-competitive behaviour was highlighted during the year. In June 2013 the Competition Commission fined the major construction firms a collective R1.46 billion for anti-competitive behaviour, including collusive tendering relating to projects concluded between 2006 and 2011.

The Commission launched the Construction Fast-track Settlement Process on 1 February 2011, by inviting firms in the construction industry to disclose projects and tenders that were subject to bid-rigging conduct, for the purposes of settlement. The closing date for this invitation was 15 April 2011.

This process ran concurrently with the Commission's Corporate Leniency Policy in which the first firm to disclose a rigged project would earn conditional immunity from prosecution for that project.

Applicants were required to provide the Commission with truthful and timely disclosure of information and documents relating to the prohibited practices and to provide full and expeditious cooperation to the Commission concerning the prohibited practices.

The Commission received applications from 21 firms in the construction industry, including the top six construction firms, covering 300 projects worth an estimated R47 billion.

Of these 300 projects, 160 are prescribed, while 140 are not prescribed (falling within the time frame stipulated for prosecution and hence eligible for settlement).

Rather than facing protracted and costly legal action, firms that participated in the process would be liable for penalties that constituted a percentage of yearly turnovers for the 2010 financial year.

Of the 21 firms that applied for settlement, 18 firms were found liable to settle and three firms were considered to be exempt from settlement as they were the first to apply and so qualified for conditional leniency.

Of the 18 firms found liable, the commission reached settlement with 15. An agreement is yet to be reached with Group Five, Construction ID and Power Construction on some projects and various other companies relating to specific projects.

Correcting the course of capital projects: Plan ahead to avoid time and cost overruns down the road

Large capital projects, with their multi-year timelines, changing requirements and complex procurement issues, are inherently risky. They require diligent oversight from management and the board given the common occurrence of budget overruns and their effect on the company's financial health.

Boards have the responsibility to oversee an organisation's strategy and key risks. Capital projects fall squarely within this realm in the light of their significant costs and the business implications of delayed or over-budget projects. Lack of oversight from the board can result in severe consequences. For example, in the power sector, regulators have rejected substantial portions of capital funding requests in situations where they believe management and the board could have exercised better oversight of costs, schedules and risks.

Any institution that has ever undertaken major capital building projects knows they almost always take longer and cost more than expected. Unless strong project controls are in place, project owners often don't realise the severity of delays and cost overruns until well after a project has foundered.

How a board and its management handle the various issues on a capital project go a long way in determining the success of the project.

A recent international analysis carried out by PwC of 52 capital projects missteps at public companies¹ showed that after a public announcement of a capital project delay or shutdown, a majority of companies experience a steady decline in the share price. By the three month mark following the announcement, the declines in price averages 15%. In the most severe case of the companies analysed, one experienced an almost 90% decline in share price.

While cost overruns and delays have always been serious issues, companies have become increasingly concerned about them since the recent economic uncertainty. A report issued by PwC, 'Correcting the course of capital projects', finds that mega-projects usually exceed their budgets by 50% or more. Also, large projects tend to be risky with costs for some exceeding \$1 billion over many years and encompassing many moving parts, resources and contractors.

In emerging markets, such as Africa, project developers also face unique problems, including language barriers in contract negotiations, different legal standards, a greater likelihood of political interference, and the need to import skilled labour, equipment and materials.

A number of infrastructure projects have been rolled out across the African continent. The Industrial Development Corporation invested a total of R6.2 billion in 41 projects across 16 African countries in 2012, the majority of these being in mining, industrial infrastructure and tourism.

¹ Correcting the course of capital projects: Plan ahead to avoid time and cost overruns down the road (PwC April 2013)

Within South Africa, the Government is on track to spend in excess of R4 trillion on infrastructure in the near future, focusing on rail, roads, water, energy, communication and sanitation.

Infrastructure is a top priority in Africa, with many countries still not investing enough, hampering their growth prospects and increasing burden on the years ahead and on future generations.

Many projects experience problems along the way because they didn't get off to a good start. Poor estimates during project planning and missed deadlines are the largest contributors to project failure.

But even projects that veer far off track can be corrected if both the owners and contractors are amenable to working together to resolve the immediate problems and establish a more effective plan to work together to resolve the immediate problems and establish a more effective plan for managing and monitoring the project.

The three key elements of the control environment are proper transparency of controls, clear accountability of responsibilities and a meaningful audit trail of information to make sure people are performing their required roles effectively, states the report. An effective risk management process is also critical to ensure project managers monitor risks and assess when they need to put a mitigation plan in place.

The best way for a company to get back on track fast is to be alert to red flags. Such signals usually indicate it's time to investigate to determine whether the project is truly in trouble and if so, how to fix the problems.

Two obvious signs of project trouble are requests to expand the budget and stretch the schedule. Other indicators that a project is in peril include changing the scope, delay of materials, suspicion of fraud, and safety concerns. One serious injury or a string of minor injuries can bring a halt to the project to investigate causes and even lead to the revision of risk management plans.

There are a number of actions that can bring a project back on track. These include the balancing of costs, quality and time. A knee-jerk response may be to cut costs or to rush to get back on schedule. But in trying to cut costs that are out of control, or speed up a project that has fallen behind, quality may suffer.

Companies should seek experienced project managers. To help fix troubled projects, owners may need to strengthen their project management team by filling in gaps or bringing in different and more experienced people. All parties should also keep a comprehensive audit trail. Litigation is always a possibility, so all parties should thoroughly document project decisions and developments.

Infrastructure in Zambia: a case study

A large number of South African construction companies are doing construction projects in Africa or are considering to increase their footprint on the continent. The main driver is access to higher margins which should compensate for the potential higher risks taken in these countries.

As Africa is endowed with significant natural resources, it's natural that significant large scale infrastructure projects often follow mining developments and associated infrastructure.

On the back of global copper demand Zambia is also faced with growth limitations as a result of its infrastructure deficiencies. This case study looks at the challenges faced by Zambia and its efforts to address these which create opportunities for construction entities.

Enhanced infrastructure key to unlocking growth potential

Zambia is Africa's largest and the world's seventh-largest copper producer. Copper mining has historically been the mainstay of the economy, contributing over 20% of GDP.

Zambia is also the world's fourth-largest producer of cobalt, with other mining production including gemstones, ferrous metals, precious metals and industrial minerals. There is growing development of other resources such as emeralds.

Discovery of copper for commercial production took place in 1895 and it was finally commercialised in the 1920s. The mines were privately owned during the colonial period. Following Zambia's independence in 1964, the government of President Kaunda nationalised the entire mining industry. However, following a period of falling copper prices and stagnating production, the Zambian copper mining industry was privatised in the 1990s.

In 2012, copper production of 800 000 tons exceeded the previous peak achieved in 1972 of 700 000 tons, with projections that copper production should reach 1.5 million tons by 2016 on account of major new projects coming on-stream.

Infrastructure

Inadequate infrastructure is one of the key factors restraining development of the Zambian mining industry. The World Bank's Global Competitiveness Report 2012-2013, ranks Zambia 118 out of 148 countries in terms of infrastructure quality, lagging behind other major African producers such as Ghana and South Africa. The challenges posed by the lack of infrastructure development can be summarised as follows:

- Smelting capacity

The Ministry of Mines acknowledges that smelting capacity will be insufficient to cater for the increased production coming on-stream by 2015. Current smelting capacity stands at 800 000 tons per annum with current projects expected to increase capacity to 1.2 million tons. This will leave an anticipated deficit of 300 000 tons. Further investment in efficient smelters is therefore essential.

- Roads

The Zambian economy is overwhelmingly reliant on road transport, which is currently the only reliable mode of transport for both freight and passengers. The relatively poor state of Zambia's road network is exacerbated by serious damage caused by trucks carrying copper, other minerals and mining equipment. Given that Zambia is a large, landlocked country, this poses a barrier to further development in the mining sector.

The Zambian Government is implementing the Link Zambia 8000 road project, which aims to increase the capacity of the road network by undertaking 15 major road projects between 2012 and 2015 as well as upgrading existing routes.

- **Rail**

While rail transport is generally regarded as the most competitive means of transport for bulk commodities, the Zambian rail networks are currently unreliable and inefficient. Over the years, a lack of investment has led to a gradual deterioration in the rail network causing a fall in cargo traffic and a reduction in average speed from 60km/hr to 15km/hr.

The Zambian Government acknowledges these problems and has committed to enhancing the rail transport system. Part of the proceeds of a USD750-million Eurobond issued in 2012 has been invested in the rail sector. Progress to date includes the completion of the Chipata rail line connecting Zambia, Malawi and Mozambique. New and improved cargo trains are being acquired to facilitate transportation of minerals and other cargo to the ports in Dar es Salaam, Tanzania and Maputo, Mozambique.

There is scope to integrate the Zambian rail system further with the Democratic Republic of Congo's mineral-rich Katanga region. Other potential improvements include a rail line to link the country to Walvis Bay, Namibia where Zambia has been granted access to build a dry port that could significantly enhance its access to export markets.

- **Power supply**

Zambia is home to approximately 40% of the SADC region's water resources and its power sector is dominated by hydro-electric power generation. Zambia's hydro power resource potential is estimated at 6 000MW, but only around 1 900MW is currently utilised.

To support the energy supply infrastructure for mining activities, the Zambian Government established a private sector operator, Copperbelt Energy Corporation (CEC), to supply electricity to mines. CEC operates around 900km of transmission lines and 38 major substations. It obtains most of its supply from the state-owned power company, ZESCO.

CEC also generates 80MW from its own gas turbine generation facilities. This demonstrates that the private sector can make an important contribution in delivering the infrastructure needs of the Zambian mining sector. However, given that the domestic sector suffers from regular power shortages, it is imperative to encourage further investment in power supply to safeguard sustainable growth in the mining sector.

The power supply deficit is currently 250MW and will grow significantly without substantial investment. Another issue is the quality of supply, with current fluctuations having the potential to damage electrical equipment.

- **Water supply**

The high demand for water in the mining sector for processes such as product dilution, extraction, heating, cooling, dust control and waste separation, poses a critical challenge for Zambia, which has low seasonal rainfall. Pipelines connecting mining and processing facilities with water resources are required.

About 40% of drinking water for Zambia's major cities is derived from the Kafue River, which is also the destination for some mine effluent. Further investment is required to diversify water supply and undertake environmental protection. Such measures are critical to balance the demands of the domestic and mining sectors for water.

Outlook

It is imperative that the Zambian Government continues to prioritise the development of infrastructure to support economic growth in the mining and other sectors. This requires an integrated programme, including the following key elements:

- Innovative funding for government projects, building on the successful 2012 Eurobond issuance. This must be underpinned by accountable and transparent expenditure on suitable projects in transport, power, water and other key infrastructure.
- Enhanced cooperation between the Government and its international partners to ensure that external funding for infrastructure projects are focused on key strategic priorities including enhancing road/rail connectivity to major regional ports.
- Encouraging further private investment to build on the successful operation of private-sector power supply to the mining sector.

4. Safety



The past two years have seen leading construction companies, the Government and unions showing increased concern with respect to occupational safety, which is essential if the industry is to remain sustainable in the long run. This is evident in the emphasis placed in recent initiatives such as the Construction Health and Safety Accord. The Accord is an agreement between government, labour and business to improve the status of health and safety in the construction industry and was signed in August 2012.

Numerous stakeholders such as the Department of Labour (DoL), Department of Public Works (DPW), Congress of South African Trade Unions (COSATU), the Federation of Unions of South Africa (FEDUSA), the National Council of Trade Unions (NACTU), Black Business Council in the Built Environment (BBCBE), South African Federation of Civil Engineering Contractors (SAFCEC) and Master Builders South Africa (MBSA) all participated in the signing ceremony.²

There has also been an increase in awareness for the need for greater discussion of safety matters in annual integrated reports, increasing rigorous safety inspections by the DoL, safety stoppages, construction safety articles in the media and union commentary over this matter.

The construction sector has increasingly come under scrutiny for the high number of injuries and fatalities experienced. The DoL highlighted the following safety status during an initiative to meet with construction industry leaders:



The building and construction sector identified as one of high risk sectors alongside the agriculture and forestry; chemical; food, drink & tobacco industries and iron & steel paid more than R287 million for occupational injuries in the year ending 31 March 2013. In the building and construction sector in the period from 2007-2010 there were 171 fatalities and 755 injuries.³

While there have been insinuations that fatalities are linked to the high-price environment – that chasing profits causes accidents that result in injury and death – the reality is that improving safety has a profit incentive. The DoL laments that while it endeavours to protect vulnerable workers and monitor the impact of legislation, South Africa continues to be plagued by lack of adherence to the Occupational Health and Safety Act, resulting in injuries and deaths in the workplace. The effects are loss of income due to a halt in production and a decline in gross domestic product.

² "DoL to sign a Construction Health and Safety Accord to help stem casualty list." Department of Labour. <http://www.labour.gov.za/DOL/media-desk/media-alerts/dol-to-sign-a-construction-health-and-safety-accord-to-help-stem-casualty-list/> (accessed 8 November, 2013)

³ "Department of Labour meets chiefs of construction industry to improve the status of occupational health and safety in the industry." Department of Labour. <http://www.labour.gov.za/DOL/media-desk/media-alerts/department-of-labour-meets-chiefs-of-construction-industry-to-improve-the-status-of-occupational-health-and-safety-in-the-industry> (accessed 8 November, 2013)

While occupational hazards and risks are probably more easily identifiable and manageable in some sectors (e.g. mining and the chemicals), the construction industry faces a number of unique challenges pertaining to effective occupational safety management:

- Construction projects, especially large ones, are complex and dynamic. Several employers may work on one site simultaneously, with the mix of contractors changing with the phases of the project⁴;
- One can argue that, a limited number of tasks/activities are truly repetitive due to the wide variety of projects and changing conditions;
- Construction workers are more prone to naturally occurring unsafe conditions such as strong winds, heat, cold, rain and lightning;
- Construction workers are typically employed from project-to-project and may spend only a few weeks or months at any one project site. There are consequences for both workers and work projects. Workers must make and remake productive and safe working relationships with other workers whom they may not know, and this may affect safety at the work site;
- The complex safety administration hierarchy of principal contractor, subcontractor and sub-subcontractor requires strong administrative, communication and leadership skills;
- At certain given times during a construction period, a project may include a large proportion of inexperienced, illiterate, temporary and transient workers who may not be fluent in the common language;
- Construction workers may have several employers and less than full employment. In order to make up for non-busy times, many construction workers have other jobs at the same time, which is more likely to increase the health and safety burden. Although construction work must often be done in teams, it is difficult to develop effective, safe teamwork under such conditions; and
- The administrative cost of effective health and safety management is seldom included (or fully) included in project costing.

The Accord acknowledges that the South African construction sector contributes immensely to the alleviation of unemployment and economic growth, and as such all necessary interventions are taken to ensure that health and safety objectives are attained, concurrently with infrastructure development, employment creation and positive economic growth.

As the end of 2013 approaches, only time will tell the extent to which these initiatives have contributed to the reduction in fatalities and injuries.

⁴ "Health and Safety Hazards in the Construction Industry." ILO Encyclopaedia of Occupational Health and Safety. <http://www.ilo.org/oshenc/part-xvi/construction/health-prevention-and-management/item/518-health-and-safety-hazards-in-the-construction-industry> (accessed 8 November, 2013)

5. *Meeting the tax challenge*



The changing tax landscape facing the construction industry

The construction industry in South Africa is diverse and involved in projects ranging from the development of civil infrastructure such as roads, bridges, ports and dams, the development of residential and non-residential buildings such as houses, retail facilities and offices as well as small private projects for individual home owners. The industry is comprised of large companies listed on the JSE to smaller participants such as small and micro businesses.

Apart from the challenging economic conditions that the industry has to deal with, it is faced with an additional challenge in the form of increased pressure from tax authorities. Tax authorities throughout the world are focussing on tax collections and compliance to bolster in-country revenue, resulting in increased tensions between tax authorities and taxpayers.

Tax authorities are rethinking the way in which they enforce the law and organise their tax systems. In South Africa, this is evidenced by the five-year compliance programme announced by the South African Revenue Service (SARS) and detailed in the publication entitled 'Compliance Programme 2012/2013 to 2016/2017'⁵. In his foreword, the SARS Commissioner states that the publication provides a high-level overview of the plans to grow compliance with tax and customs legislation over the next five years.

SARS plans to do this by paying particular attention to areas that its research shows pose a significantly higher risk of non-compliance. Of particular interest is the fact that the construction industry is listed as one of the seven areas on which SARS would like to focus in the next four years. SARS says its research has shown compliance within the construction sector to be low.

SARS has therefore expressed its intention to conduct extensive compliance checks and integrated audits in this industry, paying particular attention to individuals and entities that are awarded government tenders. Filing, declaration and payment behaviour will be scrutinised for corporate income tax, value-added tax (VAT) and employee tax (PAYE). Attention will be paid both to contractors and the various levels of subcontractors.

Apart from VAT, where SARS reports significant incorrect disclosures, SARS will also focus on PAYE and corporate income tax, where audited cases show under-declaration of 50% and 61% respectively. Of concern is the fact that SARS reports a lack of compliance in respect of the filing of returns, evidenced by the fact that 64% of corporate income tax returns are not filed on time, while 36% of VAT returns and 28% of PAYE returns are not filed on time. SARS also reports that over half of payments of corporate income tax and VAT are made late.

SARS will be concentrating on creating a sustainable improvement in compliance levels in the construction industry through:

- Integrated multi-tax audits, where entities are audited for all taxes simultaneously;

⁵ <http://www.sars.gov.za/AllDocs/SARSEntDoelib/Ent/SARS-Strat-07-G02%20-%20Compliance%20Programme%202012%202013%20to%202016%202017%20%E2%80%93%20External%20Guide.pdf>

- The imposition of administrative penalties for late filing and payment;
- Ensuring continued compliance for the duration of a government tender – rather than only requiring a tax clearance certificate at the beginning of the process;
- Introducing an early contact strategy with non-compliant taxpayers to ensure that unexpected tax debts do not threaten their ongoing viability; and
- Making use of agency appointments to recover outstanding debts.

It appears that SARS will encourage compliance by focussing on a new risk-based approach. It envisages a new form of relationship between itself and large business in which both parties work together to achieve the highest possible level of compliance across the taxes for which particular businesses need to account. The new approach is based on a simple principle: if a company can show that it has a functioning internal tax control framework, then the company will not be ‘harassed’ or audited in the conventional way.

SARS’ initiative to bolster revenue collections and make the tax system fairer and more effective while simplifying compliance requirements is in line with recent developments led by the Organisation for Economic Co-operation and Development (OECD). The OECD has established an independent foundation to provide international auditing expertise and advice to assist developing countries address tax base erosion. This will include tax avoidance and evasion. These OECD initiatives have been championed by the SARS Commissioner and the Deputy Finance Minister.

It is therefore apparent that the biggest financial and reputational risks facing the construction industry in the future may relate to taxation. Taxpayers within the industry should therefore evaluate their tax risks in line with the changing governance and risk landscape of their organisation and recognise that the tax resources within the organisation should no longer be responsible only for tax technical and tax compliance.

This new landscape requires improved governance, adequate risk management practices, improved transparency and disclosure to the board, audit committee and stakeholders in respect of taxes. The new compliance enforcement strategy adopted by SARS, and influenced by the OECD’s guidance on tax administrations, will adjust SARS’ audit approach towards a taxpayer if that taxpayer transparently discloses relevant information on the internal management of tax and has proper validation systems in place.

With the increased attention on the construction industry, it is advisable for organisations to assess their tax functions and consider whether they would be ready to face the challenges posed by the new tax environment, coupled with the complexity and volume of new legislative changes. The increased focus on an internal tax control framework requires an enquiry by construction entities to ascertain whether their organisation is capable of controlling and monitoring its tax environment.

Tax professionals responsible for an organisation’s tax affairs generally do not have a risk, governance and compliance proficiency and the gap between tax, enterprise risk management and corporate governance might leave organisations exposed and unable to substantiate their compliance landscape.

This places further importance on risk management and the need for internal assurance, as boards and audit committee members will start raising questions and looking to management teams across the organisation to provide the necessary comfort.

Management will therefore be under increased pressure over the next three to five years to provide assurance in response to the concerns of the board, audit committee and external stakeholders, including SARS, in respect of tax risk and the tax control environment.

Governance, enterprise risk management and the concepts of risks, controls and combined assurance frameworks should therefore form part of an organisation's tax function lexicon. In order to meet the demands and requirements of stakeholders, there would be an increased need for an organisation's tax function to assist with the integration of tax risk into the organisations' risk frameworks and governance structures. The tax function will increasingly have to demonstrate to its stakeholders, such as SARS, that it is a good corporate citizen, that risk management requirements are met and that an adequate and effective tax control environment exists.

Having an effective tax function alone will not achieve the value required by stakeholders and the demands that will be placed on a tax functions as a result of SARS' new approach. Integration and synergies with co-assurance providers will not only be an enabler for the tax function, but will ensure that the board, audit committee and stakeholders can rely on the tax risk control environment.

Value-added tax and the construction industry

21 years and counting

“The full list of mega-infrastructure projects for the country that is under consideration at this time is estimated to be worth around R3.2 trillion.” These are the words of finance minister Pravin Gordhan contained in the South African Revenue Service (SARS) Strategic Plan for 2012/13-2016/17.

These comments bode well for the future of the construction sector in the South African market given SARS' increased efficiency in revenue collection and the Government's commitment to increase public spending and ambitious infrastructure development programmes. Or does it?

Let's first go back

Value-added tax (VAT) was introduced in South Africa in September 1991. VAT was introduced at an initial rate of 10%, but has been fixed at 14% since 1993. With global economic uncertainty at an all-time high, the debate about where our VAT rate is going continues.

Global trends seem to suggest that indirect taxes (most notably VAT) are the preferred mechanism should National Treasury be forced to consider an increase in the rate of any of the key sources of taxation. The implementation of an ambitious universal system of health insurance in South Africa certainly strengthens the argument of raising the standard rate.

Compared to the global average of 18-20%, the South African VAT rate is on the low side. All things considered, there are a number of reasons to believe that the VAT rate will remain unchanged for the time being. No doubt, any attempts to increase the rate of VAT will be met with strong resistance from civil society and the population at large.

SARS' strategic focus

SARS' Strategic Plan lists four core desired outcomes, including increased tax compliance.

In an address to Master Builders SA in June 2012, then SARS Commissioner Oupa Magashula said:



VAT under-declaration in the construction industry is of serious concern, where almost 70% of audited cases reveal incorrect disclosures. Our assessment suggests that the biggest risks lie in the small and medium business segments, and particularly in contractors and subcontractors involved in paving, painting, decorating, plumbing, wall and floor tiling, heating and ventilation and ceilings and flooring.”⁶

Increased SARS scrutiny in this sector is no secret. It is also plain that VAT will play a significant role in this increased focus.

VAT challenges facing the construction sector

Cost of VAT compliance

It takes a model company around 123 hours to comply with VAT compared to 74 hours for corporate income tax. This is one of the findings of PwC's annual 'Paying Taxes' 2012 study, issued jointly with the World Bank and the International Finance Corporation. In South Africa, companies with annual turnover exceeding R1million have to complete three tax returns for company tax purposes versus 12 VAT returns.

The introduction of e-filing has reduced the amount of paperwork associated with doing taxes and has lowered the costs of administration. The improved transparency it provides in interactions with SARS has resulted in increased automatic systems-generated queries such as explanations in variances from month to month. It is doubtful that SARS has the capacity to interpret all VAT responses received from taxpayers on a monthly basis, but this does not detract from the increased costs in complying with VAT rules and administration.

IT14SD reconciliations

A large number of taxpayers have already received SARS' latest tool in its shift from being a gatekeeper to implementing a risk management approach. This requires the taxpayer to reconcile (to R100) its revenue and expenses declared in its IT14, VAT returns, Customs declarations, PAYE, costs of sales and financial statements.

⁶ Cokayne

This reconciliation will create obvious challenges on the VAT front for the construction industry where special time-of-supply rules exist that differ from accounting and corporate income tax revenue recognition rules. This reconciliation will also challenge the robustness of companies' accounting systems such as the ease of extracting detailed information and the accuracy of its controls.

Limited time (around three months) is afforded to respond to this SARS query, while sanctions loom large: from the withholding of tax clearance certificates and refunds to the denial of deductions and the issuing of assessments plus penalties and interest.

This reconciliation is here to stay and those that have not yet received it will do well to prepare by making sure the required information can be retrieved and analysed.

Direct attribution and apportionment

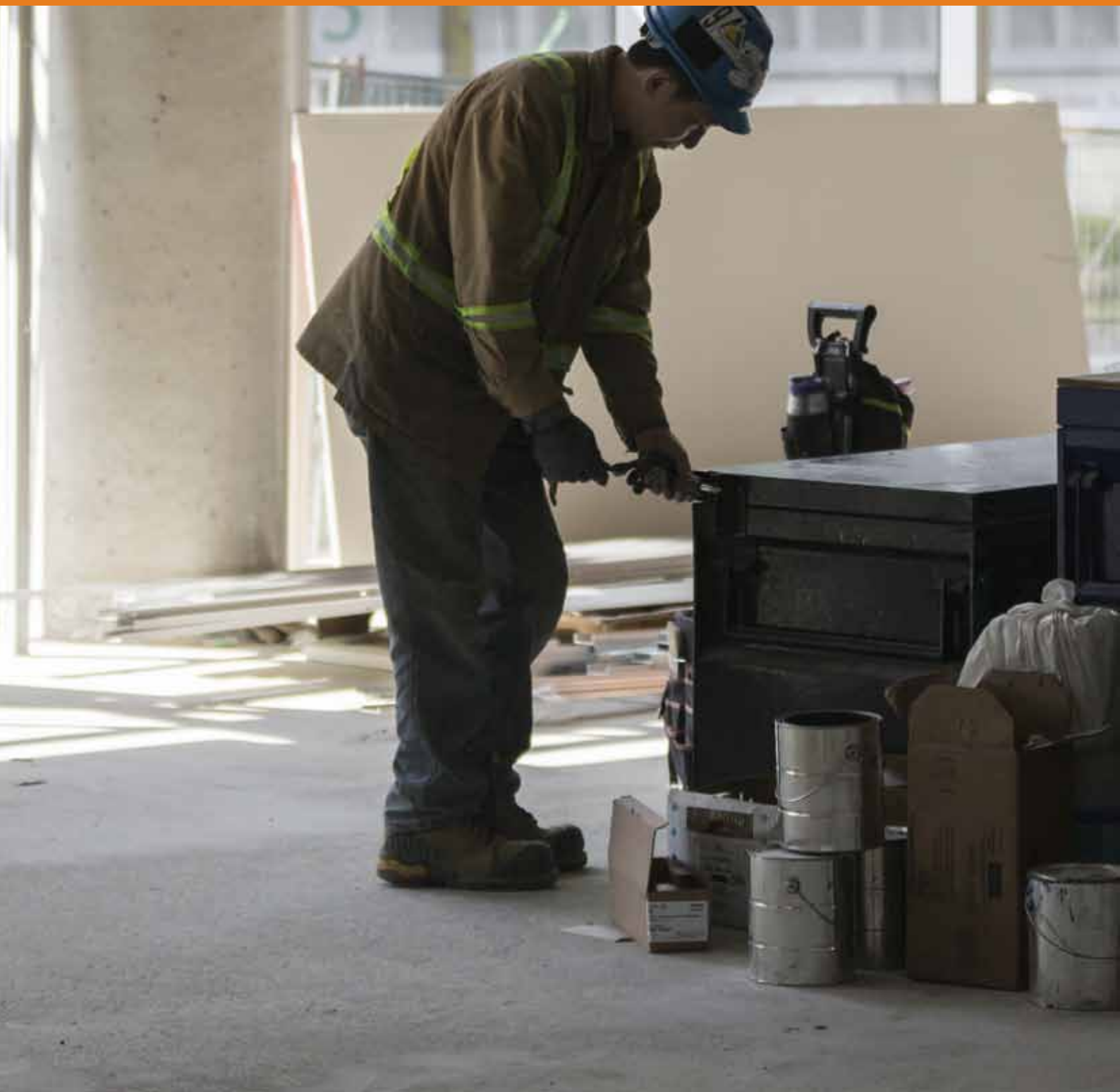
Input VAT is only claimable to the extent that goods and/or services are acquired for the purposes of consumption, use or supply in the course of making taxable supplies.

Companies in the construction sector often receive large amounts of upfront payments that yield significant interest income. This, together with foreign exchange movements as a result of pricing variances resulting from goods imported, could easily comprise 5% of a company's turnover (if one applies the standard turnover-based method of apportionment, i.e. the only SARS pre-approved method of apportionment), which will require such company to apportion some of its input tax.

It further remains to be seen how SARS will use the Appeal Court judgement in the De Beers-case to attack the deductibility of input tax paid on goods and/or services acquired that relates to 'non-enterprise' activities.

Taking into consideration SARS' intention to increase its activity levels in the construction sector with a particular focus on VAT, it is now more necessary than ever that players in this sector include VAT compliance in their strategic planning activities and where necessary, be prepared to defend business and VAT decisions from overeager tax officials.

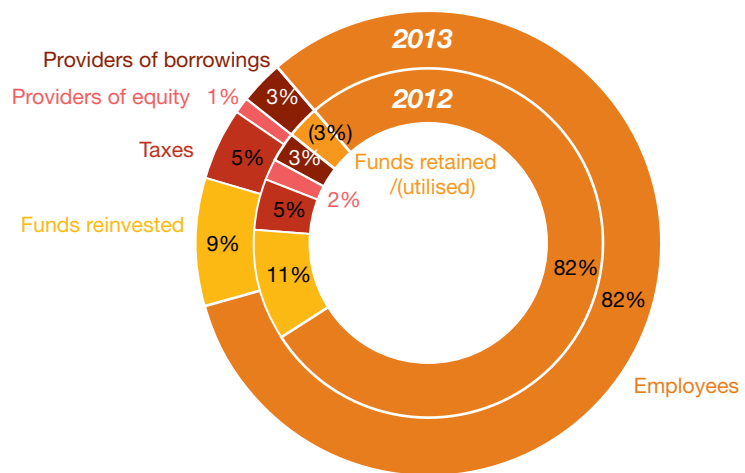
6. *Value added*



The construction sector adds significant value to our country and its people. Stakeholders in the construction industry include employees, their families, unions representing them, the Government as regulators and custodians of the tax income for the country, investors, suppliers and customers. The monetary benefit received by each of these stakeholders is often summarised by companies in their value added statements.

Nine of the 10 companies included in this analysis representing 94% of the revenue for all companies considered provided readily available value added statements. Figure 9 shows how the value created, being the difference between income and direct purchases, was distributed to the various stakeholders.

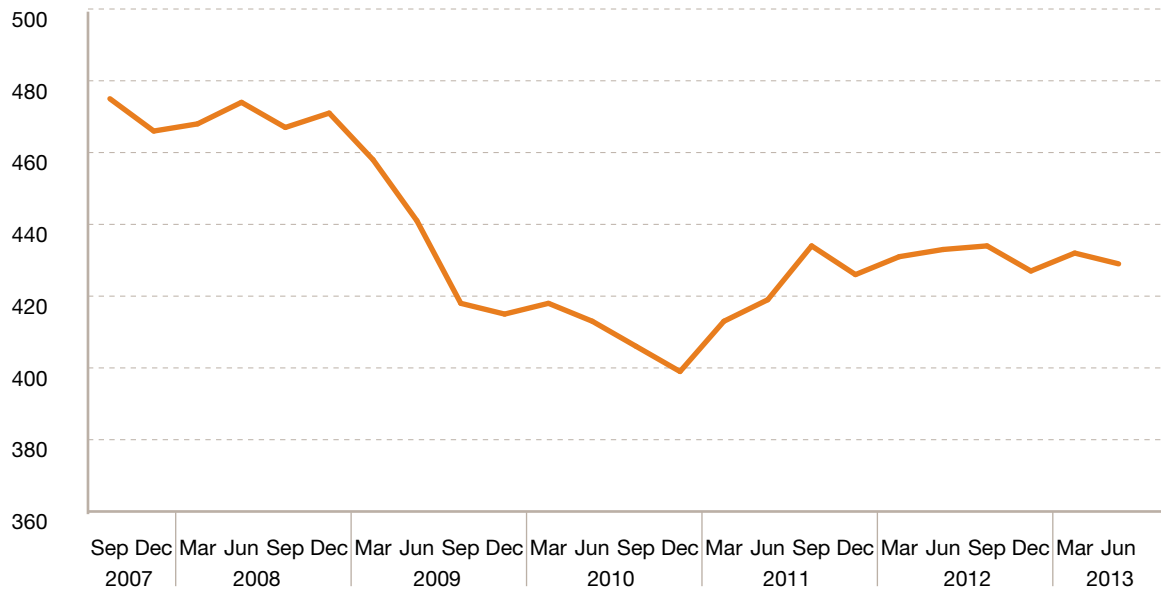
Figure 9. Value added distributed to stakeholders



Source: PwC analysis

The value received by employees, including employee tax, represented 82% (2012: 82%) of the value created. This is a significant contribution to the labour market. According to Stats SA, more than 420 000 people are employed directly by the construction industry. Their employment depends to a large extent on the construction activity in the country and can vary with the economic cycle, as illustrated by the Figure 10.

Figure 10. Number of employees in the construction industry (thousands)



Source: Stats SA

The percentage of value created that is collected by providers of debt capital has remained consistent with the prior year at 3%. This low percentage reflects the fairly conservative levels of gearing in the South African construction industry.

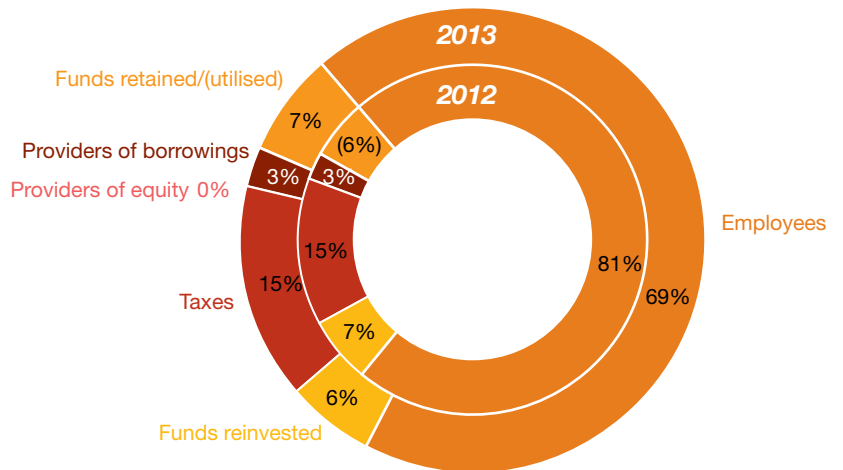
The 1% (2012: 2%) received by the providers of equity capital decreased from the prior year, and reflects the volatility of returns to shareholders. The decrease was mainly due to a decrease in the dividends paid by Aveng.

Of the value created, there were no funds left to retain for future growth. In the prior year, retained funds had to be utilised to fund the reinvestment. Using borrowings or retained cash resources to fund operations and capital projects during a downturn is common for any cyclical business. It goes without saying that this cannot continue in perpetuity. Solvency ratios for the South African construction industry remained strong despite a marginal weakening.

The state received 5% (2012: 5%) of value created in the form of direct taxes. The reality is that the state receives significantly more if one takes into account the tax on employee income deducted from employees' salaries and net indirect taxes like VAT.

Only two companies, representing 34% of total revenue, but 61% of net profit, disclosed information to calculate the impact of employee taxes and VAT on the value distributed.

Figure 11. Value added distributed to stakeholders taking into account indirect tax



Source: PwC analysis

The significant increase in tax benefits received by the state compared to the calculation of direct tax only, indicates the impact of indirect taxes and the benefit for the fiscus.

Construction companies added value not only through the development of infrastructure and buildings, but also through wealth which increased by 19% during the current year.

To create more value for all stakeholders it will be necessary to increase the size of the pie. An increase in the total value created will increase the total benefits received by employees, the Government and investors.

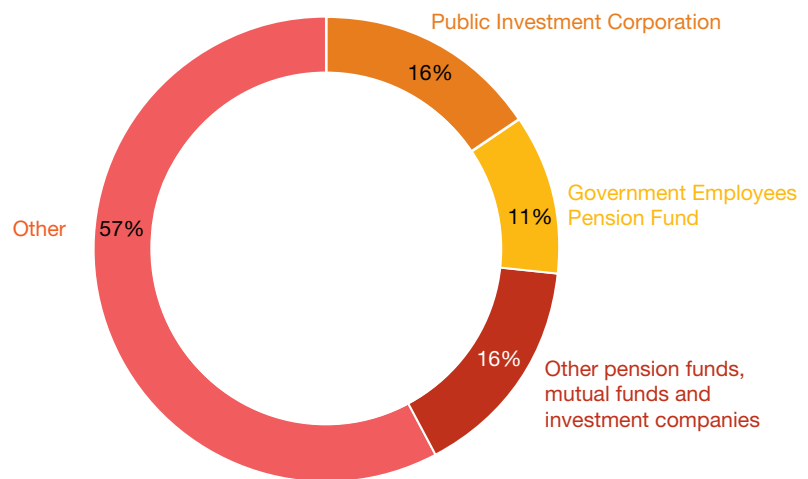
7. *Shareholders analysis*



In analysing the shareholding (5% or larger) in construction companies, the significance and importance of this industry to the South African economy is clear. Investment in this industry supports not only domestic economic growth and job creation, but also contributes to the creation of wealth for pensioners and investors.

Figure 12 shows the extent of investments by public-interest investors such as the Government Employees Pension Fund (GEPF) and the Public Investment Corporation (PIC) in the South African construction industry. Together, their investment represents 27.3% of the market capitalisation in the sector represented by the top 10 companies. Major investment by other pension funds, mutual funds and investment companies makes up a further 15.6% of the total investment in the industry.

Figure 12. Shareholder breakdown



Source: PwC analysis of annual reports

8. *Boardroom dynamics*

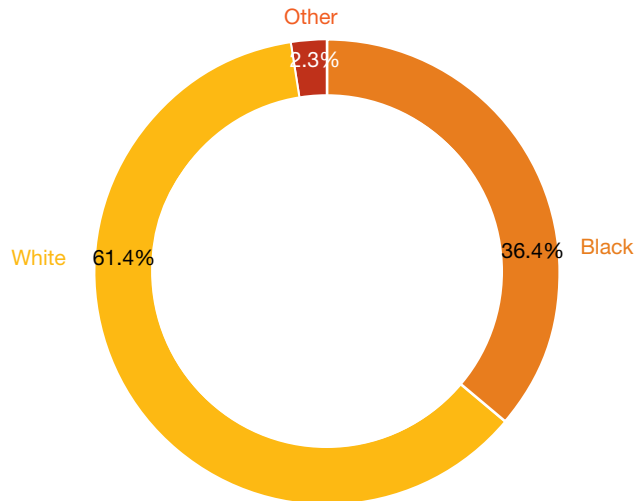


Board composition

A review of the board composition of the companies analysed suggests that the construction industry is currently on track to comply with the minimum empowerment levels of board representation required by the Construction Charter.

At present, 38.7% of board members are represented by historically disadvantaged individuals (HDIs). The Construction Charter requires a minimum of 40% representation within the seven-year period from June 2009. These targets will possibly change as the Construction Charter would need to be aligned to the generic codes by October 2014.

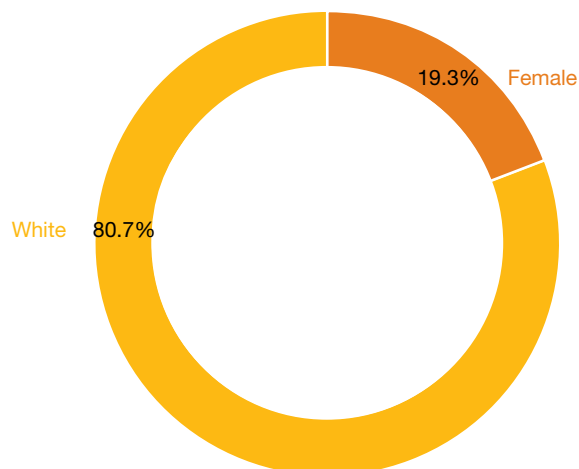
Figure 13. Board composition by race



Source: PwC analysis

Female representation at board level is currently 19.3%. The representation of black woman at board level is currently 14.8%, which is still below the minimum requirement of 20% black woman set out in the Construction Charter.

Figure 14. Board composition by gender



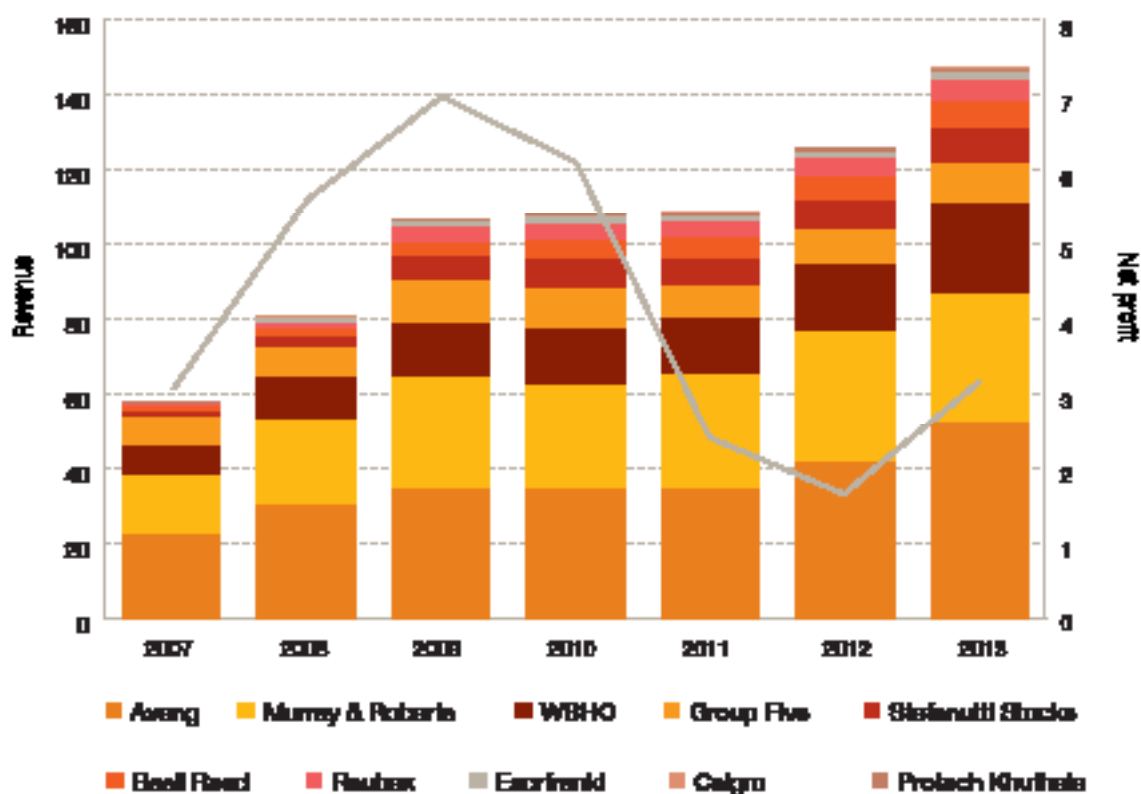
Source: PwC analysis

9. *Financial performance*



Seven-year history

Figure 15. Revenue vs net profit, 2007-2013 (R 'billions)



Note: The R6 billion profit on the disposal of an investment by Aveng has been removed from the 2007 result

Source: PwC analysis

The historic trend revenue numbers show the significant revenue growth experienced on the back of global economic growth and the infrastructure development leading up to the 2010 FIFA World Cup in South Africa and the subsequent stagnation in growth. In 2012 and 2013 revenue improved significantly signalling a hopeful recovery for the industry.

Note that the 2012 figures shown in Figure 9 differ from the income statement that follows where discontinued operations have been split out from historic numbers. Profit decreased substantially over the seven-year period as cost increases and competition as a result of spare capacity resulted in a significant decrease in margins. There are promising signs of a recovery in profits in 2013.

Current-year financial performance

	Current year R 'millions	Prior year R 'millions	Difference R 'millions	% change
Construction revenue	133 407	108 782	24 625	23%
Other revenue	12 386	12 046	340	3%
Total revenue	145 793	120 828	24 965	21%
Operating expenses	(140 951)	(117 992)	(22 959)	20%
PBIT	4 842	2 836	2 006	71%
Net interest	(246)	(289)	43	-15%
Tax expense	(1 512)	(1 281)	(231)	18%
Net profit	3 085	1 266	1 819	144%
PBIT margin	3.3%	2.3%	1.0%	
Net profit margin	2.1%	1.0%	1.1%	

Source: PwC analysis

Revenue

Total revenue increased by 21% on the prior year mainly as a result in increase in construction revenue.

The increase is mainly derived from R10.8 billion from Aveng, R5.9 billion from WBHO, R2.9 billion from Murray & Roberts, R2.3 billion from Group Five and R1.3 billion from Stefanutti Stocks. The total increase was largely as a result of increases in revenue in the Australasian businesses and a weaker rand. Growth in the local market for some companies was largely offset by decreases in revenues for others.

Operating expenses

Operating expenses consists of employee costs, subcontractor costs, materials plant and other costs. Unfortunately, disclosures of the underlying costs by their nature are insufficient to provide a detailed analysis of costs and their drivers.

Total costs increased by less than revenue, therefore resulting in a slight increase in margins achieved. The increase achieved takes into account the substantial Competition Commission penalties provided for. However, it should be noted that companies might already have provided for part of this expense in the prior year. The full extent of its impact is not readily available from the financial statements.

Staff costs made up 27.9% of total operating costs (2012: 29.4%). This cost component increased by 13.5%, which is well below the construction revenue increase of 23% and therefore could indicate improved productivity. However, for a number of the new projects, a substantial component of the contract is the sourcing and supply of equipment. It is therefore more likely that the contract mix has changed.

The accompanying tables provide an overview of salary increases for construction and other industries.

Total average lift to payroll for the year to August 2013

Employee category	Construction / Engineering / Petrochemical	Financial services	Manufacturing / Fast-moving consumer goods / Retail	Mining / Quarrying	Other	Parastatal / Tertiary education
Executives	7.8%	5.9%	6.3%	6.5%	6.3%	6.8%
Management	7.7%	5.8%	6.4%	7.0%	7.0%	6.9%
General staff	7.6%	6.5%	6.6%	7.2%	6.3%	7.5%
Key specialists	7.8%	5.9%	6.5%	6.3%	7.2%	7.0%
Unionised staff	8.1%	7.8%	7.5%	7.2%	8.0%	8.0%
Total average lift to payroll	7.6%	6.3%	6.7%	7.2%	6.6%	7.2%

Sources: PwC Remchannel biannual Salary and Wage Movement Survey,

Average year-on-year increase in total guaranteed package across various industries for the year to August 2013.

Employee category	Mining	Construction	Project engineering
Executive management	6.0%	10.1%	7.4%
Senior management	6.2%	12.2%	7.0%
Middle management	5.9%	7.4%	7.0%
Junior management	4.6%	9.7%	7.3%
Entry-level management	4.6%	10.6%	9.0%
Supervisory	6.8%	9.6%	9.3%
Senior clerical	8.5%	10.4%	9.6%
Clerical	8.1%	6.9%	9.0%
Semi-skilled	11.5%	8.3%	10.1%
Unskilled	13.1%	10.1%	8.7%
Overall average	7.7%	9.5%	8.4%
Difference between unskilled and executive increases	1.7%	0.57%	1.0%

Sources: PwC Remchannel biannual Salary and Wage Movement Survey, Stats SA

As the salary tables demonstrate, the construction industry has enjoyed higher salary increases than other sectors. These higher increases are indicative of the skills shortage and efforts by the construction industry to retain key resources in anticipation of the potential upswing.

Net interest

The low net interest expense is reflective of the low gearing environment required for the construction industry. Funding is mainly derived through management of contractual cash flows. A hidden cost that is not readily available is the cost or opportunity cost of having sufficient guarantees in place for all contracts.

Taxation

The effective tax rate was 33% (2012: 50%). When one excludes the impact of discontinued operations, then this rate changes to 36% (prior year: 48%).

The higher effective rate is a result of the non-deductibility of the Competition Commission penalties, the inability to recognise deferred tax assets for losses made in some instances and differentials in tax rates in foreign jurisdictions. The prior year was particularly negatively impacted by losses such as impairment provisions without any associated tax expense relief.

Net profit

The construction industry is and has always been a very low margin industry. During the down cycle, a number of projects were accepted at low or no margins in order to maintain capacity. This reduced margins further.

Only half of the companies improved their profits (or reduced losses) for the current year. The most significant improvement was by Murray & Roberts, which improved from a R0.6 billion loss to a R1.5 billion profit. The prior year loss was as a result of specific provisions required against large-scale projects.

Group Five improved by R0.5 billion from a R0.2 billion loss to a R0.3 billion profit as the impact of its discontinued construction materials business was removed. The most significant reduction in profits was experienced at Stefanutti Stocks (R0.4 billion) and Basil Read (R0.3 billion).

Analysing margins in this low-profit environment is difficult, as the impact of the Competition Commission penalties and the years in which they have been recognised in the income statement is not evident. The top-5 companies by profit before interest and tax (and discontinued operations) margins shown in the accompanying table:

Top-5 companies by profit before interest and tax (and discontinued operations) margin

	Current year	Prior year
Calgro	14.9%	15.1%
Raubex	8.6%	10.6%
Esorfranki	6.5%	3.0%
Murray & Roberts	5.4%	(0.7%)
Group Five	5.1%	3.8%

Source: PwC analysis

Cash flow statement

	Current year R 'millions	Prior year R 'millions	Difference R 'millions	% change
Cash generated from operations before working capital changes	8 464	6 614	1 850	28%
Working capital changes	(1 179)	(3 954)	2 775	(70%)
Cash generated from operations	7 285	2 660	4 624	174%
Tax paid	(1 668)	(1 898)	230	(12%)
Other operating cash flows	(242)	(186)	(56)	30%
Cash from operating activities	5 375	576	4 799	833%
Additions to property, plant and equipment	(4 597)	(4 965)	368	(7%)
Proceeds on disposals	2 857	1 232	1 625	132%
Other investing cash flows	(421)	386	(807)	(209%)
Cash from investing activities	(2 161)	(3 347)	1 186	(35%)
Net borrowings (repaid)/raised	(418)	1 022	(1 440)	(141%)
Distribution to shareholders	(790)	(1 695)	905	(53%)
Other cash flows from financing activities	21	2 069	(2 048)	(99%)
Cash from financing activities	(1 187)	1 396	(2 583)	(185%)
Foreign exchange impact on cash and cash equivalents	831	1 006	(175)	(17%)
Movement in cash and cash equivalents	2 858	(369)	3 227	(875%)
Opening cash and cash equivalents	15 984	16 353	(369)	(2%)
Closing cash and cash equivalents	18 842	15 984	2 858	18%

Source: PwC analysis

Cash flow from operating activities

Profits need to be converted into cash in order to be of value to stakeholders. This is particularly true for the construction industry where estimates of final outcomes play an integral role in recognition of accounting profits. The industry has done exceptionally well in this regard with cash from operating activities well in excess of net profits.

Seven of the 10 companies improved their cash flow from operations. Most notable of these was a R3.6 billion improvement from Murray & Roberts, which included a R2.1 billion lower investment in working capital, a R0.9 billion improvement from Basil Read and a R0.6 billion improvement from WBHO. Aveng's cash flow from operations showed the most significant negative movement of R1.2 billion mainly due to investment in working capital.

Management of working capital and its cash requirements is essential for any construction company. As would be expected, at the start of an upward cycle additional investment in working capital is often required. This position may be exacerbated by the suspension of contracts, notably in the mining sector, which may require outflows in the finalisation of positions.

Tax paid is higher than the income statement tax expense, as construction companies are generally in a tax pre-paid position with a high deferred tax asset position during an upswing.

Cash flow from investing activities

Additions to plant and equipment are essential to support the industry. These additions mainly relate to plant and equipment required to deliver on projects. The high level of investment required on an annual basis puts the cash flow from operating activities into perspective. The reality is that plant and equipment utilised the bulk of cash generated from operating activities in the current year and could not fund investment requirements in the prior year.

Proceeds on disposals mostly relate to non-core businesses and assets disposed by Murray & Roberts, in particular its associate investment in the Australian entity, Forge Group, which yielded R1.7 billion.

Cash flow from financing activities

Murray & Roberts repaid a R1.4 billion finance lease in line with expectations. The finance obtained by other companies, notably Aveng (R0.6 billion), relates to asset-backed finance generally linked to the additions of plant and equipment.

There were no individual significant distributions to shareholders. The amount mainly consists of dividends paid and some share buybacks.

Financial position

	Current year R 'millions	Prior year R 'millions	Difference R 'millions	% change
Non-current assets				
Property, plant and equipment	17 970	17 488	482	3%
Deferred tax asset	2 475	2 045	430	21%
Non-current receivables	2 365	2 402	(37)	(2%)
Other non-current assets	8 129	8 658	(529)	(6%)
	30 939	30 593	346	1%
Current assets				
Inventories	4 373	4 239	134	3%
Contracts in progress	19 668	16 960	2 708	16%
Trade and other receivables	17 382	16 388	994	6%
Cash and cash equivalents	20 383	16 473	3 910	24%
Other current assets	3 721	2 112	1 609	76%
	65 527	56 172	9 355	17%
Total assets	96 466	86 765	9 701	11%
Equity and liabilities				
Equity				
Share capital	5 621	5 570	51	1%
Other equity	31 686	28 726	2 960	10%
Total equity	37 307	34 296	3 011	9%
Liabilities				
Non-current liabilities				
Interest-bearing borrowings	3 780	3 121	659	21%
Deferred tax liabilities	1 107	1 093	14	1%
Other non-current liabilities	3 142	2 190	952	43%
	8 029	6 404	1 625	25%
Current liabilities				
Excess billings over work	8 824	8 064	760	9%
Trade and other payables	30 911	28 600	2 311	8%
Interest bearing borrowings	2 641	3 344	(703)	(21%)
Other current liabilities	8 754	6 057	2 697	45%
	51 130	46 065	5 065	11%
Total liabilities	59 159	52 469	6 690	13%
Total equity and liabilities	96 466	86 765	9 701	11%
Key ratios				
	Current year	Prior year		
Solvency ratio	1.6	1.7		
Liquidity ratio	1.3	1.2		
Acid ratio	1.2	1.1		

Source: PwC analysis

The statement of financial position reflects a strong position, which should allow for future growth. Half the entities improved their liquidity position and only one had an acid ratio of less than one.

The statement of financial position reflects carrying amounts at historic costs. The market value of these entities indicates investors' perceptions of these carrying amounts and potential future growth options among other things. Total market capitalisation for these 10 entities compared to net asset value excluding non-controlling interest (NCI) is 1.3 times (2012: 1.4 times). Half of these entities reflected market capitalisations of less than carrying amounts.

Market capitalisation on 30 June 2013 as a percentage of net asset value excluding NCI

	Current year	Prior year
Protech	58%	60%
Esorfranki	68%	59%
Aveng	72%	90%
Stefanutti Stocks	82%	81%
Basil Read*	95%	60%

**Adjusted for assets held for sale sold after year end but before 30 June 2013*

The preceding table shows a disconnect between the market perception of value for these companies and managements' perception of the fair value of the underlying assets. This difference may be attributable to incomplete information available to the market, differing perceptions over contract successes and close outs and different views on the profitability of order books.

Non-current assets

Property plant and equipment remained stable as the impact of depreciation was more than offset by capital expenditure.

Deferred tax assets consist mostly of deferred tax assets recognised on losses. The remaining deferred tax assets and liabilities pertain to temporary differences relating to the timing of recognition of profits and losses for accounting and tax purposes.

Non-current receivables relate mostly to contractual debtors where payments are made over more than 12 months. These receivables are potentially still the overhang from the credit crises. However, it would be more concerning if these receivables relate to amounts in dispute, which could significantly delay payments.

Other non-current assets mostly relate to goodwill and other investments.

Working capital

Contract working capital position

	Current year R 'millions	Prior year R 'millions	Difference R 'millions	% change
Contracts in progress	19 668	16 960	2 708	16%
Trade and other receivables	17 382	16 388	994	6%
Excess billings over work	(8 824)	(8 064)	(760)	(9%)
Trade and other payables	(30 911)	(28 600)	(2 311)	(8%)
Working capital position	(2 685)	(3 316)	(631)	(19%)
Cash and cash equivalents	20 383	16 473	3910	24%

Source: PwC analysis

The working capital position reflects a fairly balanced position. Half of the entities are in a negative working capital position. These positions often relate to advance payments required when projects are undertaken in higher-risk environments.

If working capital is managed well it can be an excellent source of capital for a construction company. However, these positions will unwind as contracts come to completion and if these entities do not have replacement projects or funding in place, it could result in significant negative liquidity issues.

Cash position

The cash position remains strong and allows these companies to take on large-scale projects. The difference between this cash balance and that of the cash flow statement is over drafts included in short-term borrowings on the balance sheet.

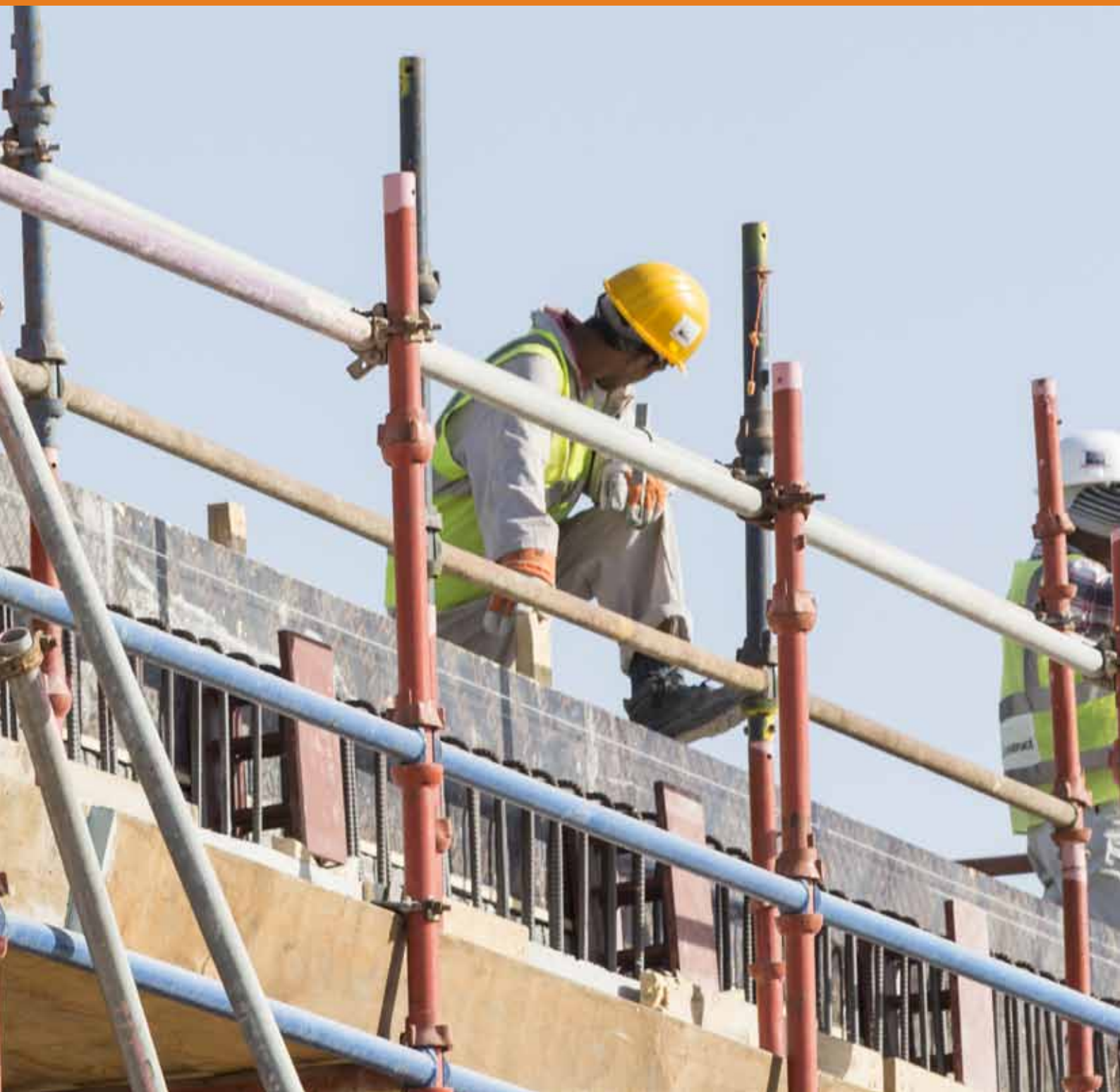
Financing for sustainability

The companies evaluated were all in a net cash position, in order to comply with the requirements of large construction projects. Guarantees are usually backed by the cash balances and no changes are expected to occur in the near future.

The construction industry is well placed to cope with new growth requirements.



10. *Glossary*



Acid ratio	(Current assets less inventory)/Current liabilities
ACSA	Airports Company of South Africa Limited
Adjusted EBITDA	EBITDA adjusted for impairment charges
B-BBEE	Broad-Based Black Economic Empowerment
BBCBE	Black Business Council in the Built Environment
CEC	Copperbelt Energy Corporation
DoL	Department of Labour
DPW	Department of Public Works
FEDUSA	Federation of Unions of South Africa
GEPF	Government Employees Pension Fund
HDI	Historically disadvantaged individual
ILO	International Labour Organisation
JSE	Johannesburg Stock Exchange
KPI	Key performance indicators
MBSA	Master Builders South Africa
MTEF	Medium-term expenditure framework
NACTU	National Council of Trade Unions
OECD	Organisation for Economic Co-operation and Development
PIC	Public Investment Corporation
PICC	Presidential Infrastructure Coordinating Commission
SADC	Southern African Development Community
SAFCEC	South African Federation of Civil Engineering Contractors
SANRAL	The South Africa National Roads Agency Limited
SARS	South African Revenue Service
CPI	Consumer price index, published by Statistics South Africa
HDI	Historically disadvantaged individual
JSE	Johannesburg Stock Exchange
Market capitalisation	The market value of the company calculated as the number of shares outstanding multiplied by the share price
NCI	Non-controlling interest
Net borrowings	Interest-bearing debt, less cash
PBIT	Profit before interest and tax

11. Other information



Companies included

	Company	Year end
1	Aveng Limited (Aveng)	30 June 2013
2	Basil Read Limited (Basil Read)	31 December 2012
3	Calgro M3 Holdings Limited (Calgro)	28 February 2013
4	Esorfranki Limited (Esorfranki)	28 February 2013
5	Group Five Limited (Group Five)	30 June 2013
6	Murray and Roberts Holdings Limited (Murray & Roberts)	30 June 2013
7	Protech Khuthele Holdings Limited (Protech)	28 February 2013
8	Raubex Group Limited (Raubex)	28 February 2013
9	Stefanutti Stocks Holdings Limited (Stefanutti)	28 February 2013
10	Wilson Bayly Holmes-Ovcon Limited (WBHO)	30 June 2013

Basis for compiling this report

The data set out in this publication was drawn from information publicly available for the period ended 30 June 2013. The information was taken from the annual reports of the top ten engineering and construction companies listed on the Johannesburg Securities Exchange (JSE).

The results aggregated in this report have been sourced from information that is publicly available, primarily annual reports or reviewed results made available to shareholders. Companies have different year ends. The information included is based upon aggregated results of those top ten construction companies reported on.

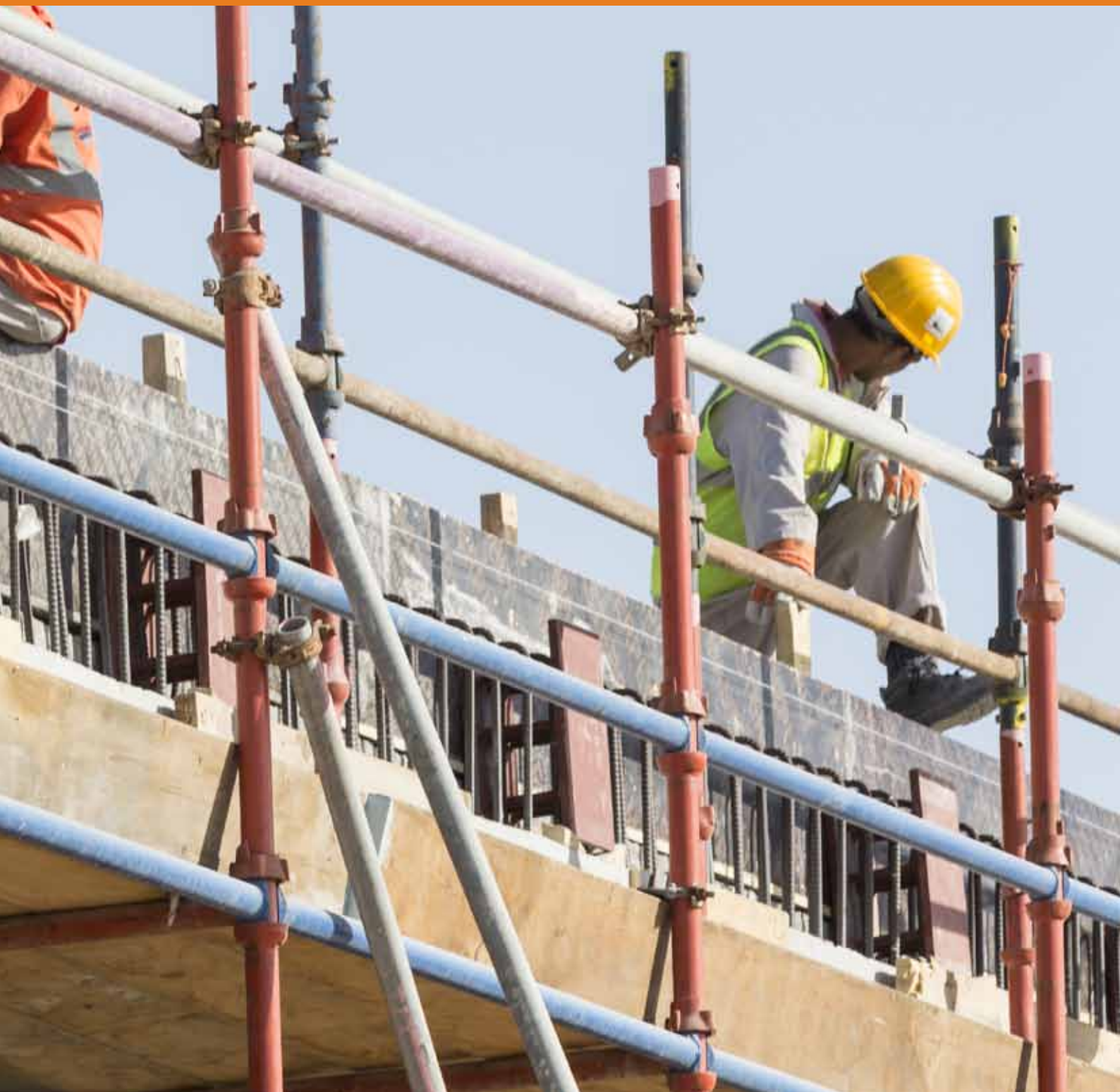
The results for the year ended and as at 28 February 2013 were used for Raubex, Stefanutti Stocks, Protech, EsorFranki and Calgro M3. Basil Read financial information was included as at 31 December 2012. The remaining company results were included for the year ended 30 June 2013. No adjustments have been made to take the different year ends into account.

All currency figures in this publication are reported in South African rands, except where specifically stated otherwise. Some diversified companies undertake part of their activities outside the construction industry. No attempt has been made to exclude such non-construction activities from the aggregated financial information.

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