March 1, 2014

The South African civil construction industry experienced a mixed bag of business conditions during the 4th quarter of 2013. Industry turnover (nominal) improved by 13 percent, y-y compared to the same quarter in 2012, representing a real increase of 6 percent, the best performance in the industry since the 2nd quarter of 2012, when turnover increased by 22 percent in real terms. Nominal turnover for 2013 contracted by 5 percent, or 10 percent in real terms (compared to an increase of 6 percent in 2012 and 7,6 percent in 2011).

Gross fixed capital formation as percentage of GDP stabilized at an average of rate of 20 percent in the first three quarters of 2013, compared to an average of 19,8 percent in 2012. The National Development Plan aims to increase the contribution of GFCF to GDP to 30% and public sector infrastructure expenditure to 10% of GDP.

Although budgetary allocations towards public infrastructure for the next three years were not cut in the 2014/15 budget, projected expenditure will be barely enough to cater for higher construction costs over the period. Nominal growth in total public sector infrastructure is expected to increase by 8,1 percent in 2014/15 (R273bn), 5,4 percent in 2015/16 (R287bn) but fall by 0,3 percent in 2016/17 (R286bn), totaling R847bn over the medium term expenditure framework. Thus in real terms, total infrastructure expenditure is likely to contract over the next three years. The contribution of infrastructure spending by state owned enterprises as a percentage of total public infrastructure expenditure will soften in the next three years to 43 percent (of which a large portion will not be used in construction but on purchasing of equipment), mainly due to a slowdown in energy infrastructure expenditure.

This doesn’t mean that the budget does not present opportunities for the civil contracting industry. The contribution by government will be strengthened as more money is allocated towards infrastructure expenditure on transport and water. Transnet has however stated that it is on the verge of the next wave of capital investment, starting in 2014/15 and peaking in 2016/17. Total government spending (excluding SOE’s) is projected to increase by between 5 and 7 percent in real terms during 2014/15, totaling R386bn over the medium term expenditure framework. By the end of 2016/17 government spending on infrastructure will exceed that of the SOE’s, estimated at R138bn compared to projected expenditure of R132 bn by SOE’s by 2016/17.

The industry not only continues to grapple with familiar issues such as lack of skills affecting project planning and implementation, non-expenditure of budgets, , unfair tender procurement and the slow awarding of contracts, but is also sensitive to the impact on tenders in the post-election period. Tender activity generally increases in the run up to an election for various reasons, but this momentum is quickly reversed after the election, as tender activity generally slows by between 10 and 15 percent, resulting in tendered projects not reaching awarded stage. This could be because of a political agenda, where projects are put out to tender to encourage voters in a particular area, where after projects may be postponed due to lack of available funds, or a change of staff members in a specific department. For whatever reason, the industry generally does not walk away unscathed during election periods.

The delay in the implementation of e-tolling has come at a cost to the industry. The loss of revenue, by SANRAL, most likely resulted in an adjustment in allocations towards other SOE’s such as Transnet and Eskom over the last two years, according to revised estimates in the 2014 Budget. R5,8 bn additional allocations were made to SANRAL to finance the void left in outstanding e-toll revenue, resulting in less money being made available for other transport related projects. This ultimately had a direct impact on civil industry turnover. National Treasury has however adjusted allocations to Transnet in the 2014/15 Budget, increasing the infrastructure budget from R25.3 bn in 2013/14 to R41.3bn in 2014/15 increasing to R55bn by 2016/17. Transnet's contribution to infrastructure expenditure will become more significant compared to Eskom's contribution over the next three years.

SAFCEC supports the rationale behind centralised procurement but questions the practicalities of how a single department will be able to deal with thousands of tenders on a monthly basis. In the civil industry alone, there are over 300 tenders per month, not including tenders in the building industry. It is ultimately about finding the correct balance between curbing corruption without causing further delays in the awarding of contracts.

As part of government's focus on skills development and job creation, through programmes such as the expanded public works programme and various other initiatives to encourage spatial transformation, contracts are generally broken into smaller more manageable contracts, and this has created increased opportunities for the medium and smaller contractors. We have seen a gradual shift in favor of medium and smaller contractors, while the contribution of larger firms, according to recent data released by Statistics South Africa, has moderated from 61,8 percent in the 2nd quarter of 2012 to 55,3 percent in the 3rd quarter of 2013. Larger firms are categorised by Stats SA as firms with a turnover exceeding R182 million. There was a notable increase in the publication of CIDB, Grade 7 to 9 projects out to tender during the 4th quarter of 2013, and this could start to support industry turnover by mid-2014, provided these projects are awarded during the first quarter of 2014.

According to the SAFCEC survey, medium size contractors (according to SAFCEC's profile of firms employing between 100 and 1000 people) experienced better than average working conditions over the last few quarters. More than 70 percent of the medium size contractors that participated in the survey reported very busy working conditions during the 1st quarter of 2014, compared to only 25 percent of the larger firms. The outlook for the 2nd quarter of 2014 is mixed. Half of the medium size firms expect the improved working conditions to be sustained through to the 2nd quarter of 2014, while the other half expect quieter conditions. None of the larger firms expect conditions for the 2nd quarter to be anything more than just satisfactory.

Employment was relatively unchanged over the period under review, but this was as a nett result of either stable or a cut in employment by the larger contractors vs increased employment opportunities offered by medium size contractors.

Pessimism towards the awarding of tenders continued in the 4th quarter of 2013. Firms were less optimistic regarding the value of contracts awarded during the current survey, from a positive nett satisfaction rate of 12.0 in 2013 Q2 to a negative -82.0. Larger firms were unanimous in their views, that awarding of contracts was slow, but medium size firms seemed more confident. The nett satisfaction rate of medium size contractors improved from (minus) -33.0 in the 2013 Q2 to (positive) 20.0.

Based on the rate by which contracts are being awarded, according to an independent project database of construction activity, firms have a reason to be concerned. The number of civil contracts awarded fell by 9,8 percent in the 4th quarter of 2013, the third consecutive quarter of negative year on year growth. Overall there were 5 percent fewer civil contracts awarded in 2013 compared to 2012, compared to a 7 percent increase in the number of published tenders. Comparing the publication of tenders vs the awarding of contracts over the last few years, it is clear that, as from 2008, the awarding of civil contracts has been lagging (refer fig 1 below). Reasons aren't always transparent, and differs from client to contractor, but the economic slowdown did impact on government revenue, resulting in financial constraints, while in some cases projects are put out to re-tender due to problems with the adjudication process. Skills remain a critical constraint to improve successful delivery of projects and it is therefore important that government engages with organisations such as SAFCEC to not only understand the constraints, but to find practical solutions to improve delivery. Infrastructure spending, and the fortunes of the civil industry, is after all not just about the multi billions rand spent on the construction of power stations or pipelines, but about every rand spent on the maintenance of provincial and local roads and the improvement of water and sanitation access to the poor.

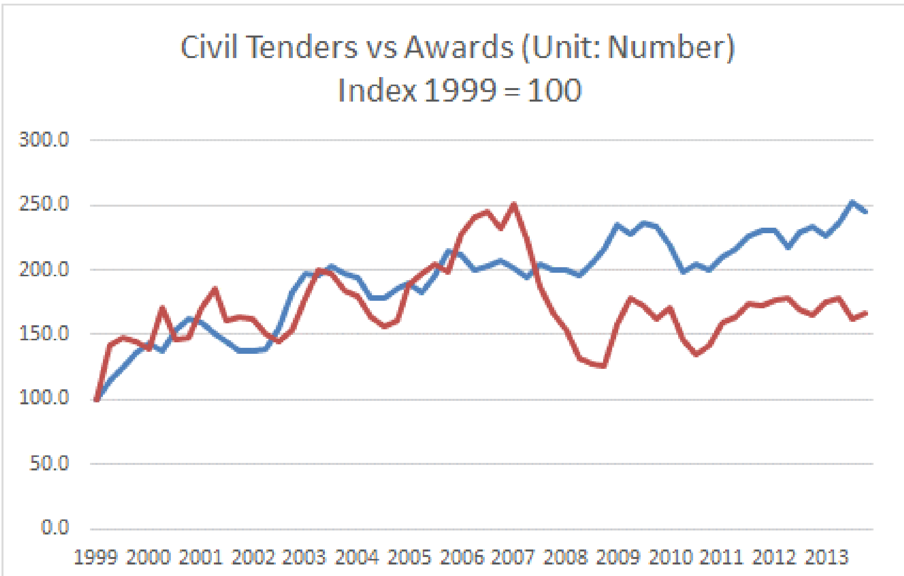

Figure 1

In spite of economic turmoil, firms have not been too negative regarding the state of order books. However, firms have become increasingly negative, particularly from the perspective of larger firms as projects are increasingly affected by policy uncertainties and labour disruptions in the mining sector, the slowdown in infrastructure spending by state owned enterprises and the proliferation of contracts into smaller manageable contracts.

There has always been strong competition for tenders amongst larger firms, considering that CIDB Grade 9 projects (excluding private sector projects) generally represent less than 2 percent of total tender activity in the industry. However, tendering competition has started to increase amongst medium size contractors with close to 60 percent of firms experiencing competition of between 11 and 25 tenders per bid.

Profitability and prices remain under pressure. The opinions of firms related to profitability has improved over the last few quarters, and reported a positive nett satisfaction rate of 15.3 percent in the current survey, compared to 4,8 percent in the previous survey. However, there is disparity between large and medium size contractors. Larger firms are more comfortable with (albeit lower) profit margins, while an increasing number of medium size firms have reported dissatisfaction. It can be expected that profit margins will be negatively affected as competition in tendering increases because contractors need to be more competitive in their tender prices. Reduced tender prices alongside an increase in input costs, may pose a challenge for medium size contractors if not carefully managed. According to Stats SA, the average profit margin in the construction industry moderated from an average of 7 percent in the 2nd quarter of 2012 to 5,9 percent in 3rd quarter of 2013. Larger firms reported profit margins of between 2 and 3 percent, compared to an average of 6% by medium size contractors (3rd quarter 2013).

Price pressures are expected to accelerate in 2014 as currency volatility is expected to impact on the cost of plant equipment and fuel, while consumer inflation is also expected to increase at a faster pace, averaging 6,2 percent in2014. Including the four main drivers of construction input cost inflation, (plant, fuel, materials and labour), input costs are expected to accelerate from an average increase of 5,7 percent in 2013 to 8,1 percent in 2014.

The quarter to quarter movement in the civil industry's confidence index (weighted according to firm size) has been volatile over recent years. The nett satisfaction rate failed to move into positive territory, (meaning there are still more firms concerned about the outlook for the industry than those that are expecting improved conditions). The underlying trend has however started to show some improvement, suggesting conditions are not deteriorating any further. The overall nett satisfaction rate "improved" from -18.0 in the previous survey to -15.0 in the current survey.

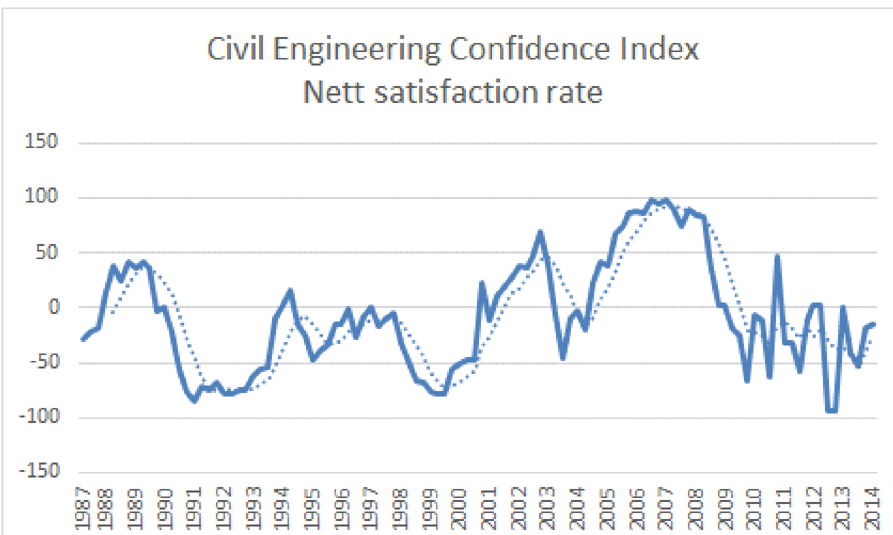

Figure 2

Considering all the above, we expect the industry to show a marginal recovery in 2014, increasing by between 3 and 5 percent in real terms, supported by higher real growth in infrastructure expenditure by government (including central, provincial and local governments) and a marginal increase in expenditure by state owned enterprises. Renewable energy projects should also support private sector spending in 2014, while there may be some improvement (albeit) marginal in mining activity according to Nedbank's infrastructure project listing. Risks include the impact of the election on tendering activity, slow roll out of projects, labour disruptions, the recent deterioration in order books, low industry confidence, and economic uncertainty associated with emerging market jitters, capital flows, currency volatility and growing inflationary pressures.

End

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