June 12, 2014

# State of the South African Civil Industry 2014Q2

## Executive Summary

Conditions in the South African civil construction industry came under greater pressure in the first quarter of 2014, following a contraction of 10 percent in real terms during 2013. Nominal **turnover** contracted by 12 percent on a quarter on quarter basis, but because of a particularly weak 1st quarter in 2013, turnover increased by 18 percent y-y in real terms. However this is offset by a notable deterioration in other indicators that have shown a growing dissatisfaction amongst civil contracting firms regarding the outlook for the civil industry.

The unexpected slow start to the **economy**, weakened by the relentless labour strike action in the platinum industry and a contraction in the manufacturing sector, raises fears that government will not be able to deliver on it's infrastructure expenditure programmes as was projected in the 2014/15 Budget in February 2014. Considering the fact that the increase in allocations over the next three years were already below construction cost inflationary expectations, this could have serious implications for the civil construction industry. The budget was underpinned by economic growth of 2,7 percent and inflation at around 6,2 percent, but latest forecasts by the World Bank as well as the IMF have been revised downward to 2,0 percent. With growing speculation that the economy may be in a technical recession following the 0,6 percent contraction in the 1st quarter of 2014, even a 2 percent growth outlook may be regarded as being too optimistic.

Contrary to historical trends, the civil industry did not show any real benefit in the run up to the **election**, which is normally accompanied by a stronger than usual increase in tender activity. However, because this is normally followed by a contraction of between 10% and 15% in activity in a post-election period, the nett result will simply imply a less volatile working environment. National Treasury is serious about improving the financial stability of the economy and this includes reducing the deficit on the current account, while the conditions to release infrastructure-linked grants have been tightened. Also, money not spent will simply be re-allocated elsewhere. It is therefore understandable that under these circumstances that tender activity did not react as usual within an election period.

The 2nd quarter survey highlighted a few interesting developments.

**Employment** increased on average by 2,5 percent q-q in the 1st quarter vs the 4th quarter of 2013, as larger firms provided increased employment opportunities, but this was offset to some extent by medium size firms who offered no additional employment and a reduction in employment by smaller firms. This contradicts results from the 1st quarter survey, which showed that it was the medium and smaller size firms that increased employment. The mobility of staff is generally more favourable in the 1st quarter, following the holiday and bonus period in the 4th quarter.

The tide may be turning for medium size contractors in terms of the overall business environment. In the last few surveys we noted that medium size contractors are benefiting by the fact that contracts are broken down into smaller more manageable contracts, generally implemented by provincial and local authorities. Medium size contractors however seem to be under increasing pressure as tendering competition has become keener and tender prices pushed lower. This in turn impacts on profitability which according to Stats SA has moderated from an average of 6,5 percent in the previous 4 quarters to zero percent in the 4th quarter of 2013. Added to this, the survey has found that the value of late payments has increased by 139 percent q-q, which increased late payment as a percentage of turnover from 11,1 percent in the previous quarter to 15,6 percent.

Late payments also had an effect on large contractors. The value of late payments to larger contractors increased by 67 percent q-q, increasing the ratio of late payments to turnover from 11,5 percent to 12,0 percent. Contradictory to medium size contractors, there appears to be a gradual improvement in the profitability of larger firms. Late payments are nonetheless considered unacceptable in an industry where government has committed to ensure payment to contractors is made within the 30 day period.

Medium size firms may therefore find themselves in a far worse position as their cash flow may not allow them to carry the additional burden of late payments, alongside deteriorating profitability.

According to the survey, medium size contractors experienced better than average working conditions over the last few quarters, but indicators are somewhat less optimistic in the 2nd quarter of 2014. Only 37,5 percent of medium size firms reported "very busy" working conditions, down from over 70 percent in the previous survey. None of the larger firms reported busy conditions in the 2nd quarter (in line with expectations), compared to 25 percent in the previous survey. The outlook for the 3rd quarter of 2014 is mixed. While a higher percentage of larger firms expect to be busier (25 percent), fewer medium size

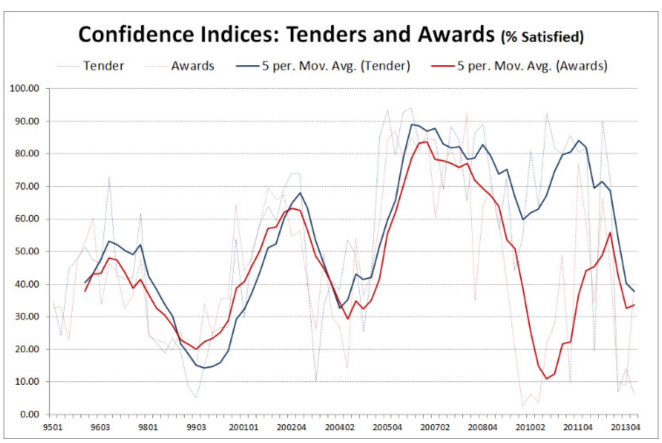


*Figure 2: Opinions related to tenders and awards*

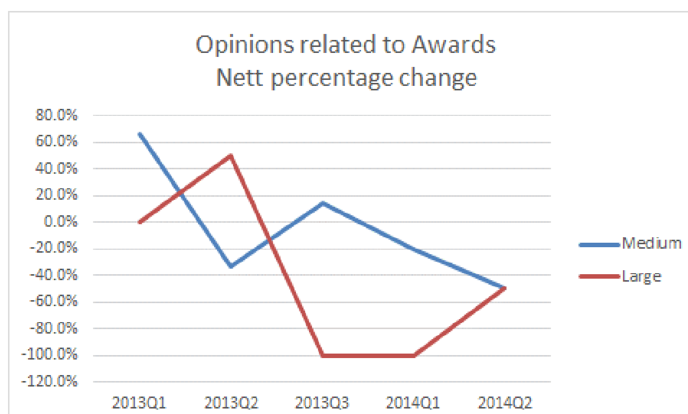


*Figure 1: Opinions related to awards by firm size*

firms expect busy conditions (down to 25 percent).

There was a slight improvement in the opinions regarding the awarding of tenders, and although the nett satisfaction rate remains negative it did improve from a level of -82 to -22,5, supported mainly by an uptick amongst larger firms (See chart above).

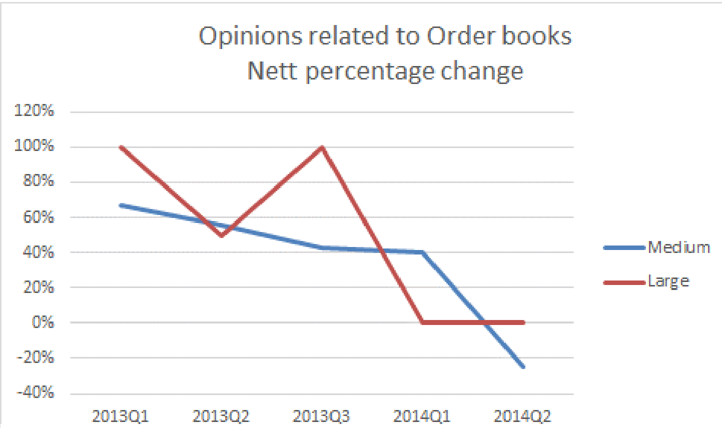


*Figure 3: Opinions related to order books*

Opinions related to tender activity continued to deteriorate, from a negative -72 in the 1st quarter to -87 in the 2nd quarter, while opinions related to the state of the two year forward order book also continued to deteriorate from a positive 91 to 11,4 and a negative -0.2 over the last three quarters. An increasing number of medium size firms were of the opinion that the value of order books were low (63 percent) compared to 30 percent in the previous survey.

The estimated value of tenders released during the 1st quarter of 2014 was 31 percent lower compared to the 1st quarter in 2013, as fewer higher CIDB grade projects (7 and up) were put out to tender.

After peaking at 91 percent of firms that said competition in tendering exceeded 10 bids per project in the 3rd quarter of 2013, competition eased somewhat with 44 percent of firms reporting tendering in competition exceeding 10. Smaller firms experienced the highest level of competition with 75 percent of firms reporting competition in excess of 25 bids per project.

The opinions of firms related to profitability has improved over the last few quarters, although the nett satisfaction rate fell to -13.4 in the current survey, from 15.4 in the previous survey. Opinions are not as negative when compared to 2011 and 2012, and is showing signs of stabilization. Pressures on profitability is nonetheless broad based affecting all firm sizes, in spite of reports that tendering in competition has eased over the last few quarters. Both large and medium size firms were more pessimistic regarding profitability, compared to the previous survey. Profit margins are normally influenced by the level of tendering in competition as contractors need to be more competitive in their tender prices. Reduced tender prices alongside an increase in input costs (estimated at between 6 and 8 percent), may pose a challenge for contractors if not carefully managed. According to Stats SA, the average profit margin in the construction industry moderated from an average of 5,9 percent in the 3rd quarter of 2013 to 5,4 percent in 4th quarter of 2013. The average profit margin for larger firms improved to 4,5 percent in the 4th quarter, from an average of 2,2 percent in the first three quarters of the year, compared to an average of 4,8 percent for medium size contractors for the year 2013.

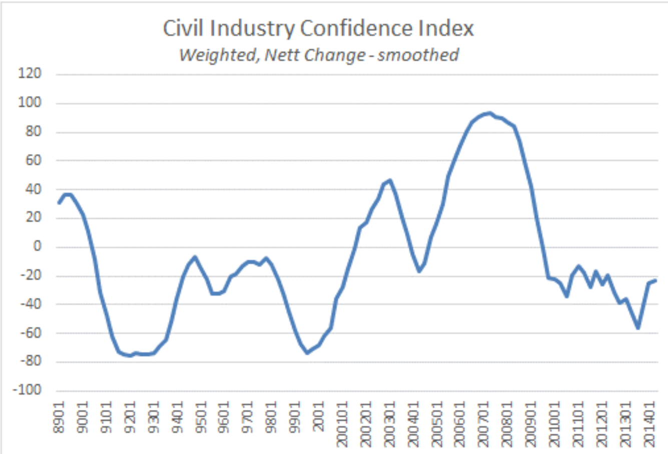


Figure 5: Confidence

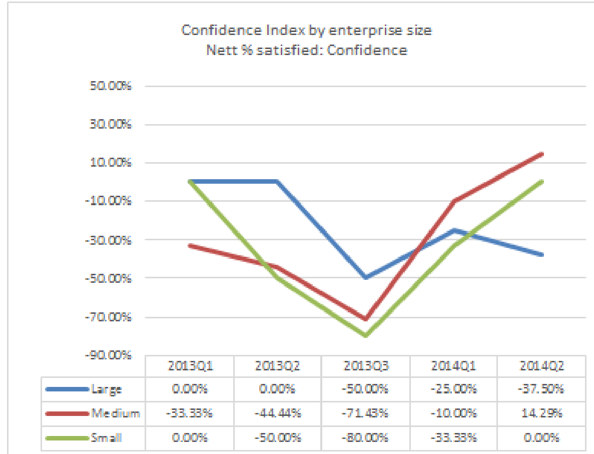


Figure 4: Confidence by enterprise size

An increasing number of firms (21,4 percent) reported that their overall assessment of business conditions during the past quarter was below average (poor to very poor), yet 31 percent reported it to be above average. The nett satisfaction rate therefore improved from -15 in the previous survey to a positive 9, lifting the overall confidence index from a -25 to a -24 when smoothed over the last 5 quarters. (see chart left above). This supports our view that conditions may not be deteriorating any further at the moment, but that any real meaningful recovery also remains elusive. Industry confidence was supported by an improved outlook amongst medium and smaller contractors.

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 in 2014. 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.

Considering all the above, we are aware of the growing risk to our original forecast, which expected industry turnover to increase by between 3 and 5 percent in real terms, or around R5 billion in current prices. Our expectations were 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, while advancement in renewable energy projects should also support private sector spending in 2014. We also expected some improvement (albeit) marginal in mining activity according to Nedbank's infrastructure project listing. However, economic risks have intensified in the first 6 months of 2014 as outlined in the first section of this report, while the industry remains challenged by the slow roll out of projects, threats of further strike action to affect the steel industry in July 2014 causing further labour disruptions, the deterioration in order books, low industry confidence, combined with growing economic uncertainty associated with emerging market jitters, capital flows, currency volatility and growing inflationary pressures. All these factors may result in a lower than expected turnover for 2014 and a stronger than expected slowdown in 2015.

*Table 1*

| | Turnover Nominal | % Change | Turnover 2012=100 | % Change |
|---|---|---|---|---|
| 2007 | 38,084,310,982 | 47.7% | 51,244,150,550 | 37.9% |
| 2008 | 58,063,639,993 | 52.5% | 67,652,512,780 | 25.1% |
| 2009 | 51,147,261,584 | -11.9% | 57,273,053,598 | -10.7% |
| 2010 | 32,744,103,366 | -36.0% | 35,825,785,575 | -37.6% |
| 2011 | 36,888,136,573 | 12.7% | 38,555,689,359 | 7.6% |
| 2012 | 40,952,061,358 | 11.0% | 40,952,061,358 | 6.2% |
| 2013 | 38,920,982,014 | -5.0% | 36,835,028,400 | -10.1% |
| 2014* | 43,980,709,676 | 13.0% | 38,513,190,007 | 4.5% |
| 2015* | 46,619,552,257 | 6.0% | 38,917,046,147 | 1.0% |

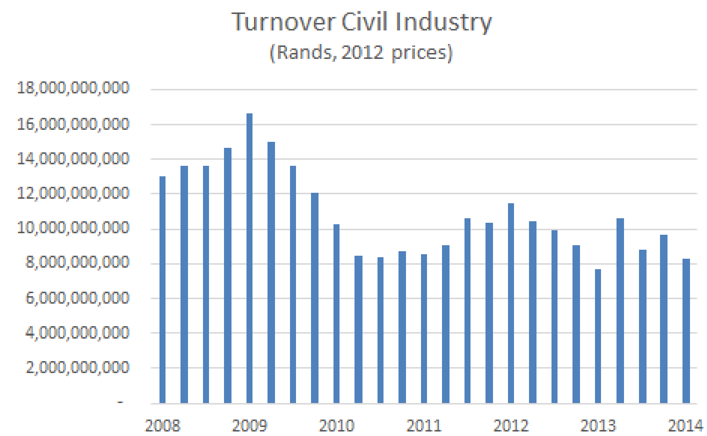


*Figure 6: Turnover Civil Industry*

End of Report

Classification of firm sizes: SAFCEC Survey vs Stats SA

| | Classification by | Large | Medium | Small |
|---|---|---|---|---|
| SAFCEC | Employment | >1000 | Between 100 and 1000 | Less than 100 |
| Stats SA | Turnover (annual) | >R182million | Between R42 million and R182 million | Between R2 million and R42 million |

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