Tender Cost Update
South Africa 2017

Tender prices on the rise amid challenging economic and political conditions

Companies across the construction industry have been facing a challenging environment over the past year and a half.

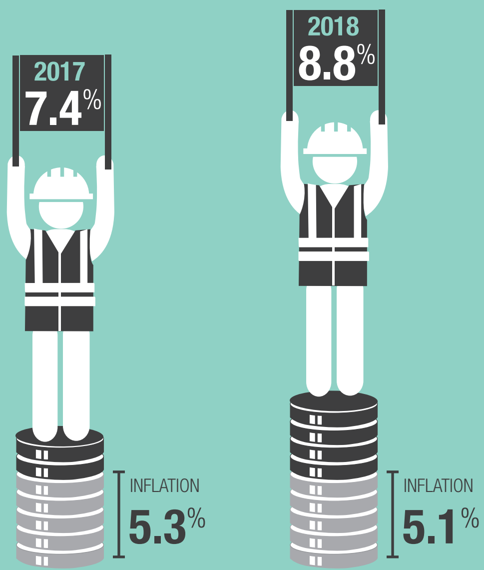
The South African economy entered a technical recession in Q1 2017 and MMQSMace observed significant drops in building plan permissions (up to 20% fewer year on year); it is clear that confidence and optimism across the general building sector remain depressed.

Despite the difficulties in the economy, we are of the view that spending on projects will continue, particularly on the healthy pipeline of public and infrastructure projects which the Government has already committed to delivering. With significant challenges in the domestic economy to be addressed, even a government suffering some turmoil, as is currently the case, must increase infrastructure budgets. These challenges include stubbornly high unemployment (and therefore a need for government stimulus), drought and water infrastructure challenges, and shortages in the health and education sectors. This has been evidenced by an increase in the number of enquiries we have received from the public and infrastructure sectors in the last quarter.

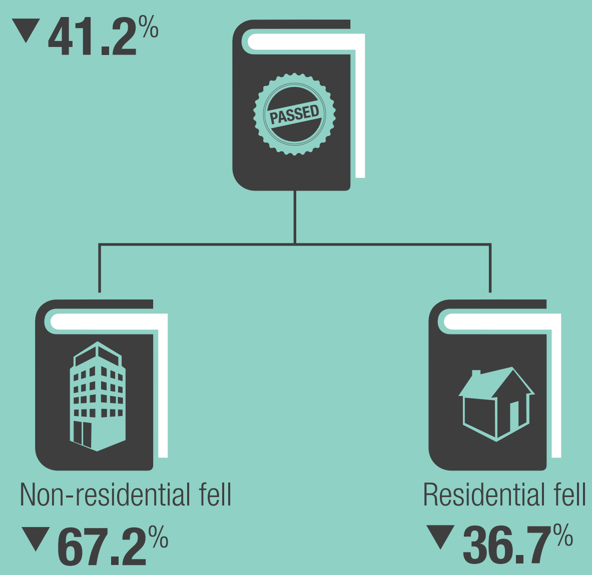
"We're seeing a strong rise in tender prices in South Africa in 2017 driven by significant input price growth and general inflation here compared to other markets. A lack of business confidence and an uncertain political and economic outlook has led to a stagnation in investment across both the commercial office and residential sectors this year, with increasing reliance on the planned infrastructure pipeline for our forecast of an improved outlook in 2018."

Mandla Mlangeni
Director, MMQSMace Cost Consultancy

Tender price growth...



Real value business plans passed fell by...



EXECUTIVE SUMMARY (CONTINUED)

Many in the industry are now looking forward to December, when a big drag on the economy and private investment will be eased as the ruling party closes out a period of political unease by electing a new leader. With increased stability the sector hopes investment and growth will return to the private construction sectors, and the certainty of the infrastructure and public building pipeline will solidify.

Meanwhile, we anticipate further drag on both the economy and construction from the continued increase in uncertainty in the mining sector.

Perceived corruption within the built environment remains a challenge, and the industry is facing its fair share of difficulty in the depressed economic environment, however despite all the challenges, we are confident we will continue to see worthwhile projects come to market.

BUILDING COSTS AND TENDER PRICE SUMMARY

Building costs surged during 2017Q1, mostly due to a rise in residential investment and somewhat higher input (mainly commodity) prices. In contrast, the activity in the non-residential sector has fallen substantially in recent quarters with no sign of a pick-up over the short to medium-term. As such, the overall building sector is set to be under significant pressure with limited to no growth in activity/work. The main non-residential sector South African contractors are looking to for reprieve is infrastructure, with a solid pipeline of logistics, transport and energy sector work planned by the government. However, with the current political jostling continuing, there is significant uncertainty around this pipeline and it may not prove to be the saviour it is expected to be. Overall, this weak environment will likely weigh on profitability across the market. Fortunately, total labour and non-labour input costs are lower than a few months ago, which should provide some relief to contractors.

Accepted tender prices rose by an annual rate of 9.5% in 2017Q1, supported by an uptick in input costs (albeit lower than end 2016 highs) for both commercial and residential property. However, the restrained outlook for building activity will weigh on input and tender prices for the rest of the year, with tender price growth already slowing to 5.8% in 2017Q2.

The ongoing turbulence in the South African market led to a moderation in tender prices during the fourth quarter of 2016, resulting in a relatively poor performance for the full year with an average increase of only 4.8%. BER[1] business survey data shows that tendering competition remains keen and contractors are still facing tough bidding conditions.

Preliminary data for the second quarter of 2017 revealed a rise in tender prices of 5.8% year-on-year (y-o-y), decelerating compared to the 9.5% rise in 2017Q1, indicating better market conditions in the first half of the year than 2016.

[1] The BER Building Cost Index is based on an analysis of accepted tender prices of building projects. This unique index includes the profit margins of building contractors and reflects market conditions.

However, most indications are that new building work, particularly in the non-residential sector, will remain scarce over the short-term. Residential demand, on the other hand, seems to be better supported. Despite the significant challenges in the market, the outlook is for tender prices to rise by 7.4% during 2017 (partly due to the steep rise in Q1), followed by 8.8% in 2018 as a result of an anticipated general improvement in economic conditions as well as a planned pipeline of infrastructure work.

ECONOMIC CONDITIONS

After hovering in net negative terrain over the past year, the RMB/BER Business Confidence Index (BCI) fell further, by 11 points to 29 in the second quarter of 2017, meaning seven out of every 10 respondents are downbeat about prevailing business conditions. This level of despondency in the index has not been seen since the 2009 recession. Particularly striking is the fact that all five sectors covered (i.e. manufacturing, retail trade, wholesale trade, motor trade and the building sector) now have a BCI below the neutral 50-point mark, which implies that there is very little optimism in the current market.

This sharp deterioration in sentiment reflects more than just the impact of increased political uncertainty. While the cabinet reshuffle and consequent sovereign credit rating downgrades undoubtedly played a role, confidence was also knocked hard by persistently weak business activity across sectors as observed in the BCI. This lower confidence has resulted in a deterioration in private sector investment, which constitutes the biggest portion of residential and non-residential building demand. Without a recovery in business confidence, it is unlikely that the building sector will grow in a meaningful way in the foreseeable future.

GROWTH

South Africa entered a technical recession in 2017Q1 as economic output contracted in two subsequent quarters: by 0.7% q-o-q in Q1, following a contraction of 0.3% in 2016Q4. Output declined despite a strong showing by the agriculture (22.7% quarter-on-quarter) and mining and quarrying (12.8% q-o-q) sectors.

The construction sector on the other hand contracted by 1.3% q-o-q, the first time since early-2013 that the sector has underperformed relative to the broader economy – a clear indication of the current strain within the industry.

LABOUR MARKET

The South African labour market is still creating jobs despite disappointing output figures, adding a net 144,000 jobs in 2017Q1, and 538,000 on an annual basis. The construction sector also grew in employment in 2017Q1 despite the contraction in output, registering an increase of 23,000 employees, representing an increase of 1.5% q-o-q, and 10.5% y-o-y, both significantly higher than the wider economy.

Despite adding jobs to the economy, the unemployment rate edged higher to 27.7% in 2017Q1. High unemployment continues to be a challenge in South Africa, putting a drag on consumer spending, wage growth, and social cohesion, as well as impacting demand for commercial and residential building.

EXCHANGE RATES

Despite significant volatility during the second quarter of 2017, the rand exchange rate finished the quarter close to where it started. The volatility was largely due to geopolitical factors, including a cabinet reshuffle and the resulting multiple sovereign debt ratings downgrades. Overall, the rand averaged R13.12/USD during 2017Q2, from an average of R13.23/USD in 2017Q1. The exchange rate movements were also driven by movements in the US dollar, which depreciated due to policy and political uncertainty. On the other hand, more optimistic sentiment towards Europe strengthened the euro in 2017Q2, weakening the rand to an average of R14.5/€ in 2017Q2, from R14.1/€ in 2017Q1. Looking ahead, the relatively stronger rand (against the US dollar) should serve as a buffer against global commodity prices, should they start to rise again, but further strengthening could prove a deterrent to foreign direct investment.

INFLATION

Headline consumer price inflation edged slightly higher to 5.4% y-o-y in May 2017, from 5.3% in April. On a monthly basis, inflation was 0.3% in May.

Despite this uptick in May, inflation remains below the recent peak of 7.0% y-o-y recorded in February 2016. Inflation is expected to moderate even further for the rest of the year on the back of lower food prices (due to significantly better harvests relative to last year), a relatively stronger rand, and lower global oil prices. The more benign inflation outcome could provide some support to the residential building sector via improved real income and consumer demand, softening the blow of the negative wider economic climate and potentially driving improvements in commercial and retail building.

MONETARY POLICY

The South African Reserve Bank (SARB) kept the benchmark interest rate unchanged at 7.0% at their last meeting in May[2], citing the end of a tightening cycle and the possibility of rate reductions should inflation continue to surprise on the downside. They specified that in the current environment of high uncertainty the risks to the outlook for inflation could easily deteriorate as well. These factors point to a rate reduction as the most likely next steps for the SARB, a positive move for the construction and real estate sectors.

[2] Their next meeting takes place on 18–20 July 2017

GLOBAL

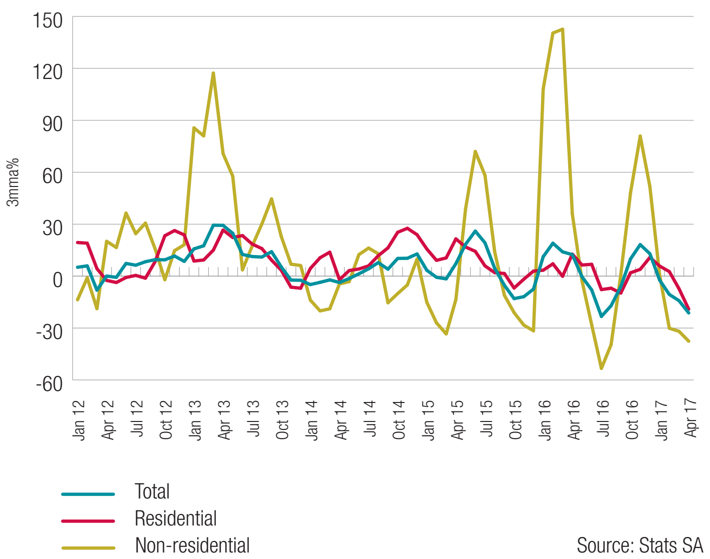
Over the last six months, prospects for the global economy have improved somewhat. This is especially true for the Eurozone and some of the larger BRICS countries, namely Russia and Brazil, who have recently emerged from recession. On the other hand, growth in the US has lost some momentum, while growth in China is moving in line with the government's 6–7% growth path. In all, the global outlook is mixed and points to constrained growth in commodities, which in turn means less upward pressure on building input costs. However, many believe that the positive results seen in the BRICS and Europe, as well as China's recovery indicate that we are entering an upturn in the global growth cycle, which could drive increased foreign direct investment into South Africa, and hence growth in construction activity.

CONSTRUCTION OUTPUT

Construction has been struggling in South Africa in the deteriorating economic climate: according to Stats SA, the real value of building plans passed fell further by 41.2% y-o-y in April 2017, following a contraction of 16.3% in March. The decline was broad-based, falling across the categories of construction covered. The largest decline was in the non-residential building sector where the value of plans passed fell by 67.2% y-o-y, driven by a decline in demand for commercial and retail building, in large part due to the difficult business environment. For residential buildings and additions and alterations, the value of plans passed contracted by 36.7% and 21.3% y-o-y respectively.

In the year to date, the real value of building plans passed was down 21.9% y-o-y, relative to the same period in 2016, mostly due to the sharp contraction in the non-residential sector.

Fig. 1: Building plans passed

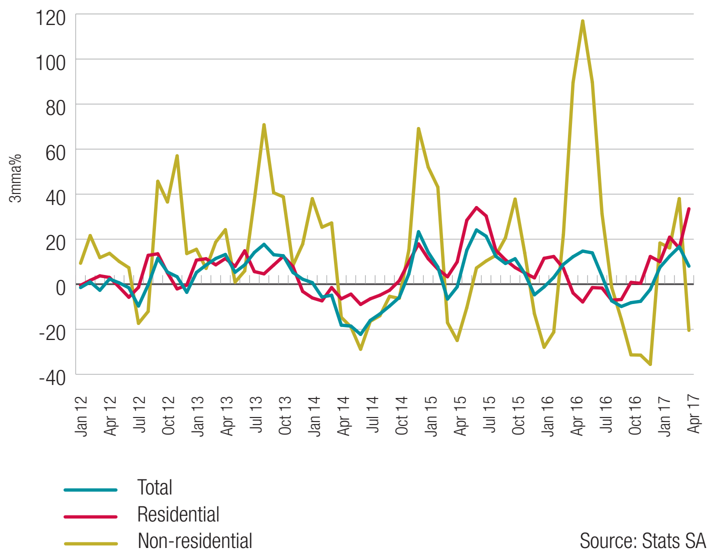


Source: Stats SA

It is not just the pipeline of construction work which has been impacted by the current economic climate; ongoing completions have also suffered a decline, with the real value of buildings completed falling in April by 5.4% y-o-y. Leading the fall was a marked decline in the value of non-residential building completions, which plummeted by 62.5% y-o-y. This fall was reasonably broad-based among retail, banking and office and industrial and warehousing space. Given the low business confidence and subdued outlook for the economy in general, none of these sub-sectors are likely to see a noticeable uptick over the short to medium term, placing a significant drag on construction output in general.

In contrast, the real value of residential building completions rose by an encouraging 52.0% y-o-y, somewhat offsetting the sharp fall in the non-residential market. However, the recent fall in consumer confidence, and significant fall in residential construction pipeline, would indicate that this sector cannot be relied upon to provide a steady source of growth for the construction industry going forward.

Fig. 2: Building completed



Given the difficulties in pipeline of work for residential and non-residential building, as well as the significant drop in completions for non-residential building, many in the industry are looking to the significant pipeline of infrastructure work planned by the Government for relief. However, political uncertainty means even this source of projects is not assured, and the construction industry is likely to see continued challenges over the next year at least.

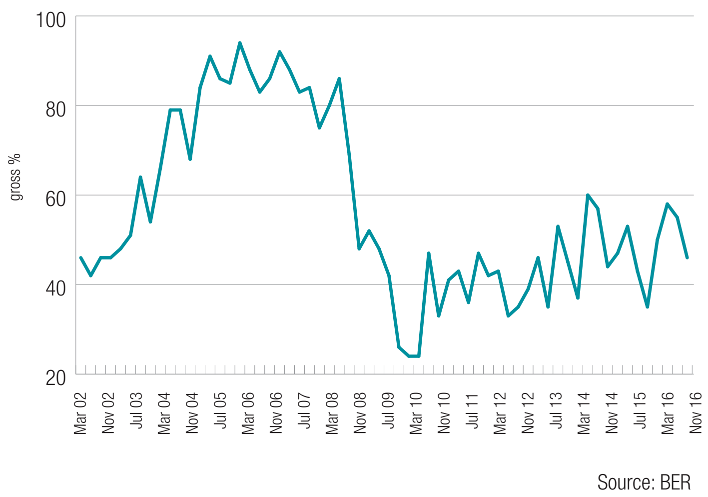
MARKET VIEW

According to the BER Building Survey, residential business confidence fell to 41 in 2017Q2 from 46 the previous quarter. However, building activity was somewhat higher for this sector of the market. In contrast, non-residential building activity remained very weak causing confidence to fall to 25 in 2017Q2.

Activity at the start of the building value chain also lost some momentum in 2017Q2. This was most noticeable among architects who registered a six-point decline in confidence to 49 index points.

Quantity surveyor confidence was also lower at 46 index points, from 55 in 2017Q1. However, their slowdown in activity was more muted.

Fig. 3: Quantity surveyor confidence



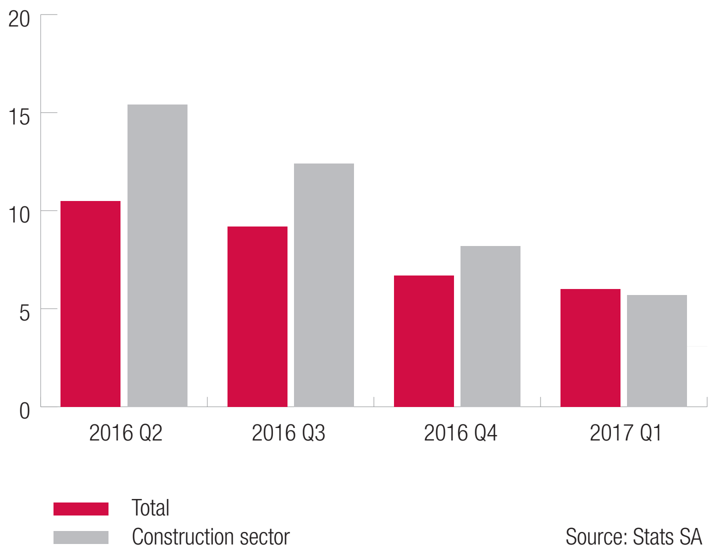
The continued weakness in non-residential building activity has become a specific theme of the results in recent quarters and this quarter is no exception. In fact, it seems likely that the outlook will worsen further before improving. Significantly, all parts of the value chain are now pessimistic about the future of their industry, as demonstrated by quantity surveyors, architects AND contractors all reporting index values below 50.

INPUT COSTS

Labour

Gross earnings in the construction sector slowed to 5.7% y-o-y in 2017Q1, from 8.2% in 2016Q4. Earnings in construction are now growing slightly slower than gross earnings for the total economy (at 6.0% y-o-y).

Fig. 4: Annual change in gross earnings

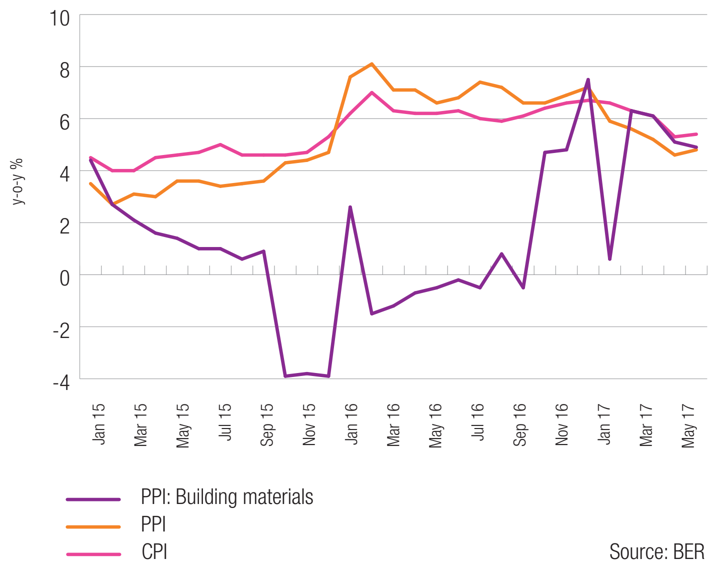


However, the average wage growth per employee increased to 6.8% y-o-y, from 6.2% in 2016Q4, despite growth in the number of employees in the sector. However, as the sector continues to slow we are likely to see this feed through to wages due to lower demand for construction labour, so labour price pressures should ease in the coming months.

Materials

The producer price index for items used in the building sector slowed to 4.9% growth y-o-y in May, from 5.1% in April, lower than current inflation figures. Price growth has eased consistently since peaking at 6.3% y-o-y in February this year.

Fig. 5: Inflation indicators



While this has partly been due to lower global commodity prices, it also reflects the weaker building demand, particularly from the non-residential sector.

Given the outlook for the building and construction sector, it is likely that building input costs will ease further as the year progresses, relieving pressure on costs and therefore decreasing tender price inflation.

Looking at the major sub-sectors, the cost of building commercial or industrial property rose by 6.3% y-o-y in May, from 6.0% in April. Similarly, residential building input cost growth accelerated to 6.2% (see figure 7 for components). While this is at odds with the building materials PPI, this is likely due to temporary factors.

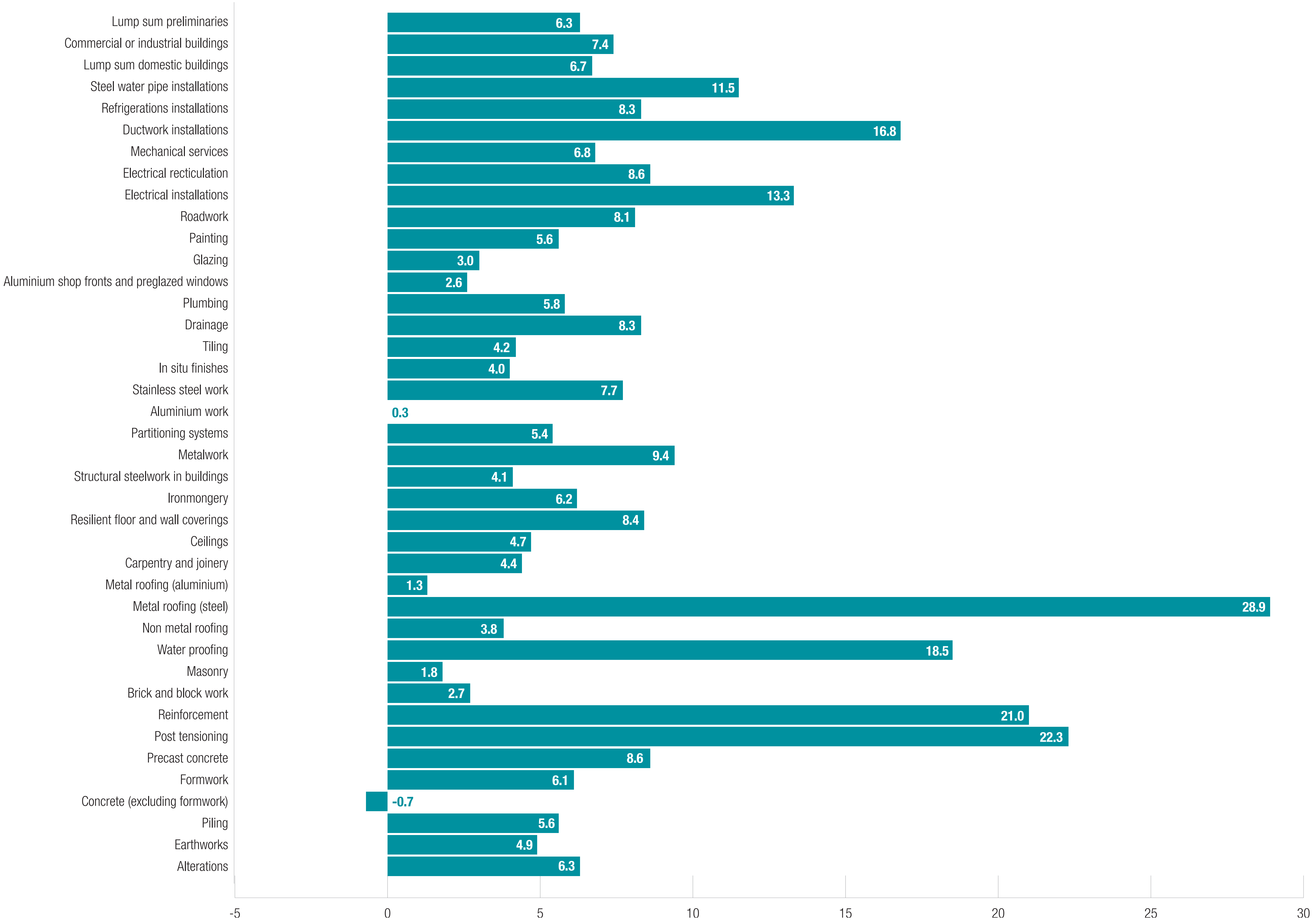
Fig. 6: Trend in costs (y-o-y)

Figure 7 provides a breakdown of the various cost components which includes metal roofing (steel) with annual growth of 28.9% in May, followed by post tensioning with growth of 22.3%. The former was due to higher industrial

References:

1. Bureau for Economic Research (BER). Various documents.
2. Medium-term Forecast Associates (MFA). Report on building costs, 2017Q2.
3. Statistics South Africa (Stats SA). Various documents.

Fig. 8: Annual growth in components of CPAP, 2017Q1



Source: Stats SA

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