**State of the SA Civil Industry: Q2 2014**

Conditions in the South African civil construction industry came under greater pressure in the first quarter of 2014, following a contraction of 10 per cent in real terms during 2013. 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 its 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 per cent and inflation at around 6,2 per cent, but latest forecasts by the World Bank as well as the IMF have been revised downward to 2,0 per cent. With growing speculation that the economy may be in a technical recession following the 0,6 per cent contraction in the 1st quarter of 2014, even a 2 per cent 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. 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.

Employment increased on average by 2,5 per cent q-q 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.

The tide may be turning for medium-sized 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. Added to this, the survey has found that the value of late payments has increased by 139 per cent .

Late payments also had an effect on large contractors. The value of late payments to larger contractors increased by 67 per cent q-q. Contradictory to medium-sized 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-sized 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.

There was a slight improvement in the opinions regarding the awarding of tenders, and although the net satisfaction rate remains negative, it did improve, supported mainly by an uptick amongst larger firms. Opinions related to tender activity continued to deteriorate, while opinions related to the state of the two year forward order book also continued to deteriorate. An increasing number of medium-sized firms were of the opinion that the value of order books was lower compared to the previous survey.

The opinions of firms related to profitability have improved over the last few quarters, although the net 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. 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.

An increasing number of firms reported that their overall assessment of business conditions during the past quarter was below average (poor to very poor), yet 31 per cent reported it to be above average. 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.

Our expectations that industry turnover would increase by between 3 and 5 per cent were supported by higher real growth in infrastructure expenditure by government 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.

*Source : SAFSEC July 2014*