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Construction slowdown continues to impact on steel construction sector

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WORKER OVERSUPPLY
The immediate outlook for the South African construction industry remains challenging, owing to a significant lack of demand for construction and an oversupply of semiskilled workers

While building confidence among contractors, materials manufacturers and quantity surveyors has increased marginally over the last two years, the immediate outlook for the South African construction industry remains challenging, says credit solutions provider Coface South Africa lead analyst **Saijil Singh**.

He notes that, although some companies are reflecting steady growth rates, the industry is still reeling from a three-year battle among companies competing to win contracts for projects with a lower profit margin.

"Currently, we are seeing a significant lack of demand on all construction bases – infrastructural, commercial and residential.

"This results in an oversupply of workers and a sizeable portion of small and medium-size enterprises (SMEs) accepting contracts with minimal profit margins simply to cover expenses."

This has led to increased competition among firms, which is unsustainable in the long term, says Singh.

He adds that, although profit margins will remain low unless demand increases, this strategy will not benefit the construction sector.

Business Confidence Impacts On Construction

Cement producers and brick manufacturers experienced strains in working capital and cash flow this past year, which Singh attributes to the decrease in plans passed for non-residential buildings, which was down by 22.8% in the first quarter of 2012, compared with the fourth quarter of 2011.

This decrease contributed significantly to the 4.5% drop in the total value of recorded building plans approved during that time.

"The reality is that commercial property development is directly proportional to the Business Confidence Index and indirectly proportional to the number of commercial liquidations, with a six-month lag effect," he says.

In terms of commercial property development, space use in major urban areas is reported to be 80%, and in smaller metropolitan areas it is as low as 50%, says Singh.

He explains that project volumes are influenced by private-sector commercial property developments and that new development is not as viable as it was before 2008, owing to a decrease in commercial property demand.

The construction industry will, however, benefit from government's plans to increase local infrastructure spending, but only in the second half of 2013.

Singh attributes the delay in rolling these plans out to the nature of administrating and implementing them, which includes the national distribution to municipalities, the municipal tender processes, tiered production payment schemes and subcontractor reimbursements.

Meanwhile, there is a specified amount of money awarded to municipalities each year, according to the infrastructure roll-out programme.

However, as has occurred, if a municipality fails to spend that budget in the allocated period, the funds are returned to the National Treasury and, as the next period's budget allocation is dependent on the previous spend, that municipality's budget will be reduced for the next period – something which was emphasised by Finance Minister **Pravin Gordhan** during his 2012/13 Budget speech.

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Knock-On Effect

The South African steel industry is suffering from the backlash caused by the struggling construction sector. Singh says there has been a recovery in domestic demand this year, albeit tentatively.

He states that if the country's economic growth stagnates, the steel industry suffers first.

Nevertheless, Singh believes that stagnation is unlikely to occur, owing to the prediction of low but steady growth of the South African economy in general. Companies with sales-based models and poor efficiencies will be vulnerable, however, and will run the risk of failure unless effective measures are put in place beforehand, he warns.

Meanwhile, the World Steel Association has reported that South Africa's steel output fell by 12.7% year-on-year to 6.7-million tons last year, while global production increased by 6.8% to 1.5-billion tons.

Singh highlights the significant downtime experienced by the country's steel mills in 2011, with a furnace failure at ArcelorMittal South Africa impacting on an already subdued outlook for the JSE-listed steel producer.

He also points out that South Africa's second-largest steel producer, Evraz Highveld Steel & Vanadium, experienced significant downtime while making improvements to its plant, and therefore contributed to the national decline in the 2011 steel production.

"With production under strain, the largest current constraint in the steel industry is a lack of demand. The construction sector's share of the demand for steel and engineering products is in excess of 60%, while the share of basic iron, steel and metal products (excluding machinery going into the construction sector) represented 33% of sales in 2011."

Singh adds that local steel producers and exporters could, therefore, be cutting back on future investment plans. With high steel prices and margins squeezed to almost zero, there is little room for South African steel companies to recover from further interruptions, he states.

"This challenging environment mainly affects small and medium-size steel firms," he says.

"Larger firms are well capitalised and have sufficient equity reserves to cope with the current climate. As a result, we are likely to see an increase in the number of liquidations in smaller steel firms in South Africa."

Additional Challenges

Singh attributes the South African steel industry's lack of global competitiveness to the many producers using old, cost-intensive systems and processes to manufacture steel.

He cites electricity-powered-only smelters as one such example and highlights that the global trend is to use a combination of resources – gas, coal and electricity – for power generation.

"This was one of the factors identified by the Industrial Development Corporation in its decision to buy Scaw Metals and invest in upgrading the steel producer's facilities.

"Further, South Africa's manufacturing process is dependent on a more expensive and limited quantity of higher-grade iron-ore. Upgrading [manufacturing processes] would make it feasible to process less expensive, lower-grade iron-ore, which is more readily available," explains Singh.

In addition to the industry's use of outdated technology, he cites the unpredictability of the basic steel price, fluctuating currencies and rising labour costs as further challenges facing the industry.

He also includes the need for education and skills development, but says this does not relate directly to the steel industry.

"If the skills shortage problem is resolved in the construction sector, the steel industry would see improved demand and reduced costs," he maintains.

Long-Term Prospects

While the immediate outlook for the steel construction sector is challenging, Singh offers some hope for the industry's long-term prospects, but only as a direct benefit of South Africa's logistical reach into nearby developing economies.

"Our large corporations have internal mechanisms to weather the storm and position themselves attractively for large tenders; however, the previous and current lack of profitability for shareholders would have to be compensated for," he says.

For this reason, Singh expects subcontracting margins to be squeezed to ensure maximum profitability, resulting in SMEs entering a price war to secure business. Singh, therefore, is not optimistic about the outlook for SMEs.

"South African companies still need to be more innovative and need to invest in research to promote technological developments. Advances in our technology would give us the competitive edge we need, as we are no longer competitive by price, owing to labour costs."

Singh warns that if this is not done, a positive shift towards global supply from Asian companies could become a reality.