MANUFACTURING CIRCLE INVESTMENT TRACKER

A quarterly index tracking investment spending in the manufacturing sector

Q2 2018 Summary findings and outlook

Background and objective

The Manufacturing Circle Investment Tracker (MCIT) is a composite index tracking investment trends in the manufacturing sector on a quarterly basis. The focus of MCIT is on actual expenditure patterns of a sample of manufacturing firms across all sub-sectors of the sector. A reading above the neutral 50-point threshold indicates that expenditure is expanding; below the neutral 50-point threshold indicates that expenditure patterns are declining.

The objective is to develop and derive insights about manufacturing investment patterns in the South African economic environment. The micro-level MCIT data aims to supplement existing macro-level data to deepen the understanding of trends in the manufacturing sector. Trade and Industrial Policy Strategies (TIPS) on behalf of the Manufacturing Circle compile this publication.

Survey sampling: Profiling the firms surveyed in Q2 2018

The latest survey sample of manufacturers in all nine provinces of South Africa showed that Gauteng (at least 40%) and Western Cape (at least 20%) continue to host the majority of the manufacturing operations. Most companies sampled in Q2 2018 operate in the basic iron and steel (15%); motor vehicles (15%); textiles (15%); and packaging (11%) manufacturing sectors. For instance, Western Cape hosts most of the operations in the textiles, clothing and leather goods sector, while Gauteng hosts basic iron and steel sectors. Motor vehicle operations are spread across Eastern Cape, Gauteng, Free State and Kwa-Zulu Natal provinces.

The MC members who were asked to participate in the survey are large, employing more than 200 employees and together employ more than 51 700 staff members. They have a combined annual revenue estimated at R113.4 billion and the annual average revenue is around R4.54 billion.

More than 65% of respondents reported that their investment spending in Q2 2018 is within their budget range, with 80% reporting that their capital spending on property and human capital is within their allocated budgets.

Overall, investment in 7 out of 8 sub-indices increased in Q2 2018 - specifically on human capital (salaries, wages, training and development) as well as on plant and equipment for expansion, upgrades, replacement and maintenance. Spending on inventories decreased in Q2 2018. The drought in the Western Cape has had a major impact on certain companies, while others are starting to see an increase in demand.

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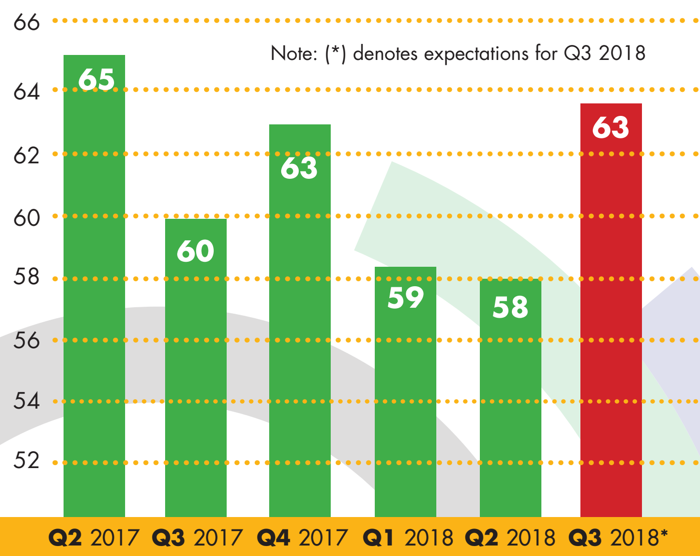
SUMMARY FINDINGS AND OUTLOOK: MODERATED MANUFACTURING INVESTMENT IN Q2 2018

The MCIT Composite Index measures the investment by manufacturing firms in the following indices:

1. Property (Land and Buildings)
2. Plant and Equipment
3. Inventory
4. Human Capital
5. Research and Development (R&D)

The latest MCIT survey shows a moderated investment appetite by manufacturers in the second quarter of 2018 compared to the preceding five quarters. The year-on-year MCIT Composite index moderated by 8 indices to 58 index points in the second quarter of 2018, compared to a stronger 65 points in the second quarter of 2017. This was in line with manufacturers' expectations provided in Q1 2018. Pleasingly, the Composite index remains solidly above the 50-point mark, although it has dropped below the 62 point average recorded over the past nine quarters.



The decline is due to a sharp decrease in investment on inventories, a reduction in replacement and maintenance of property, plant and equipment as well as a decline in human capital training and development. Some respondents noted that the effects of the drought in the Western Cape had negative outcomes for production volumes. In addition, subdued demand and production over-capacity affected inventory investment levels, especially in the packaging sector, partly due to low demand in the plastic business, offsetting better activity in the paper business. The risk of expropriation of land without compensation discouraged agriculture companies from further investments in new property.

Sub-Index

1. Plant and Equipment

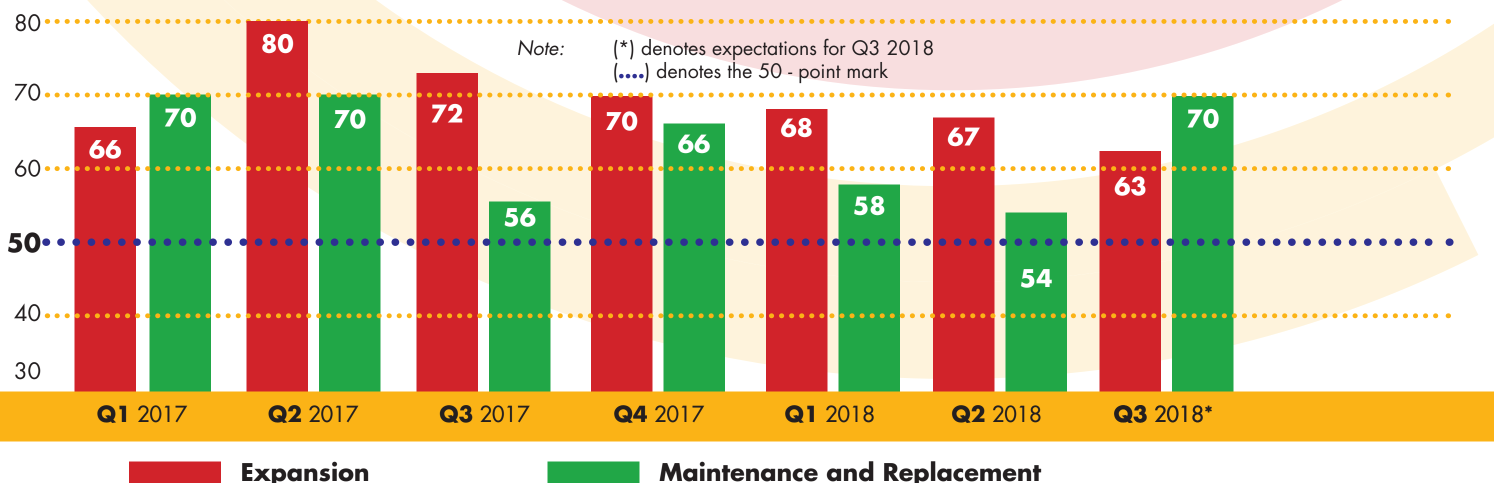
The sub-index, Plant and Equipment, is divided into two categories:

1. Expenditure on acquiring new plant and equipment
2. Expenditure on maintaining and replacing existing equipment

This sub sector shows a declining trend for the past four quarters. Capital expenditure on acquiring new plant and equipment as well as on maintenance or replacement of existing plant and equipment reduced again in Q2 2018. Capex on new plant and equipment declined 13 index points to 67 points, down from 80 points in Q2 2017. Investment on maintenance and/or replacement of existing plant and equipment dropped 16 index points to 54 points over the same period.

Looking to the next quarter, some companies manufacturing food, beverages and tobacco products, are still feeling the effects of the drought and will not be increasing investment. Other respondents expect investment in new plant and equipment to decline by 4 index points to 63 points in Q3 2018, while spend on maintenance and/or replacement of plant is projected to rise by 16 points to 70 points in the next quarter. Generally, this capex will be allocated to maintenance.

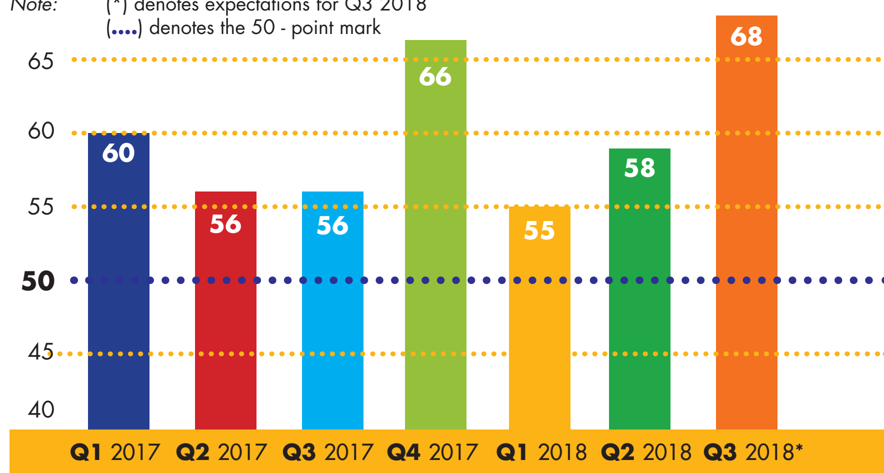
Manufacturers in the packaging and paper sector have indicated that they continue to strive to achieve a global competitive advantage by investing in biomaterials and biochemical. Any new investment by the textiles and clothing sector in plant and equipment will be to meet growing export demand.

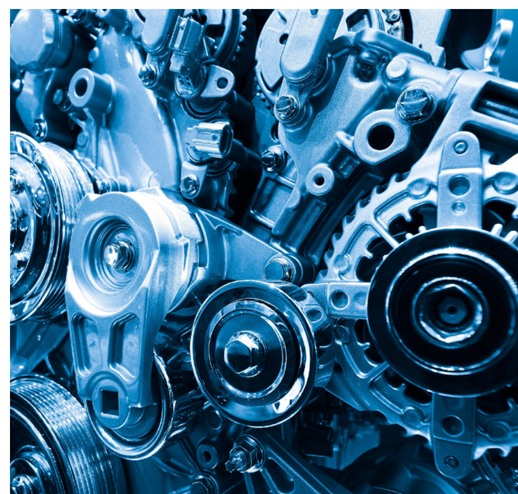


4. Research and Development

Investment in R&D rose slightly to 58 index points in Q2 2018 and compared to the same quarter last year. Encouragingly, manufacturers plan to increase spending on R&D to the highest reading since the start of the MCIT Composite index to 68 index points in Q3 2018. The reasons differed across sectors.

Manufacturers in the basic iron and steel sector anticipate growth in expenditure to keep them on par with global competitors whose products continue to be imported into South Africa. Companies in textiles, clothing and leather goods will invest further to meet growing export demand. In contrast, some in the electrical machinery and electronics sector plan to reduce expenditure on R&D in the 3rd quarter due to less orders in the pipeline. While manufacturers in the food products, beverages and tobacco products are adopting cost-containment measures through budget cuts to mitigate the effects of the drought.





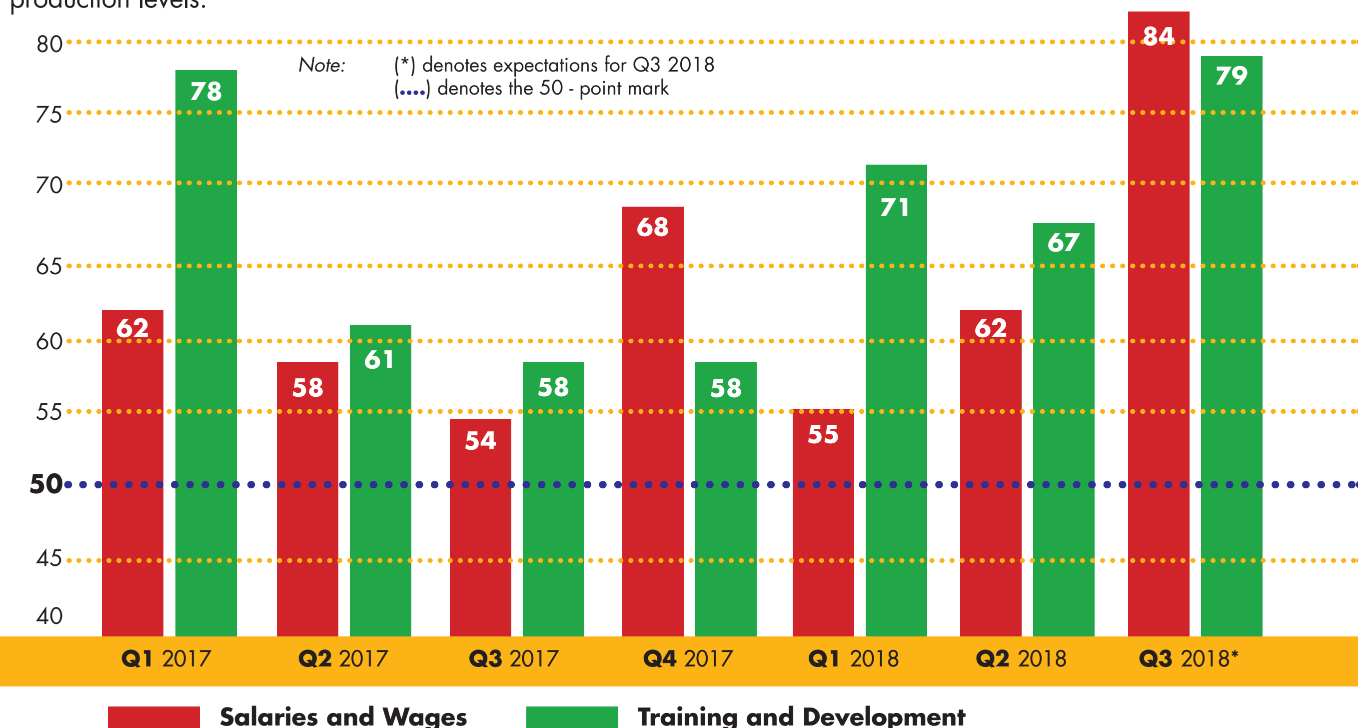
5. Human Capital

Human Capital is divided into two categories:

1. Expenditure on salaries and wages
2. Expenditure on training and development

Expenditure on salaries and wages recovered in Q2 2018 to 62 index points in Q2 2018 compared to 58 points in Q2 2017 and 55 points in Q1 2018. There was an increase in spend on training and development, up by 6 points compared to this time last year. Salary adjustments due to inflation and annual increases (including the rise in the minimum wage), partly contributed to the improvement.

A sharp rise is anticipated in Q3 2018 to 84 index points in salaries and 79 points in training and development spending. This is to support or accelerate production processes to meet outstanding orders and growing export market demand in various sectors. In some cases, a moratorium on new appointments is starting to ease as companies anticipate returning to normal production levels.



2. Property (Land and Buildings)

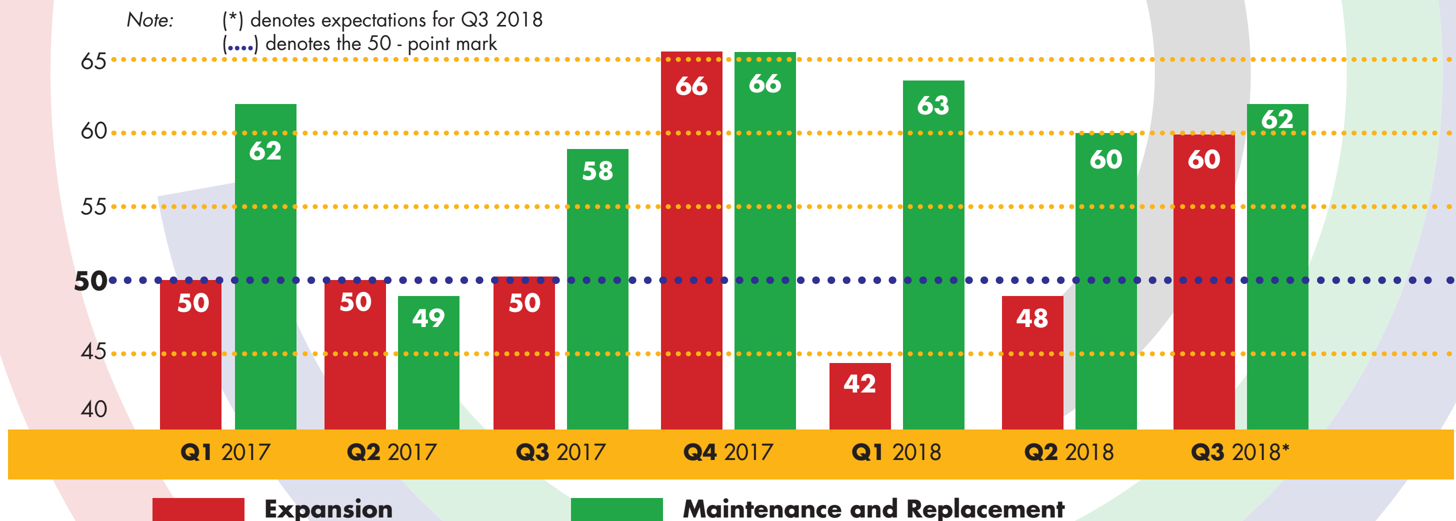
Property (Land and Buildings) is divided into two categories:

1. Expenditure on expanding existing property or the purchasing of new buildings
2. Expenditure on maintaining existing property

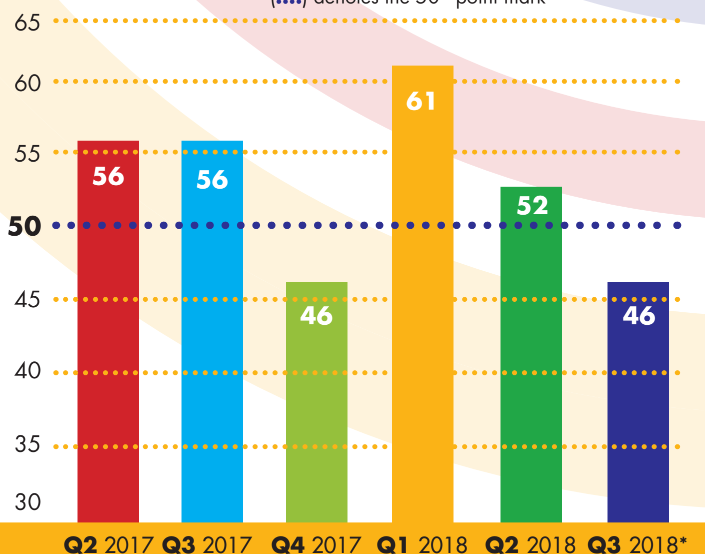
Expenditure on expanding existing property or purchasing new buildings recovered by 6 index points up to 48 points, up from the revised 42 points in Q1 2018, but disappointingly remained below the 50-point mark. The growth from the first quarter of 2018, was in part driven by a new production facility in the electrical machinery and electronics sector to boost local production of pre-paid electricity meters.

Although spending on maintenance and replacement of property fell from the first quarter of 2018, year on year, investment recovered sharply - by 11 index points - from 49 points in Q2 2017 to 60 points in Q2 2018.

Manufacturers are more optimistic about investment spending on both existing property and new buildings, and maintenance or replacement for Q3 2018, projecting growth by 12 and 2 index points to 60 and 62 points respectively. The growing export demand for textiles, clothing and leather goods is one of the reasons manufacturers are expecting to increase investment in the third quarter. Other manufacturers - in the packaging and paper sector - plan to increase capital spending on new property to increase capacity to optimal levels, minimise production costs, to use less water and harness the benefits of new technology.



3. Inventory



Expenditure on inventory decreased to 52 index points in Q2 2018 compared to 56 this time last year and dropped 9 points since Q1 2018. Furthermore, manufacturers are anticipating a further decline in investment on inventories to 46 points in Q3 2018, due to reduced turnover and lower demand. Some companies cited examples of customers with cash flow problems and the increase in customer liquidations or business rescue.

Food, beverage and tobacco producers in the Western Cape continue to face lower crop levels, which they expect to persist, resulting in reduced inventory levels. In the basic iron and steel sector, import pressure and the lack of adherence by government to designation has led to lower inventory levels. In the diverse sectors producing chemicals, minerals, energy, water, defence and security related products, companies have inventory build ups due to customers delaying taking delivery of goods. This could potentially halt spending on inventory.