Investment and profitability

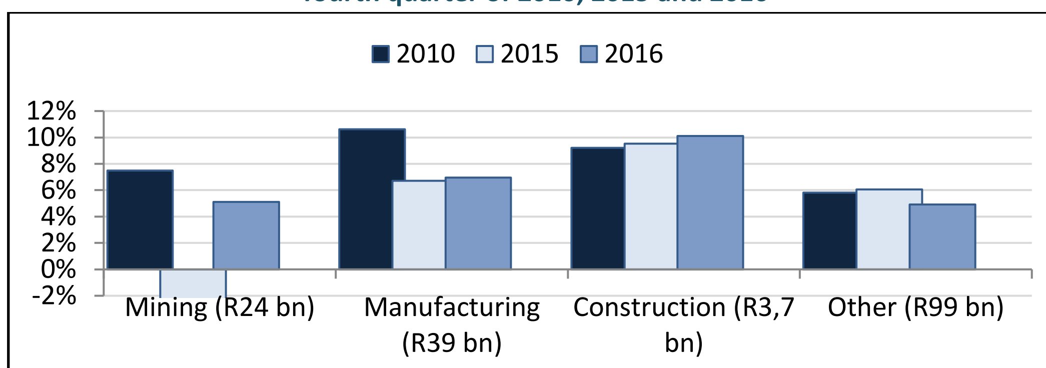
The past year saw an improvement in profitability in the real economy. Nonetheless, total investment decreased sharply in 2016, primarily in the private sector. State investment stagnated largely due to the onset of fiscal consolidation.

Profitability in the fourth quarter of 2016, calculated as pre-tax profits relative to assets, was strong in the real economy (Graph 15). Return on assets in mining confirmed its recovery from 2015, rising from R14 billion to R24 billion from the third to the fourth quarter. This situation resulted from a combination of higher global prices, although still far off 2011 peaks, and the closure of less profitable activities in the interim.

Profitability in the manufacturing sector remained stagnant compared to last year, with a sharp decline when compared to the previous quarter. After a disappointing performance in the previous quarter, the construction sector returned to strong profits, in line with 2015 results.

The rest of the economy showed satisfactory returns, although in decline both on a quarter-to-quarter and year-on-year basis.

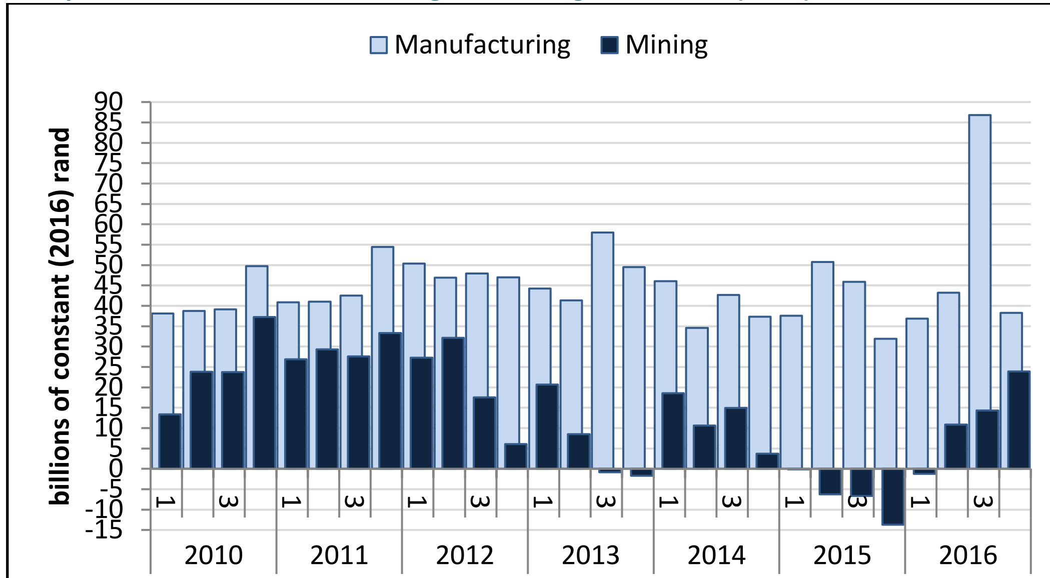
Graph 15. Return on assets (profit before tax as % of asset value) in the fourth quarter of 2010, 2015 and 2016



Source: Statistics South Africa. Quarterly Financial Statistics, third quarter of relevant years.

In constant rand, profits in the manufacturing sector returned to conventional levels after the spike reported in the previous quarter, which resulted from a major merger in the beverages industry (Graph 16). While the recovery of the mining sector remained fragile, the sector confirmed its return to profitability with a third quarter of improvement, returning to 2010 levels.

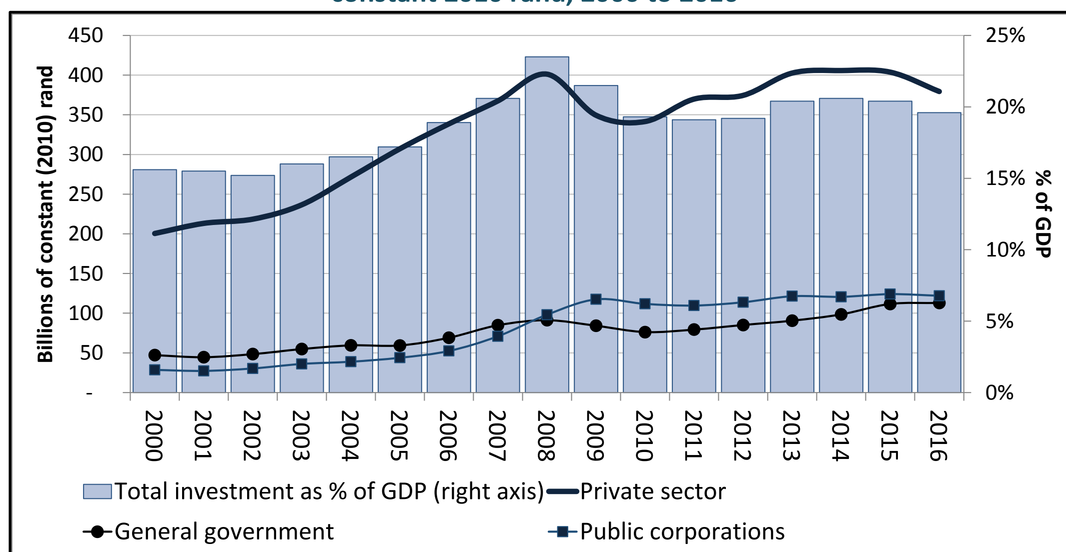
Graph 16. Profits in manufacturing and mining in constant (2016) rand, 2010 to 2016



Source: Statistics South Africa. Quarterly Financial Statistics, relevant years.

Despite this recovery in profits, total investment decreased in 2016, for the first time since 2009 and the financial crisis (Graph 17). Private sector investment in particular dropped by some 6% after a couple of flat years. After five years of steady growth, state-led investment did not compensate for the decline in the private sector and levelled out (0.3%) in 2016, in line with the fiscal consolidation trend. Investment by state-owned enterprises declined by about 1.5% while government investment grew marginally by 1%. As a result, investment as a percentage of GDP further weakened in 2016, reaching 19.6%, far from the 2008 peak at 23.5%.

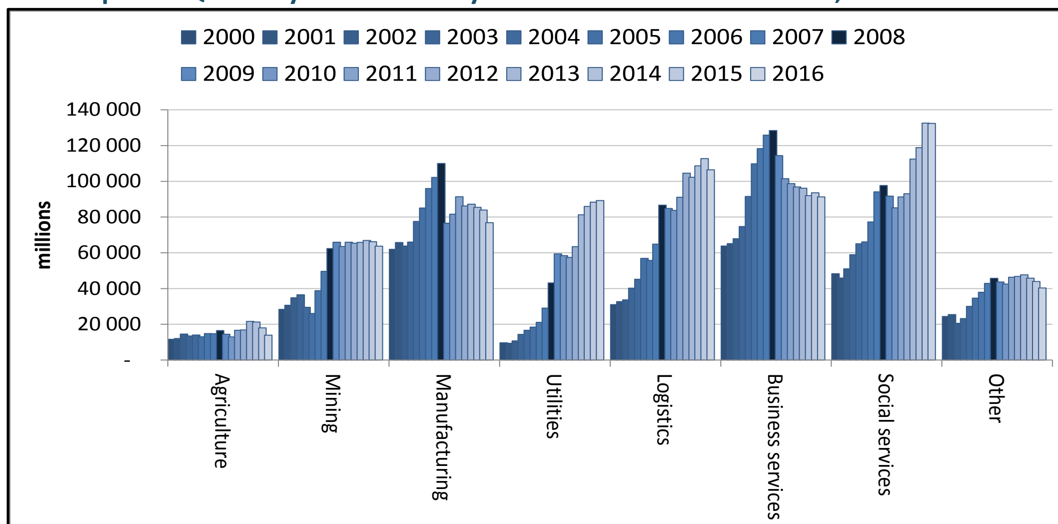
Graph 17. Yearly investment by type of organisation in constant 2010 rand, 2000 to 2016



Source: Reserve Bank. Interactive data set. Downloaded in June 2017.

At the sectoral level, investment materially declined in all sectors of the real economy with the exception of utilities and social services, which essentially stagnated (Graph 18). Affected by the drought, the agriculture sector continued its sharp fall initiated in 2014, with investment in decline of 23%. Manufacturing investment also severely decreased by more than 8% in 2016, reaching a level last seen in 2009. Investment in mining and logistics respectively declined by 4% and 6% in 2016, as a result of depressed commodity prices and weak economic activity.

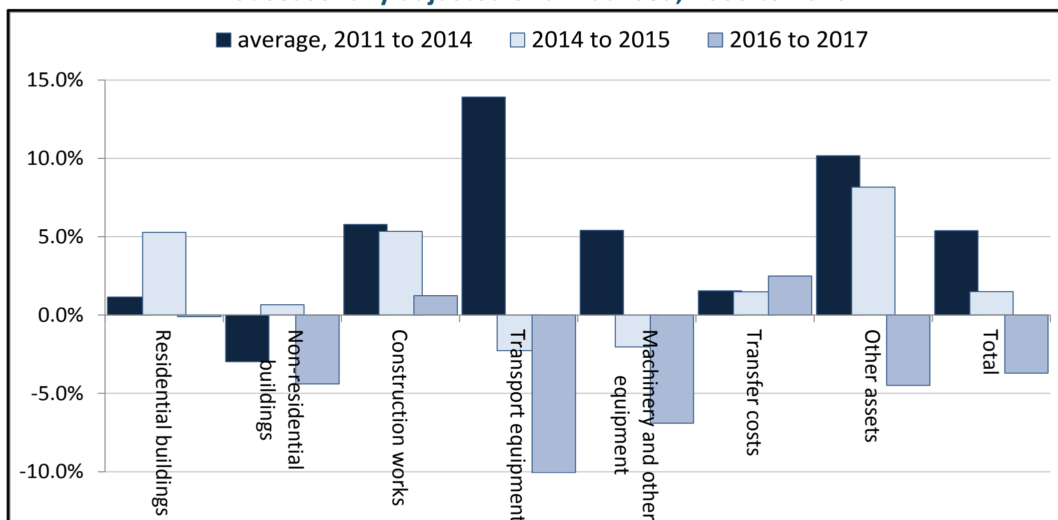
Graph 18. Quarterly investment by sector in constant 2010 rand, 2000 to 2016



Source: Reserve Bank. Interactive data set. Downloaded in March 2017.

From an asset perspective (Graph 19), infrastructure-related investment considerably slowed down in the last year, dragged by a 3% decline in investment in building and subdued growth in construction works. Investment in capital equipment plunged by 9% in 2016, in line with the decline in manufacturing and mining investment.

Graph 19. Yearly investment by type of assets in constant 2010 rand, not seasonally adjusted or annualised, 2000 to 2016



Source: Calculated from Statistics South Africa. GDP Excel spreadsheet. Downloaded from www.statssa.gov.za in June 2017

Major new projects

This section summarises major new foreign direct investment (FDI) projects, drawing on a new TIPS database, as well as domestic initiatives in the real economy.

Luxembourg-headquartered Czech company PEGAS, an established global producer of nonwoven textiles, announced plans to invest R1,3 billion over a period of two years in a new textiles manufacturing plant in Atlantis in the Western Cape. Operations are expected to begin at the end of 2018, creating 200 direct jobs. The company, which will receive incentives from Wesgro, the Western Cape's investment agency, and the Western Cape government, is committed to sourcing building and raw materials from local suppliers and to training local staff.

Confirming the attractiveness of the Automotive Production and Development Programme (APDP), South Africa's sectoral development programme for the automotive industry, Mercedes Benz and BMW announced new investment in the first quarter of 2017. Mercedes Benz will be adding three new AMG models to its East London production line. The AMG engines will be imported, while the rest of the components will be locally manufactured. BMW will be constructing a state-of-the-art regional parts distribution centre in Midrand in Gauteng. The project will include a training centre and offices for its IT operations hub. R200 million will spent on fitting out the distribution centre once complete.

In contrast, General Motors announced in May it would be exiting South Africa. The move, triggered by a global restructuring and the difficulties of the American firm on the local market (which failed to reach the necessary production volumes to fully benefit from the APDP), is consistent with the international restructuring and consolidation occurring in the automotive industry. The Struandale vehicle assembly plant in Port Elizabeth will be sold to Japanese commercial vehicle manufacturer Isuzu.

In March 2017, Australian firm iSelect Limited - which specialises in online insurance, utilities and personal finance comparison - launched a new call centre in Cape Town, in the Western Cape, valued at R320 million. The company partnered with South African business process outsourcing company Merchant, which will manage the facility. The centre hosts 140 employees, with plans to create 500-1 000 over the next five years.

On the acquisition side, the Chevron Corporation (known as Caltex), involved in the refining and distribution of petroleum products in South Africa through 15 depots, 845 retail outlets and 21 terminals countrywide, actioned a three-year divestment programme announced in 2014. The company sold 75% of its local asset to the China Petroleum & Chemical Corporation (a subsidiary of the Sinopec Group, China's state-owned oil, gas and petrochemical producer) for an estimated R11.3 billion. A consortium of black economic (BEE) partners and an employee trust jointly hold ownership of the remaining 25% of the business.

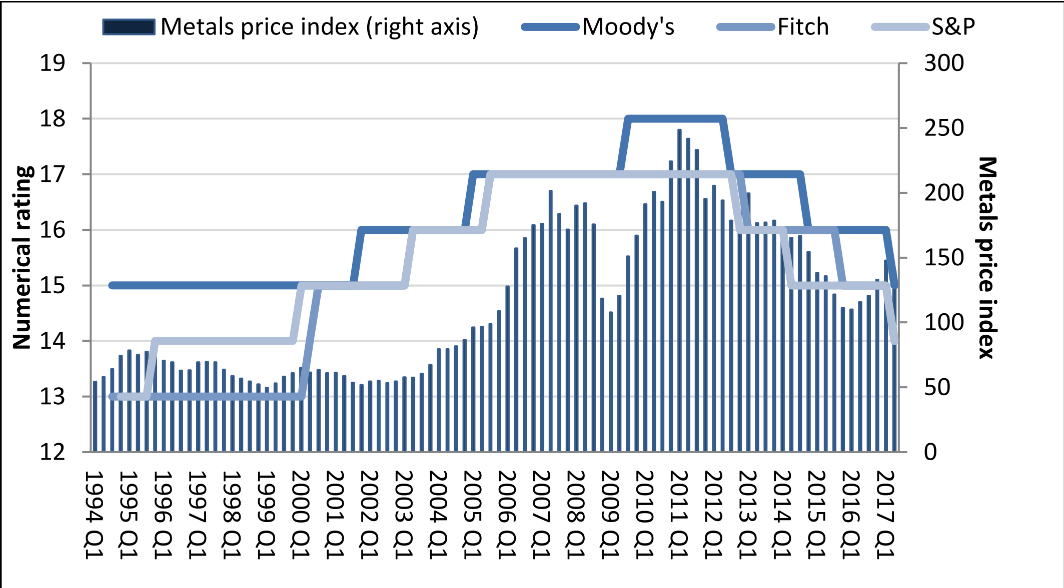
Briefing note:
South Africa’s credit downgrade – A commodity story

Generating much debate about the state and performance of the South African economy, leading credit ratings agencies recently downgraded South Africa’s grade. Fitch and Standard and Poor’s downgraded South Africa’s long-term sovereign ratings by one notch in April 2017 from BBB- to BB+ while Moody’s decreased the country’s grade from Baa2 to Baa3 in June 2017. But the downgrades did not affect any of the developments covered in this Real Economy Bulletin, which is based on data up to March 2017.

According to the agencies’ statements, the move was primarily driven by the political uncertainty following the Cabinet reshuffle and the perception that the fiscal consolidation stance (notably a rise in contingent liabilities of state-owned enterprises) will, as a result, be undermined by the pursuit of the nuclear power plant programme and efforts to spur radical economic transformation.

While not negating the role of internal political turmoil, South Africa’s credit rating history seems, however, to provide other important angles of analysis. The country’s credit ratings have been mainly determined by GDP growth, in turn underpinned by global commodity prices. Indeed, considering South Africa’s rating in the light of commodity prices, (Graph 20) shows that South Africa’s credit rating has been closely linked to international dynamics.

Graph 20. South Africa’s credit rating and metal prices, 1994 to 2017

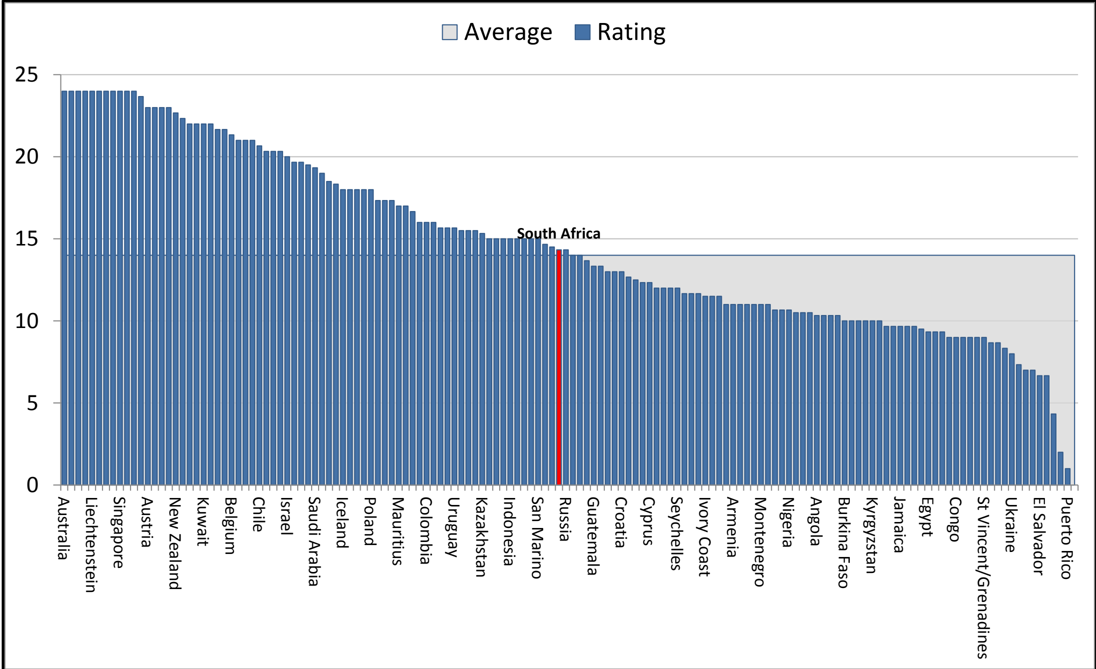


Source: credit ratings converted to numerical scale (0-24). Credit ratings downloaded from Trading Economics. Metals price index: IMF data

South Africa’s ratings should also be put into perspective on a global scale. Based on an average of the three main agencies, South Africa is ranked 72nd out of 146 countries which have a credit rating (Graph 21). South Africa’s ratings remain on par with India,

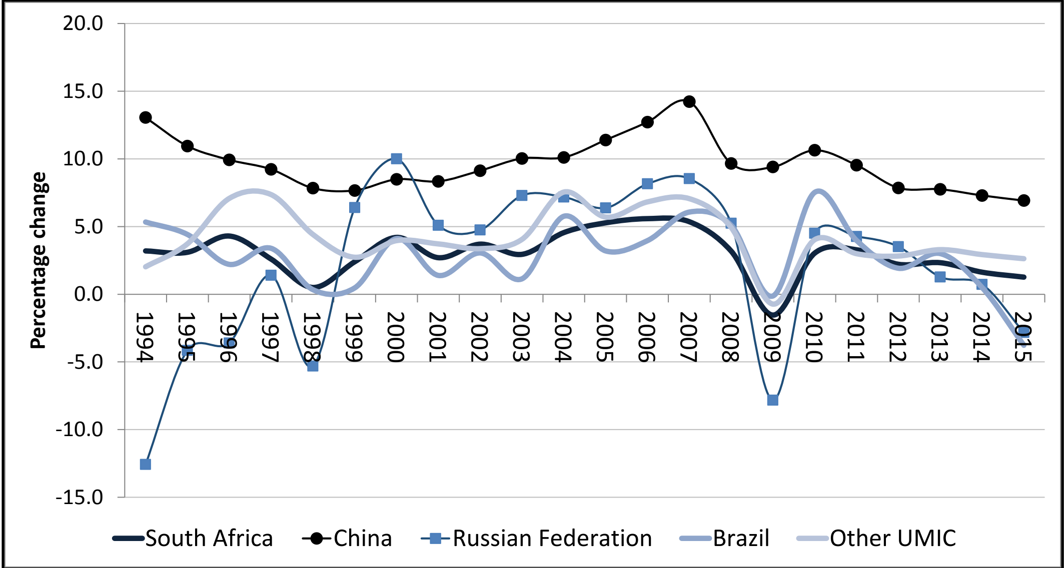
Russia, Brazil and even Portugal. The country's weak economic growth performance (the main determinants of credit ratings) moreover appears in line with other upper-middle income economies (with the exception of China), as shown in Graph 22.

Graph 21. World credit ratings, June 2017



Note: The grey area indicates speculative status. Source: *credit ratings converted to numerical scale (0-24). Credit ratings downloaded from Trading Economies*.

Graph 22. GDP growth in upper-middle income economies, 1994 to 2015



Source: World Bank data

While South Africa undoubtedly displays some domestic weaknesses, worsened by the political noise, global dynamics seem to largely explain the downgrade spiral. Importantly, these trends determined the country's rating, and not the other way around. Indeed, ratings which, as a reminder, are tools to help investors evaluate the

risks of a country defaulting on its debts, respond mostly to economic trends.

Undoubtedly, the downgrade will have some noticeable impact on the country, negatively affecting the sentiment on the domestic economy. The acceleration of capital outflows (already triggered by the fall in commodity prices) will ultimately increase the cost of capital, reducing the ability of both the public and private sector to invest. In addition, larger capital outflows are likely to push the value of the rand down, with the known positive effect on exports but negative impact on imports (particularly petroleum). However, in the long run, the impacts on the real economy are expected to be fairly muted and the current credit rating is unlikely to markedly affect South Africa's performance, compared to global demand and commodity prices.

Briefing note:
Industrial policy and the locomotive procurement – Corruption undermines industrial development

The procurement by Transnet of 1 064 locomotives was hailed as a boon for industrial policy. Transnet consolidated several years of procurement and sent the market signal that there was sufficient demand in South Africa for a major investment by locomotive producers and their suppliers. It also promised to stimulate local manufacturing firms to become suppliers into this global industry and support an export base in these products.

The firms bidding for the locomotive procurement were required to commit to localising their production, investing in local firms and building a competitive local supplier base.

Four firms were awarded the contracts, including China South Rail and China North Rail, which subsequently merged. Yet, research commissioned from the Centre for Competition, Regulation and Economic Development (CCRED) by TIPS under the Industrial Policy Research Programme[1] showed that China South Rail undertook virtually no localisation of production.

The recent leak of emails showing that the Transnet procurement process was hi-jacked helps explain this situation. They reveal that China South Rail paid a staggering 20% of the R50 million paid for each locomotive – some R10 million apiece - in "fees" to an intermediary company that facilitated its bid.[2] In total, it paid over R5 billion for the 500+ locomotives that Transnet will be buying from China South Rail.

TIPS research found that, to date, not one of the China South Rail locomotives has been assembled in South Africa; all have been manufactured in China. It appears that Transnet gave China South Rail "exemptions" on the number of locomotives that

[1] A recent presentation at a TIPS Development Dialogue is available on the TIPS Website www.tips.org.za; the full report is Crompton R., Fessehaie, J., Lauralyn Kaziboni L. and Tatenda Zengeni T. 2017. *Railway Locomotives and Transnet: A Case Study.* CCRED Working Paper 9/2017. CCRED. University of Johannesburg, available on www.competition.org.za.

[2] AmaBhungane. 2017. *#Guptaleaks: Guptas and Associates Score R5.3bn in Locomotives Kickbacks*. Downloaded from www.amabhungane.co.za in June 2017.

needed to be produced in South Africa, even though the procurement programme aimed explicitly to simulate local industry and industrial development.

The findings are verified in scrutinising the import bill for locomotives, which has grown significantly. The imports were less than $50 million per year through 2013, but then climbed to US$100 million in 2014 and US$550 million in 2015.[3] The remaining suppliers to Transnet under this procurement process have lived up to their obligations; they have invested, developed suppliers and are exporting components to the region and globally. Transnet Engineering has also built its own capabilities to produce locomotives, which is a positive signal.

With the slowing economy, the effects of high-level corruption can now be explicitly felt. Where government policies designed to stimulate industrialisation have been captured, the result is not only corruption and money-laundering, but also weaker foreign direct investment and slower industrialisation.

The state has few tools available to stimulate industrialisation, and the localisation of its procurement is one of its most important levers. Moral outrage aside, when corruption results in the importation of these items, it is a double blow to the economy – South Africa pays more for public investment and also loses the hoped-for stimulus to industry with the jobs and domestic manufacturing opportunities that would have been created.

As a minimum, the remaining locomotives that Transnet will get in 2018 must be locally manufactured, and the cost of each locomotive must be reviewed to ensure they do not incorporate corrupt payments.

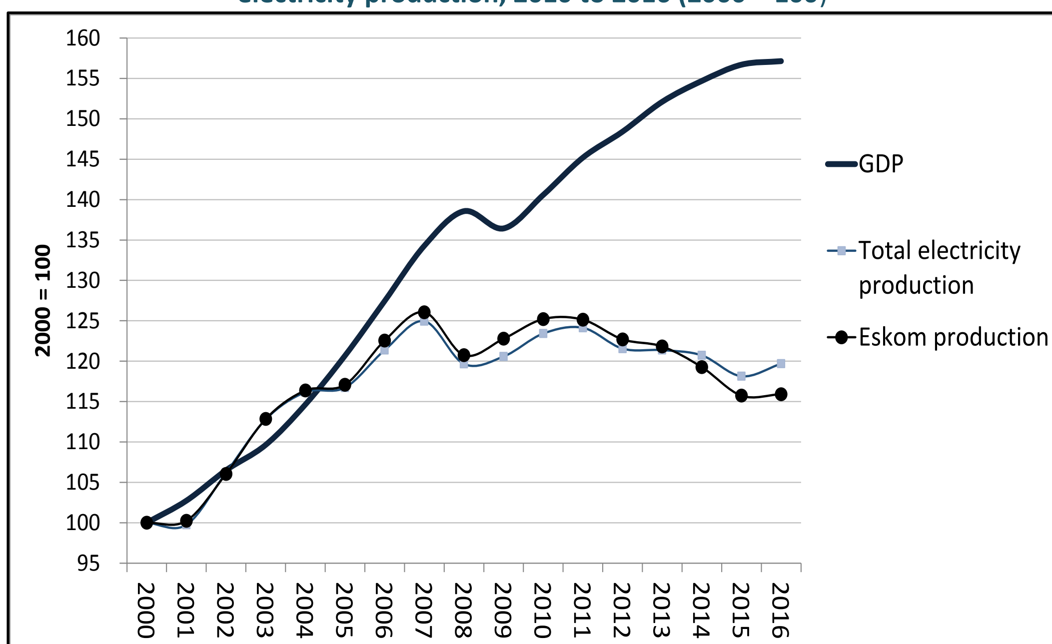
Briefing note: The electricity oversupply – Implications for economic policy

Since 2011, Eskom has experienced a sharp decline in demand, while the electricity-intensity of the South African economy fell by a quarter from 2005 to 2017. A TIPS briefing note (available at www.tips.org.za/policy-briefs) analyses the factors behind the fall in demand and, on that basis, a range of strategic responses.

As the Graph 23 shows, electricity production is now substantially lower than in 2008, despite continued growth in the GDP.

[3] Crompton R., *et al.* 2017. *Railway Locomotives and Transnet: A Case Study.* CCRED Working Paper 9/2017. CCRED. University of Johannesburg.

Graph 23. Indices of the GDP in volume terms and annual electricity production, 2010 to 2016 (2000 = 100)

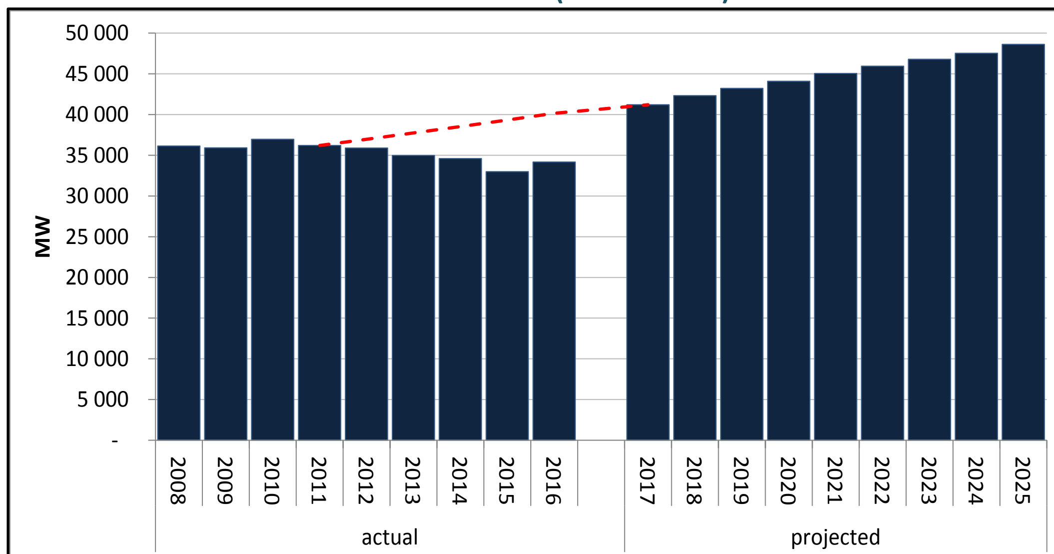


Source: For GDP, calculated from South African Reserve Bank. Interactive dataset. Series on GDP in constant rand. Downloaded from www.resbank.co.za in May 2017. For electricity, calculated from Statistics South Africa. Electricity generated and available for distribution. 201703. Excel spreadsheet. Series on monthly electricity generated and available for distribution, not seasonally adjusted. Downloaded from www.statssa.gov.za in May 2017.

Despite these trends, both Eskom and the regulator assume that demand will pick up in the near future. That belief ignores both the likelihood of slow growth in metals exports at least for the next few years as well as the strength of national and business strategies to reduce energy intensity. The risk is that it could lead to substantial overinvestment in generation in the next few years.

Graph 24 shows that NERSA's projections for electricity demand have not been corrected to take into account the realities of the past nine years.

Graph 24. NERSA's projections for peak demand (2017 to 2025) vs actual demand (2008 to 2016)



Source: NERSA. "System Adequacy Outlook." Issue 12. 4 January 2017. Pp 2-3.

The TIPS briefing note concludes that it would be unsustainable in economic, environmental and social terms to fall back on the historic solution of boosting demand by subsidising new investment in metal and coal refineries.

Instead, Eskom has to develop a new business model that takes into account current realities - in particular the decline in metals refining due to higher electricity costs and the end of the commodity boom, as well as efforts to reduce greenhouse gas emissions. These realities mean Eskom will have to adapt to more or less stagnant electricity demand for the foreseeable future. To achieve that end, it should adopt smaller-scale and more flexible generation technologies.

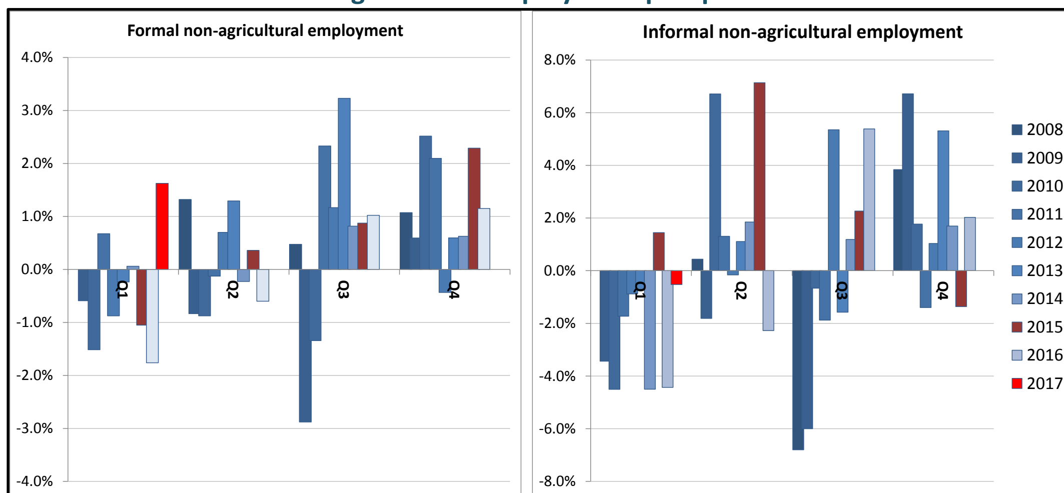
Promoting future growth also requires that electricity supply be far more closely aligned with industrial policy. That would entail substantial modifications in current processes for determining tariffs and the allocation of electricity. The aim would be to prioritise projects that support industrial deepening and inclusive growth, which in turn would sustain Eskom over the longer run.

Briefing note:
What's going on with the employment data?

As Graph 25 shows, the Quarterly Labour Force Survey (QLFS) reported a markedly strong increase in formal non-agricultural employment in the first quarter for the first time since the survey was initiated nine years ago. Informal employment accounts for around 17% of all jobs and is more volatile.

The survey found that, on average, informal employment declined by 2,2% in the first quarter of the year, each year from 2010 to 2016. For the first quarter of 2017, in contrast, it reported that informal employment dropped just 0,5%.

Graph 25. Reported percentage change in formal and informal non-agricultural employment per quarter

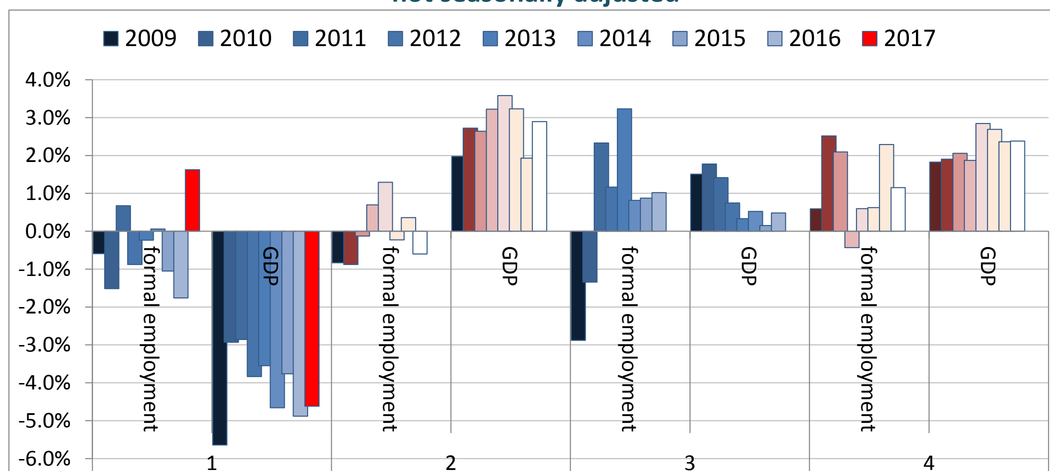


Source: Calculated from Statistics South Africa. Quarterly Labour Force Surveys for relevant year. Databases in SPSS. Downloaded from Nesstar facility at www.statssa.gov.za

If the economy were booming, this kind of jobs growth would not be exceptional. GDP growth has slowed, so the findings appear anomalous.

As Graph 26 shows, if the seasonal adjustment for GDP data is removed, employment and the GDP usually decline together in the first quarter each year, as a result of the holidays.

Graph 26. Percentage change in GDP and employment per quarter, not seasonally adjusted



Source: Calculated from Statistics South Africa. Quarterly Labour Force Surveys for relevant year. Databases in SPSS. Downloaded from Nesstar facility at www.statssa.gov.za; and GDP data in excel format, series on GDP in constant rand without seasonal adjustment. Downloaded from www.statssa.gov.za in June 2017.

Manufacturing alone accounted for 43% of the reported increase in formal employment, although it contributes just 14% of all formal jobs.

Food, beverages and the forestry value chain accounted for half the reported growth in manufacturing employment. This could in part reflect the recovery from the drought. The other main reported contributors were chemicals and non-metallic minerals, which is more difficult to explain in terms of their economic trends. In the past quarter, both of these industries reported a small decline in sales in constant terms.

In sum, the increase in employment reported for the past quarter seems at least as likely to result from data problems as from a real increase in job creation. If the QLFS results continue to diverge from other economic trends in the next few quarters, it might be useful if Statistics South Africa undertook a review of the survey's methodology.