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Renewed vigour in South Africa and Kenya as economies recover from their respective slowdowns.

"Tender prices dropped towards the end of 2017 due to adverse weather conditions, political uncertainty and credit growth stagnation. However East African economies are expected to see an expansion in the communications, mining and oil exploration sectors in 2018, along with significant investment in public infrastructure. This, combined with increasing material prices, are expected to push tender prices back up."

Simon Herd
Managing Director MaceYMR

"With the hopes of renewed vigour in the government's approach to tackling corruption, and reforming the beleaguered economy, South Africa has seen some optimism return to the construction market. However, with future pipelines held back by slow growth, and inflation dropping off, tender costs could see deflationary pressures over the next six months as contractors look to secure what work they can after the recent slowdown."

Mandla Mlangeni
Director for MMQSMace

Growth figures

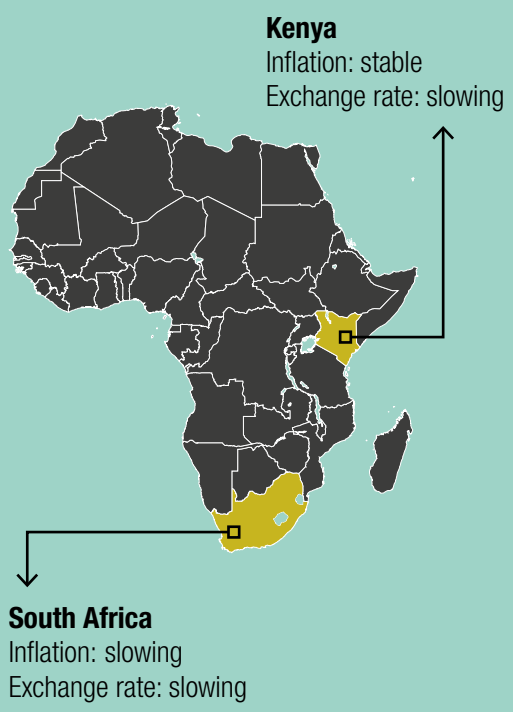
2017 GDP GROWTH

5%	0.7%	3.4%
Kenya	South Africa	SSA

2022 GDP GROWTH

6.5%	2.2%	3.9%
Kenya	South Africa	SSA

Forecast movement of inflation and currency value



EXECUTIVE SUMMARY

Similarly to other regions, Africa is forecast to enjoy a rebound in growth across the Continent, driven by investment in infrastructure, expansion of oil production to new areas and improved weather conditions after some years of drought conditions. Infrastructure projects in particular continue to be in the spotlight, particularly in East Africa where regional transport integration continues apace, providing plenty of opportunities for expansion of construction in this region.

Both South Africa and Kenya had challenging years, for very different reasons. South Africa is in gradual recovery from the recessionary conditions experienced in the first half of the year, and the election of Cyril Ramaphosa as ANC leader is hoped to inject some much needed optimism into the market, kick-starting the struggling construction industry. The South African government faces a particular challenge in balancing the need to restore fiscal credibility with the need to boost the economy. Kenya on the other hand continues to see significant return on its investment in transport, energy and social infrastructure, but has recently experienced an economic slowdown, largely driven by heightened political tensions in the run up to (and during) the protracted elections of H2 2017. However, with strong fundamentals Kenya, and its construction industry, are forecast to return to strong growth in 2018.

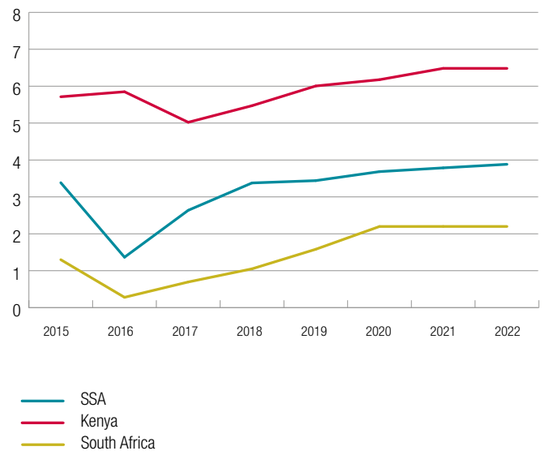
SOUTH AFRICA INFRASTRUCTURE FUELING DEMAND

Across the African continent an economic rebound is expected in 2018, driven by recovery in the big players' economies (including South Africa and Nigeria) and ongoing growth in top performers, including Ethiopia and Ghana. New investments in oil production, strengthening infrastructure investment across East and West Africa and improved weather conditions are all factors likely to contribute to the anticipated rebound. These represent particular opportunities for the construction industry, with a huge selection of infrastructure projects to work on and growing gas and oil construction demand.

Infrastructure, and in particular massive, often regional and externally funded transport and energy projects continue to be in the spotlight in 2018. Examples include the Nigeria transport network, which is due for a 12 station, 28 mile boost with the launch of Abuja light rail. Ethiopia's Ababa Bole International Airport is expected to complete in 2018, and Uganda will open its largest power plant, one of the continent's largest hydropower facilities. These large scale projects are being funded by increasingly diverse sources: as the US looks to pare down its foreign aid budget, Turkey and other countries could increasingly challenge China's position in Africa, with some recent high value wins for Turkish contractors in East Africa.

The African Union is looking to boost passage of goods, people and services between borders through the Continental Free Trade Area (CFTA) this year, predicted to spur growth and development among member states. This could provide further boosts to recovering economies, and drive stronger performance even than anticipated.

Fig. 1: GDP growth (%) - IMF



CONFIDENCE & CREDIBILITY BOOST NEEDED FOR CONSTRUCTION

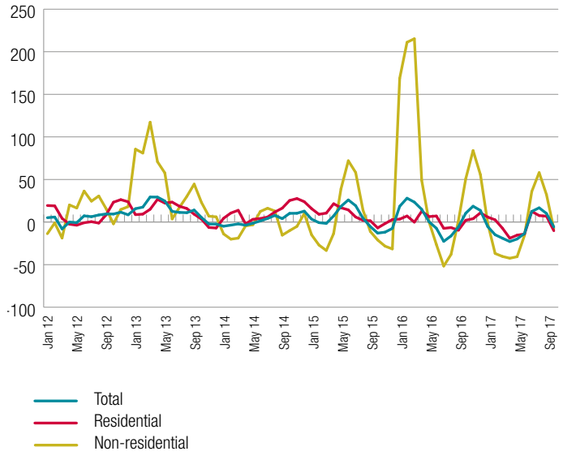
The South African economy is still in recovery mode from the various shocks faced throughout 2016 and in H1 2017. At only 0.7% for 2017, the level of economic growth is currently insufficient to meet the country's development aspirations, and the slow growth is placing significant pressure on the fiscal framework. The economy is now expected to start to recover, slowly, reaching growth rates of 2.2% by 2022. This year's marginal recovery has been concentrated in three sectors, namely agriculture, mining and manufacturing, however the slow momentum coming into 2018 means that we are likely to see a second consecutive year of falling per capita income, and therefore weak demand.

However, the election of a new leader of the ANC has injected optimism into an economy lacking in confidence. Deputy President Cyril Ramaphosa plans to target 3% growth by 2018, and 5% by 2023, and to create 1m new jobs within the next 5 years. The new leader, likely to win the presidency in 2019 elections, faces a daunting task: rebuilding an economy battered by years of mismanagement and the influence of corruption. At current forecast rates of growth the economy is not creating enough new jobs to address the structural issues in the South African labour market, including widespread poverty and severe unemployment (at a 14 year high of 27.4%). This feeds through into a circle of weak domestic demand leading to slowing growth, and more unemployment: the state hopes significant investment in apprenticeships and large scale infrastructure investments will be enough to break this cycle and start getting the population into formal work.

His stated goals include taking urgent measures to repair investor confidence, through improving institutional stability, restoring the credibility of the criminal justice system and demonstrating the state has the political will to turn the country's finances around. But credibility is hard to rebuild, and it will take considerable time for the damage done to South Africa's international and domestic investor confidence and reputation to be restored, making the 3% growth target in 2018 very ambitious.

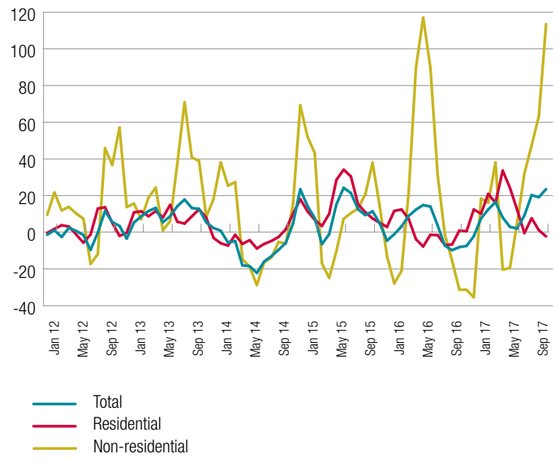
The dual need to restore credibility and invest in the economy is challenging, as the government has little wiggle room for expansionary spending to boost jobs, but needs to convince investors and currency markets they are reigning in their spending. Debt service costs are now the fastest growing segment of the budget, nearly 15% of the budget now compared to a low of 8.8% in 2008/9, underlining the need for fiscal discipline. As such we hope to see prioritisation of the most high impact projects for government investment, and an expansion of private sector funding across sectors, in order to ensure the ambitious pipeline of infrastructure work outlined by the South African government gets built.

Fig. 2: Change in number of plans passed - BER



Despite some positive movements in the South African economy recently, the volume of plans passed (indicating the strength of the future construction pipeline) was still shrinking in October 2017, by 5.7% on a three month rolling average basis, and 10.9% on a y-o-y basis. Despite a brief rally in the three months to August driven by growth in non-residential plans, the volatility in residential building is now creating a drag on overall building. However, given that non-residential, which has seen the most damaging reduction in pipeline over the past year, is now pulling out of its fall, it is hoped that residential building will soon follow, and 2018 will see the construction industry rebuilding the knocked pipeline.

Fig. 3: Building completed BER



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.

RAMAPHOSA TO BOOST INFRASTRUCTURE

A $464bn infrastructure investment gap has been identified in South Africa, with a need for investment into the water and electricity sectors to plug this gap and address anticipated population and economic growth.[1] Without this investment it has been suggested they will not be able to meet their United Nations Sustainable Development Goals. Investing in the right areas to boost growth as well as provide the essential services the growing population needs will be key going forward, and for South Africa a challenge between restoring fiscal confidence and spending the money needed. As it stands, they are forecast to meet only 66% of their infrastructure needs by 2040.

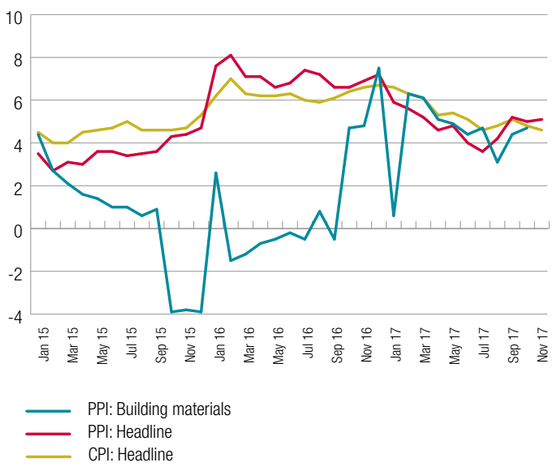
Fortunately, support to the construction market will be provided in the form of further boosts to infrastructure spending, compensating for the volatility in the buildings pipeline. Spending on new roads, power stations and ports as well as other capital projects will be boosted to 1.5tn Rand over the next 5 years under Ramaphosa,

1. G20 Global Infrastructure Hub

guided by a newly created presidential panel who will drive implementation of large projects, reduce costs and root out corruption. According to the Medium Term Budget Policy Statement for 2017/18, about half of the R300bn each year on infrastructure, will be funded directly from the budget, and private funding will be sought for much of the remaining gap.

HEADING FOR A CUT IN INTEREST?

Fig. 4: Inflation (%)

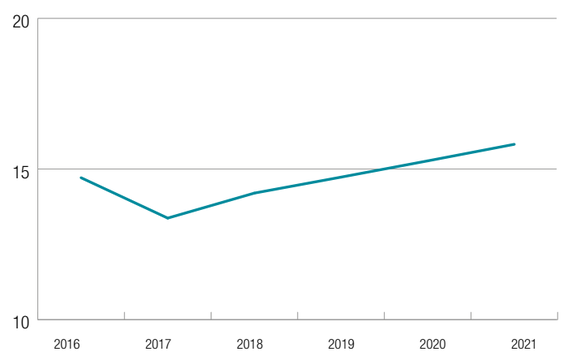


The latest readings for material inflation in South Africa show some strengthening since the low point for 2017 in August of only 3.1%, returning to a more historically normal 4.7%. However 2017 has reflected a significant pick up in materials inflation compared to previous years, and we are likely to see this feeding into tender price inflation through to 2018. At 4.4% average material price inflation in 2017 compared to 1.3% in 2016 and only 0.3% in 2015, this cost has jumped up in the past year and represents a potential risk to profit margins if increased cost cannot be passed through to tender prices in the challenging current environment.

Wider producer price inflation has shrunk to less challenging levels of 5.1% in November 2017, alongside a similar slowdown in consumer price inflation from highs of 7% in February 2016 (driven by a large currency depreciation) to 4.6% now, safely within the 3-6% target of the South African Reserve Bank (SARB). Given this slowdown we are unlikely to see strong movements from the SARB to rein in inflation, and could even see monetary policy used to combat recessionary economic conditions. Building on the previous pattern, the SARB opted to keep the repurchase rate at 6.75% in January given the continuing risks. However, with the notable appreciation in the Rand following the ANC leadership result, and the energy regulator only 5.3% growth in electricity tariffs for 2018, the lower pressure on prices is raising the probability of an interest rate later in the year. A potential downside risk to this view is the move to nationalise the SARB, which could reduce confidence in its ability to operate independently and therefore the strength of monetary policy in keeping inflation down.

South Africa's Rand saw a significant appreciation in 2017 which contributed to bringing down inflation, but negatively impacted external demand adding to the economic woes of the country in this challenging year. However, this appreciation is not expected to be long lasting, with anticipation that the Rand will depreciate steadily through to 2021 from today's value 13.37 to the US$ to 15.82 in 2021.

Fig. 5: Rand per US$

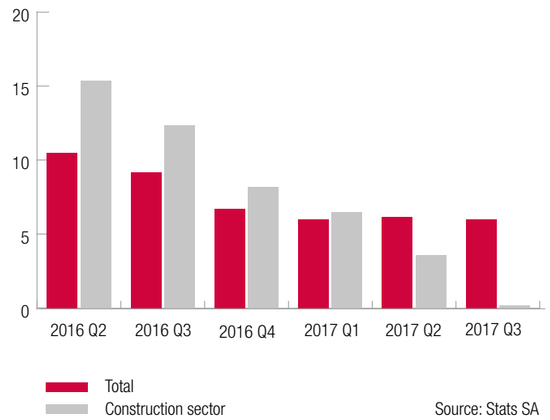


CONFIDENCE REFLECTED IN INVESTMENT DECISIONS

Understandably given the current economic situation, BER's QS business confidence survey in South Africa remains below the neutral 50 mark in H2 2017, having dropped from positive in March 2017. Since then confidence in the construction industry has plummeted due to the difficult conditions the market currently faces, reaching its lowest level since June 2016 at the end of the year at only 38. As such we can expect to see relatively cautious investment behaviour in the market for 2018, and downward pressure on tender costs as contractors look to get work into their pipelines. Across the board confidence indicators remain extremely low, whereas the real economic indicators have occasionally begun to surprise to the upside in the latter half of 2017. This includes a 6th consecutive month in contractionary territory for the ABSA manufacturing PMI, and a full 68% of South African business executives surveyed delaying business expansion plan (61% delaying investment decisions). However, Ramaphosa's victory is seen to have injected some optimism into the market, which will likely be reflected in the next round of surveys, and should feed through to an improved economic environment in confidence terms.

LACK OF SKILLS IS MAJOR RISK FOR CONSTRUCTION RESOURCES

Fig. 6: Annual change in earnings (%) - BER



Source: Stats SA

The effect of recent uncertainty and shrinking pipeline in the construction sector can be seen in the trajectory of construction earnings compared to the wider economy. Previously growing at a significantly higher rate than average earnings (a full 4.9% faster growth of 15.4% in q2 2016), as activity has slowed we have seen a reversal of this, shrinking to 5.8% less strong growth than national average at only 0.2% growth in q3 2017. Whilst this is positive in terms of labour costs, it also indicates that the construction sector is suffering the effects of the ratings downgrades and challenging economic outlook more strongly than the wider economy, whose earnings growth has slowed, but only by 4.5% as compared to construction's 15.2% slowdown in the same period. Keeping talent in the industry and ensuring capacity to complete the full infrastructure pipeline will become more challenging the less attractive earnings appear as compared to other industries, however with a large unemployed labour pool there will be plenty of unskilled labour supply for years to come.

KENYA
LEADER OF THE PACK

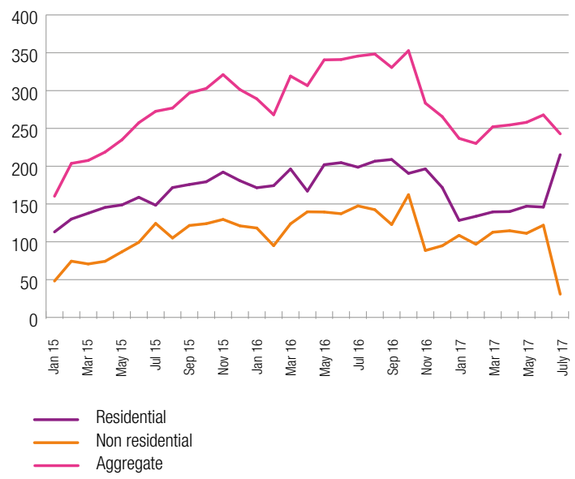
Kenya is seeing significant returns on recent investment in transport, energy and social infrastructure. In 2006 Kenya's GDP per capita was close to the African average: fast forward just over ten years and it has grown to half again the current average at $1,455 per person, a huge bound in terms of standards of living. With a rapidly growing and urbanising population, Kenya is expected to overtake the Netherlands in terms of urban population by 2025, driving the need to keep up with the growing population and their transport, energy, housing and community needs, and hence ongoing investment by the government. Between this and the strong underlying fundamentals in Kenya's economy we are likely to see stable domestic demand continuing to drive steady growth in construction over the next decade.

Despite all this economic growth decelerated in Kenya in the latter half of 2017 to 4.4% in q3, compared to 5.6% for the same period in 2016, largely due to the uncertainty creeping into the economy from the protracted (and expensive) national elections. Together with adverse weather conditions, lower investment due to this uncertainty slowed growth, despite stable fundamentals.

This slowdown is unlikely to last long however: Kenya is developing rapidly and ongoing improvement in economic and business conditions will drive this development further. In 2016, Kenya was the 3rd most improved country in the ease of doing business rankings. They are now 2nd best in logistics across the continent, second only to South Africa. And they have become the 2nd most attractive Foreign Direct Investment destination in Africa after Morocco in 2016. Positioning itself as the gateway to East and Central Africa with the growing Port of Mombasa increasingly the main transport and logistics hub to African countries in the region, Kenya is investing in the right places to combat any slowdown. After the dip in 2017, economic activity is expected to pick up, growing to more than 6% growth per year by 2019, and supporting ongoing strong demand and activity in the construction industry.

STRONG DEMAND FOR INFRASTRUCTURE DESPITE ELECTORAL SLOWDOWN

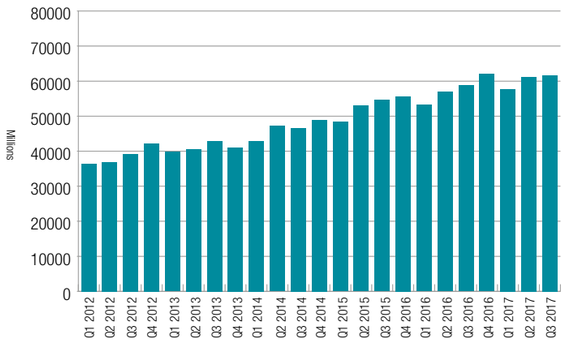
Fig. 7: Building plans approved



The Kenya construction industry has seen huge growth in recent years, and this is evidenced by the 120% surge in building plans approved between Jan 2015 and the peak in October 2016. Although the volume has fallen back since then the industry has still seen over 50% growth in plans passed since Jan 2015. This has been predominantly driven by strong growth in residential construction, supported by growth in non-residential up until H1 2017. It is likely that delayed investments are to blame for the drop in non-

residential plans passed in July 17, as companies side-lined investment plans until political uncertainty subsided. Construction as a whole is estimated to have expanded by 4.9% in the year to q3 2017, as compared to 7.8% growth to q3 2016. This slowdown is partly attributable to an extended electioneering period that prompted investors to scale down spending, and the drop off in public spending in the run up to the Kenyan elections.

Fig. 8: Kenya Construction GDP (Constant 2009 prices KSh)



Infrastructure construction has seen significant growth and investment in Kenya in recent years, growing 9.3% to q3 2016, on top of strong 15.6% growth in the same period in 2015. The government is focusing on improving transport infrastructure, both in terms of domestic and international links, and is striving to facilitate ease of doing business with port, road and rail network expansion plans ongoing. Substantial government spending on infrastructure as well as foreign investment flows are sustaining this high level of growth, however in the run up to the elections in 2017 some spending was put on hold, creating a drag on construction growth as a whole. Significant investment in roads is planned, with KES134.9bn set aside for new roads and maintenance. Add to that ongoing development at Mombasa and Lamu port, airport expansions/development across the country and more than KES327bn spent on Standard Gauge Railway development, and a picture of ongoing strong demand for infrastructure construction clearly emerges. In seeking to improve its international connections, Kenya is also benefiting from investment at the regional level into increased coordination and connection of transport between East African countries. Various regional initiatives including the $23bn multimodal transport corridor dubbed the Lamu Port – South Sudan – Ethiopia Transport Corridor (LAPSSET) corridor will also contribute to ongoing investment in infrastructure in the country. In fact, currently 11 out of the 43 biggest infrastructure projects in East Africa are in Kenya, showing the importance of this country's investment to the overall region as well as its own domestic market.

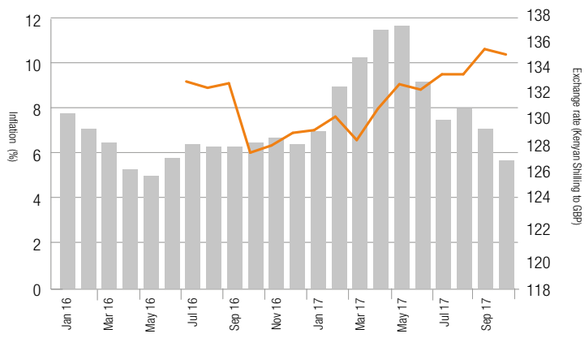
Whilst there is significant demand for construction in Kenya, there are still some elements holding the market back, such as the high cost of building materials and challenges to the provision of bank credit which are constraining demand for new development. Nonetheless, construction industry value is still forecast by BMI to grow more than 12% 2017-18 due to the sheer strength of demand in the country, as well as the ongoing investment by the government.

WEATHERING INFLATION

Inflation grew in 2017, largely due to a surge in food and non-alcoholic beverages prices, beginning in q2. This food price rise was largely driven by adverse weather conditions effecting crops through q2 and q3. Despite the increase in inflation, the Central Bank Rate was maintained at 10%, and the subsequent reversal of the inflation trend underlined this as a well forecast move, with inflation shrinking from 7.06% in September to only 5.72% in October largely due to the Kenyan shilling's appreciation against the major trading currencies (apart from the USD).

Going forward inflation is expected to average 5.1% between 2017-2020[2] due to prudent monetary policy and efficiency gains arising from regulatory reform and investment in infrastructure. Drought remains a potential risk to future inflation, and demand pressures are likely to prevent any significant slowdown in its rate from current levels, meaning inflation will be relatively predictable and well managed by the Central Bank. Predictable inflation will help companies prepare as they struggle to work around high material prices.

Fig. 9: Kenya inflation and exchange rate



The Kenyan shilling recently saw a bout of strengthening in 2015-16, growing by 0.1%, 16.7% and 3.1% against the USD, GBP and EUR respectively. The IMF attributes this to the growing volume of currency denominated capital inflows as investment in Kenya grows, increase in conference tourism receipts and the destabilising effect of the Brexit vote on Western economies. However, the Shilling remains vulnerable to global developments such as further rises in US rates and uncertainties surrounding China, and as such is forecast by EIU to weaken from 106.5 to 1USD in 2017 to an average of 120.5 in 2021. This could impact existing high material prices in the construction industry as most materials are imported, and will therefore be more expensive as the currency depreciates, despite relatively stable and predictable inflation.

OPTIMISM RETURNING IN KENYA CONSTRUCTION

In Kenya, optimism has returned to the surveys, with the highest PMI[3] in a year as the political situation stabilised in December. Business conditions improved after shrinking into negative territory for 6 months due to anticipated and realised political uncertainty. Growth was underpinned by expansion in output, new orders and growing employment, reversing the recent downward trend, and the rate of expansion was sharp, indicating a likely significant boost to the Kenyan economy in the first quarter of 2018. Overall, both the reduced political tensions and improved customer demand have determined this improvement in business conditions, which will feed through to stronger demand in the construction industry as investor confidence improves.

SHORTAGES OF CONSTRUCTION LABOUR CREATING BOTTLENECKS

As the economy has slowed during the electioneering period, so did employment growth, with fewer new opportunities in the formal sector being created. However, a return to strong demand for labour is expected as the economy picks back up, and with it growth in labour cost inflation is likely to ramp up as well. In construction, this is exacerbated by an acute shortage of skilled workers, largely driven by the young shunning technical education and work in favour of courses leading to office jobs. With a shortage in skilled workers, labour costs are rising as developers pay to get the skills they need, sometimes even upping costs enough to slow or stop development. The shortage of masons, electricians, plumbers and painters in particular has significantly pushed up labour costs, and could be compromising standards if developers turn to uncertified (but cheaper) artisans to take their place. As recently as January 2017, double digit wage inflation was impacting the housebuilding sector. In addition to this there was discussion in 2017 around the potential for a minimum wage hike in Kenya which would affect the cost of labour further.

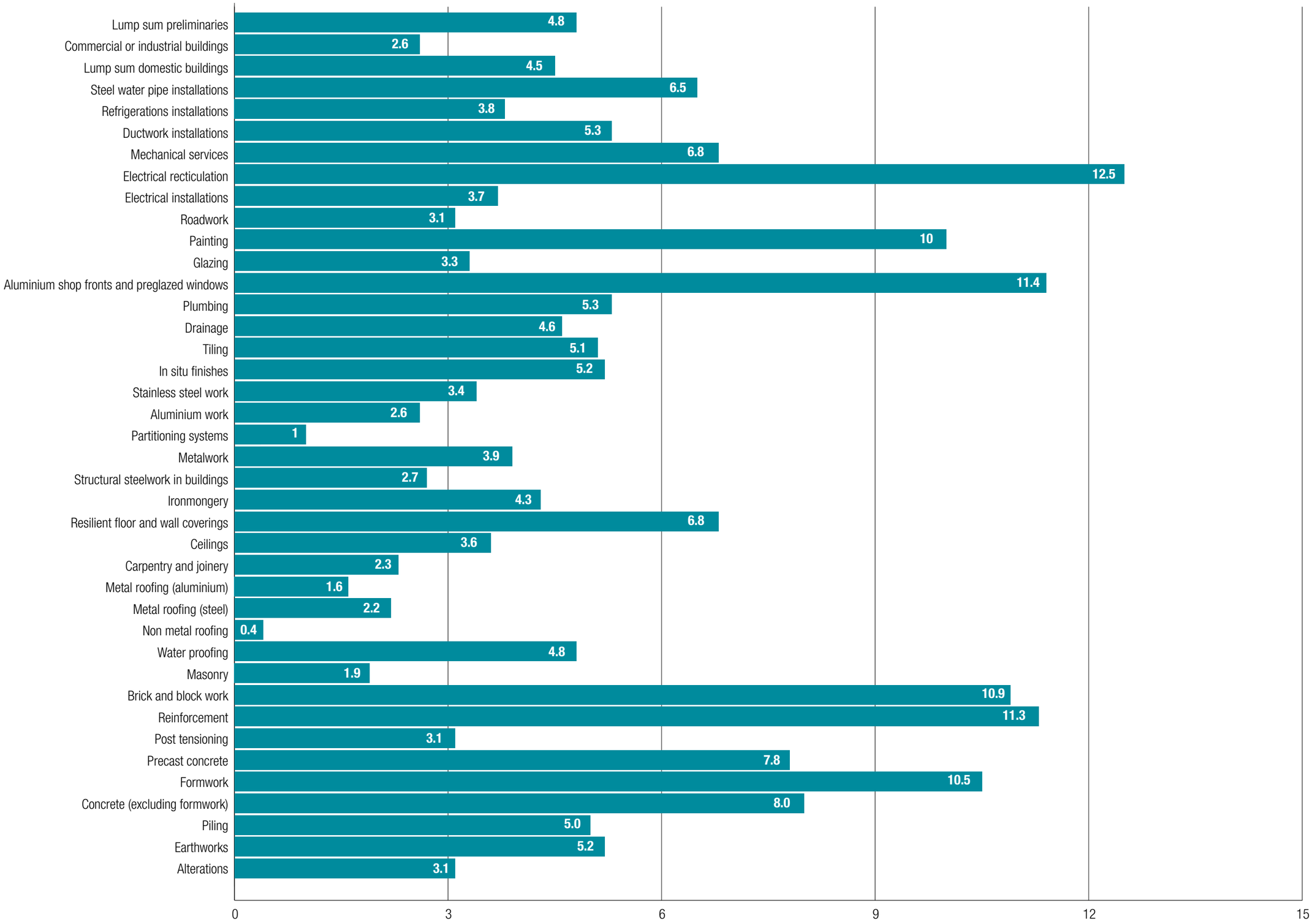
MATERIALS

The highest levels of inflation have been seen in specialty services such as reinforcement, water proofing, electrical installations, electrical reticulation and refrigeration installation. Aside from these, steel metal roofing also saw significant inflation at 11.4%. On the other hand, steel metal roofing and glazing saw very minimal inflation throughout the year, and other standard construction services such as plumbing, windows, tiling etc. all saw middling or low rates of inflation, suggesting pressure on prices is coming more from shortages in the relatively more specialised skillsets.

2. EIU

3. Stanbic Bank PMI

Fig. 10: Annual change in cost to Q3 2017 - BER data



Source: Stats SA

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