

Government and foreign investment fuel tender prices growth

Sub-Saharan Africa will see many factors sustain strong average growth over the next five years. The tailwinds of rising commodity prices, robust Chinese investment and strong pipelines, and the pull of significant infrastructure needs combine to sustain high demand for construction across the continent. Foreign Direct Investment (FDI), a main driver of construction demand in Africa, will play a significant role in both South Africa and Kenya, as investor confidence drives a continued surge of FDI in Kenya, whilst low confidence holds back FDI in South Africa as markets wait on the results of market reforms.

“With construction projects being won in the renewed confidence after the elections, tender prices are recovering to pre-election levels. However we believe the real acceleration will be seen in 2019 when work won after the election comes through to market.”

Simon Herd
Managing Director MaceYMR

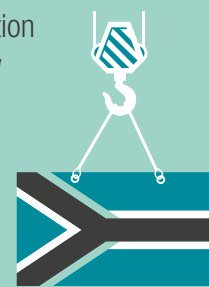
“With activity levels slow to pick up despite improved confidence, we are seeing construction firms failing as the pipeline of government projects looks increasingly unreliable.”

“Despite growing costs, tender prices will continue to hold at current levels due to the low levels of demand, seeing some erosion in margins”

Mandla Mlangeni
Director for MMQSMace

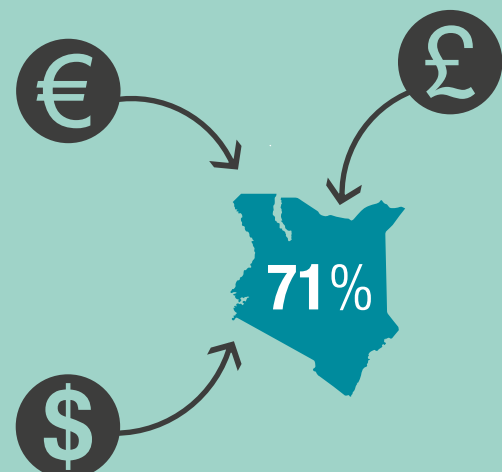
In 2018 construction output value grew by only...

1.7%
in South Africa



...but a strong...
8.9%
in Kenya.

In 2017, Kenya saw expansion of Foreign Direct Investment into the country by...



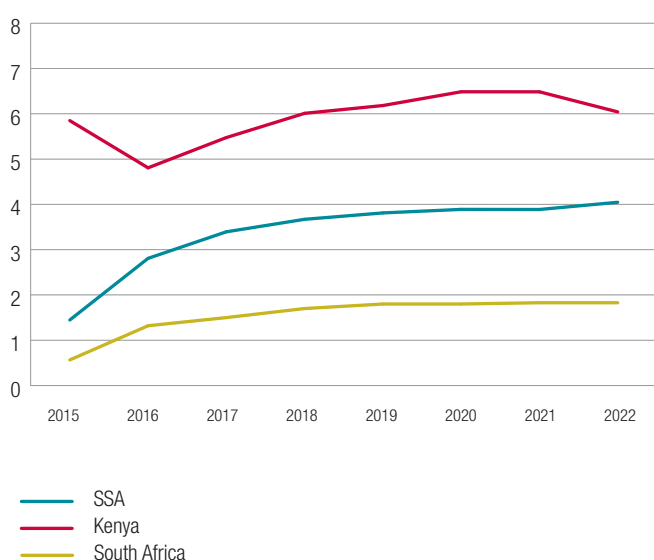
EXECUTIVE SUMMARY

The successful transfer of power at the recent elections has renewed confidence in Kenyan governance and consequently, its markets. With its role as the gateway to East African business opportunities solidifying, the country's real estate sector is booming as the middle class expands. This is driving significant demand for construction across sectors, with public and private spending fuelling infrastructure while business opportunities and the growing middle class fuel commercial construction. As the market heats up, the main challenge will be finding financing as the government battles high public debt. The private sector is entering the gap left by the government, driving unprecedented levels of Foreign Direct Investment into Kenya.

The South African government is still struggling with balancing reforming the economy sufficiently to renew investor confidence, and the need to maintain popular support in the run up to the 2019 election with very constrained budgets. The sluggish economy is impacting construction demand, which is set for slow growth this year, and well below potential growth over the medium term. On top of this, uncertainty over reforms to land ownership and mining is a drag on investment, lowering construction activity as confidence stutters. While costs are looking to see some impacts from increased taxes, this will not be sufficient to push up tender prices.

SOUTH AFRICA ECONOMY

GDP growth (%) - IMF



South Africa is still struggling to boost itself out of its recent slump. Whilst recovered from the dismal growth of 2017, the 1.5% GDP growth anticipated this year is unlikely to fuel a significant recovery in construction demand. A contraction in GDP in Q1 confirmed that despite confidence levels improving, the economy still lost momentum at the start of the year as headwinds continued for both investors and consumers. With high government debt impacting the

government's ability to invest in the economy, President Ramaphosa faces a difficult balancing act between reassuring investors about government spending and rebuilding popular support for his ANC party before the 2019 elections. If he can walk this line successfully, and not fall foul to the dangers of populism with the land reform and Mining Charter, confidence in the governance of the country should begin to return from 2019, and along with it economic growth. However, with so much reforming to do after many years of poor governance and wasteful spending under ex-President Zuma, it will be some time before the economy can hit its potential growth rates of 4-6%.

While the South African rand had been through a period of significant appreciation, this year has seen a reversal with large depreciations in the currency of 8-11.5% (against the euro, dollar and pound) since the start of the year. As the rand becomes cheaper, international investment into the country will become more attractive. If Ramaphosa delivers the reforms needed to return confidence to the market, these two factors combined will create ideal conditions for foreign direct investment and help boost the struggling construction sector. However, the challenges inherent in the market would indicate this is unlikely to happen, in the short term at least.

CONSTRUCTION

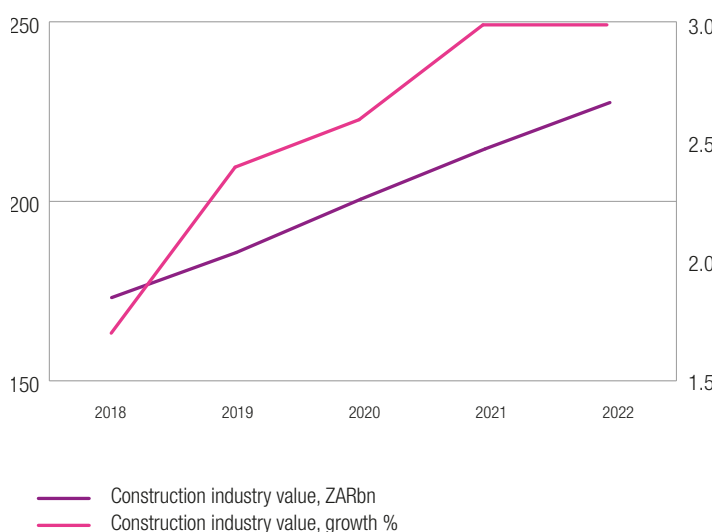
These challenges remain, even if hope has been injected into the market with the removal of Zuma. With a challenging pipeline of work to meet critical national demands, the government is facing a budget funding crisis making this pipeline look far from certain. While confidence is slowly returning to the wider market, there are still significant difficulties and private investment remains weak. As such funding is constrained both on the private and public side leaving little opportunity for anything more than slow expansion over the next decade.

In addition to this, the twin challenges of the Mining Charter and land reform will continue to impact on investor confidence in the construction sector, dampening investment levels. Land reform has long been a central campaign promise of the ANC, promising to redress the huge inequality in ownership caused by racial segregation during apartheid. After Zuma's scandal-ridden government, voters are demanding real action on this, which has led Ramaphosa's government to consider land expropriation without compensation. This threat to property rights is causing significant consternation amongst investors, and further slowing demand across the economy, particularly in construction where land rights are essential. The Mining Charter is seeing similar moves to empower black ownership and opportunity, for example, through higher requirements for black ownership of mining sites.

However, the large scale high value projects planned to boost freight logistics capacity and thermal power will maintain some demand to keep the construction industry growing, albeit slowly by African standards. Additionally, after years of mismanagement of the economy, the election of Ramaphosa comes at a time of strong popular demand

to address extreme inequality in housing and environmental conditions. This demand is driving government investment in a national social housing programme, and investment in water infrastructure but funding challenges are leading to doubts on the reliability of this pipeline. Four out of the five worst performing companies on the Johannesburg Stock Exchange are involved in construction and real estate, with their shares falling by an average 75% this year to June. It is clear construction companies are struggling. Shoring up this pipeline of work is essential if the construction sector is to avoid further deterioration.

South African Construction Industry value



After construction lost output value in 2017, contracting by 0.3% in real terms, these logistics, power, housing and water infrastructure investments would help the industry recover to 1.7% growth in 2018. While an improvement on last year's recessionary conditions, the market desperately needs Ramaphosa's government to release the economy from its regulatory and governance challenges in order to grow faster than the 2.8% annually forecast for the next decade, well below the sector's potential.

COSTS

Consumer price Inflation in South Africa will remain within the 4-6% acceptable to the central bank, and shouldn't be a concern for the construction industry. In fact, materials prices are seeing relatively low inflation at only 2.27%, suggesting material costs are unlikely to drive up tender prices in the near term. Having raised interest rates by 0.25% in March 2018, the South Africa Reserve Bank (SARB) is not poised to boost them further this year, especially given the risk of slowing down an already faltering economy.

However, recent fiscal policy movements, including the first VAT hike in 25 years, fuel tax rises and other tax increases, will drive costs upwards. Combined with rising fuel prices, we expect costs to grow despite sluggish construction activity, though not sufficiently to drive tender prices upwards. Weaker labour costs will balance out higher material costs, meaning margins can be maintained without needing to increase tender prices.

LABOUR

Construction earnings growth is slowing down, shrinking by 1.1% in the year to Q1 2018. Despite improving expectations in the wider market, activity has not yet picked up sufficiently to grow earnings, an indication of ongoing slack in the construction labour market. Demand has even weakened to the point of losing employees in the sector, a decrease of 3.4% in the year to Q1 2018. While this is a natural reaction to the lower levels of activity, it poses serious risks for the loss of valued skills, and the readiness of the industry to deliver the country's significant infrastructure needs.

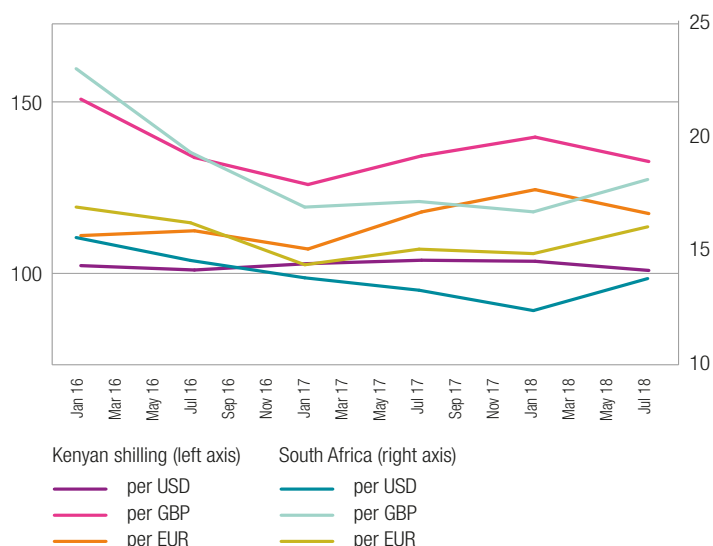
KENYA

Economy

Kenya's economy continues on its upward swing as it recovers from the slight slowdown we saw in the last report. At 5.5% growth is forecast to be well above the SSA average in 2018 and is expected to remain strong, trending at just under 6% for the medium term. Slower inflation in 2018 allowed the central bank to lower interest rates by 0.5% so far to 9.5%, aiding the economy's expansion. With a rising tide lifting all boats, and the construction sector particularly likely to benefit both from government investment and growing levels of foreign direct investment, the conditions are right for massive growth in construction opportunities.

Kenya is seeing massive growth in foreign investment, growing by 71% to USD672m in 2017 in contrast to slowing FDI across Africa as a whole. Investors are attracted to its developed financial markets, openness to foreign capital and lower hurdles to raising financing than most African markets. Nairobi was named among the top 10 urban FDI destinations in Africa in 2018, attracting USD5.9bn between 2003 and 2016 as foreign money flowed into real estate and infrastructure opportunities. Key factors driving foreign investors to Nairobi include domestic market growth, proximity to booming markets, both in Kenya and the wider East African region, a skilled workforce, and increasing quality of infrastructure and logistics, especially when compared to the rest of the Continent.

Exchange rate

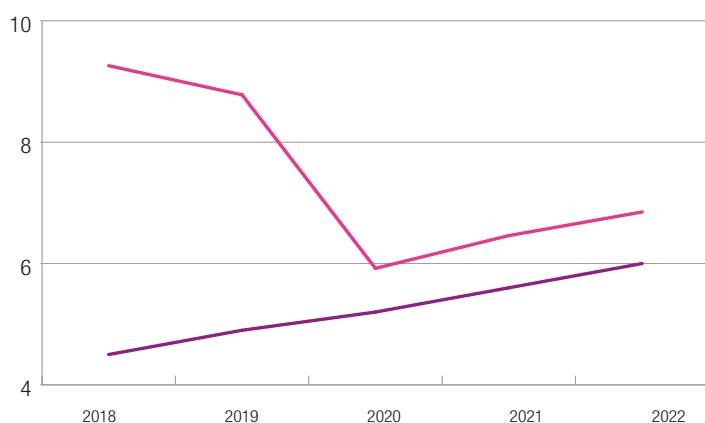


The Kenyan shilling has seen significant appreciation in 2018 as foreign investment has flowed into the country spiking currency demand. However, given significant loss of value throughout 2017 this can largely be seen as a correction. As such currency expectations have not yet started to feed through to material prices. If the trend of growing foreign direct investment continues, the knock on effect will be felt in further appreciation of the currency, and with 80% of materials imported, this is likely to further relieve any inflationary pressure.

Construction

After the government paused spending during the election, there is now a lot of buzz in the Kenyan market as activity levels pick up. With clients and contractors starting on a huge number of schemes, we are observing broad-based growth across sectors of the construction market, forecast at 8.9% for 2018. High levels of activity in Kenyan construction across sectors will see tender prices return to pre-2017 slump levels in 2018, and accelerate rapidly from 2019.

Kenya Construction industry value



Significant government spending plans are set to make infrastructure the fastest growing construction sector over the next few years. Rail and port infrastructure will see growth with government investment focused on improving logistics. Power is also a growth sector as Kenya continues to harness its significant renewables capacity – particularly geothermal.

In the meantime, the rewards of recent investments in boosting logistics and facilitating economic growth are blossoming. This can be seen in the form of a growing middle class which is increasingly driving growth in real estate as businesses expand, incomes grow and construction booms to meet these new demands. Nairobi is even somewhat a victim of its own success with people flocking to the city as opportunities grow. The government has embarked on a social housing programme to meet skyrocketing demand, which will provide a residential construction pipeline for years to come.

As businesses enter the country to take advantage of this growing consumer base and Nairobi's links to wider opportunities in the East African region, hotel and retail space will grow to meet expanding needs. This trend has made Nairobi the largest mall development hotspot in

Africa, with around 470,000 sq.m. of shopping space in the pipeline. This underpins continuing growth in commercial construction as the sector responds to huge demands for office space from the flourishing business market.

However, as activity in the market heats up, projects are running headlong into the growing challenge of financing. The cap on interest rates imposed in 2016 constrained credit markets in Kenya over the past two years, making it challenging to find funding for construction projects. In many cases this means relying on joint ventures or foreign investment rather than borrowing locally. Adding to private financing challenges is the government's high debt burden, with a particularly large portion owed in shorter term loans to the Chinese. If the government is to continue funding projects, they must also convince markets their high levels of debt remain sustainable.

Costs

Consumer price inflation in Kenya has shrunk back in 2018 to more manageable levels, after the occasionally double digit inflation seen in 2017. Standing at 4.3% in June 2018, this lower level of inflation in the wider economy means that short of currency effects, material costs are unlikely to see any inflation related pressure. However, with activity ramping up across the construction sector, prices will start tightening, particularly for key materials such as cement and steel, and inflation is expected to average 5.8% for the year.

There is some concern for the cost of financing, since the government announced they will be repealing the cap on commercial interest rates. While this will go some way to alleviating the dearth of available credit for construction projects, it will also allow banks to charge significantly higher interest, resulting in upward pressure on tender prices as contractors price in higher financing costs.

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