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REAL ECONOMY INSIGHT
MANUFACTURING

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Real Economy Insight 2019:

MANUFACTURING

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Manufacturing is one of the key sectors that keep the economic engine of South Africa running, but the industry has been under severe strain in recent years. The contribution made by the sector to the economy has declined to only 14% of gross domestic product (GDP) in 2018, from an all-time high of about 25% in 1981.

Manufacturing not only plays an important role in the national economy but is also an important source of employment, providing work for one in every ten individuals in South Africa's workforce, employing about 1.78-million people.

In the past decade, the industry has faced the global financial crisis, the end of the commodity supercycle, a collapse of mining procurement and a global steel glut. While other emerging markets have managed an accelerated recovery of their manufacturing sectors, South Africa has underperformed among its peers.

The reasons for the country's lacklustre performance in the post-2008-financial crisis era have been ascribed to a combination of external and internal factors. Policy missteps have made it more difficult for South African manufacturing companies to navigate global headwinds. When President Cyril Ramaphosa ascended to power at the beginning of 2018, he promised to revive the manufacturing industry through incentive programmes, targeting the automotive, agroprocessing, and clothing and textiles sectors. Incentives include tax benefits, infrastructure and support for companies investing in special economic zones.

The manufacturing industry staged a modest turnaround in 2018, recording its highest yearly growth rate in five years, albeit from a low base. The rebound was aided by increased export demand and a relatively competitive exchange rate.

Statistics South Africa (Stats SA) figures show that manufacturing production increased by 1.20% in 2018, following a 0.50% contraction in 2017 and an increase of 0.70% in 2016.

The food and beverages, and automotive divisions were the major drivers behind 2018's rise, while manufacturers in communication equipment, electrical machinery and clothing were the sectors that lagged.

In the first two months of 2019, manufacturing output barely grew, with an expansion of 0.80% in January and 0.50% in February.

Manufacturing production increased by 1.20% year-on-year in March, beating market expectations of a 1.10% contraction. The largest positive contributions were made by energy-intensive industries, which commentators say is surprising, given the extensive load-shedding experienced during the month. South Africa was subjected to load-shedding in March at a scale and intensity similar to that of the 2008 electricity crisis. The economy was subjected to about two days of Stage 2 and seven days of Stage 4 load-shedding.

The largest positive contributions to the March expansion were made by petroleum, chemicals, rubber and plastic products (7% and contributing 1.50 percentage points to the total percentage change); basic iron and steel, nonferrous metal products and machinery (3.20% and contributing 0.70 of a percentage point); and food and beverages (1% and contributing 0.30 of a percentage point).

On a quarter-on-quarter basis, manufacturing output shrunk by a seasonally adjusted 2.40% in the first three months of the year.

The monthly changes in factory output measured by Stats SA tend to be foreshadowed by financial services provider Absa-sponsored purchasing managers index (PMI). The PMI is usually an indicator of where the production numbers will head in two months. A figure above 50 indicates expansion in the sector and below a contraction. In the first few months of this year, the seasonally adjusted Absa PMI lingered below the 50-neutral level. The PMI slipped from 50.70 points in December 2018, to 49.90 points in January, 46.20 points in February and 45 points in March, before rising to 47.20 index points in April.

The absence of load-shedding during April may have supported the slight improvement in PMI respondents' sentiment.

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The Steel and Engineering Industries Federation of Southern Africa (Seifsa) has expressed its concern about the rate of contraction of the PMI, noting that factories are under high duress and stress, owing to slacking economic activity and poor inventory turnover. Increasing fuel prices and rising energy costs are pushing up input costs, while irregular electricity supply is compounding the problem.

Amid weak domestic demand, the local factories have significant spare capacity. Large manufacturers – those with a turnover of more than R100-million a year – reported capacity utilisation of 83.10% in November 2018, decreasing to 80.30% in February 2019. The main reasons given for the underutilisation are insufficient demand (63%), shortage of raw materials (10%), shortage of labour (6.20%) and other reasons (20.80%).

The brakes that the limping South Africa economy is putting on demand for goods have dented business confidence among manufacturers. According to the Rand Merchant Bank/Bureau for Economic Research business confidence index (BCI), confidence among manufacturers hovered well below the neutral 50-point mark at about 34 index points in the first half of 2018 and then slumped to 26 points in the third quarter, before recovering to 30 in the fourth quarter. Business confidence relapsed to 25 index points in the first quarter of 2019, as an abrupt drop in export sales hit manufacturers on top of a faster deterioration in domestic sales.

Overall, the country's BCI fell 28 points in the first quarter of 2019 – the lowest level since the 27 index points recorded in the second quarter of 2017 and the deep recession of 2009.

Factories sold R2.32-trillion worth of goods in 2018, up from R2.18-trillion in 2017. In the first three months of 2019, sales amounted to R562.80-billion. January's sales of R171.71-billion increased by 9.60% year-on-year, February's sales of R181.18-billion increased by 7.80% year-on-year and March's sales of R203.91-billion increased by 8.10% year-on-year.

Although manufacturing output recovered in 2018, formal employment losses were recorded in eight out of its ten broad subsectors. In the first three quarters of 2018, formal employment in the manufacturing sector declined by 1.20%, or 14 139 people. The downward trend continued in the fourth quarter, with employment down 1.40% year-on-year to 1.77-million people. Employment levels

Picture by Creamer Media

remained largely unchanged in the January to March 2019 quarter, when compared with the preceding quarter, at 1.78-million people. On a year-on-year comparison, employment in the manufacturing sector decreased by 3.73% in the first quarter of the year.

MANUFACTURING EXPORTS

Overall manufacturing exports expanded by 5.70% in nominal terms to R713.80-billion in 2018. The main contributors to the increase were motor vehicles, parts and accessories, nonelectrical machinery and equipment, nonferrous metal products, basic chemicals, and basic iron and steel.

The composition of the manufacturing export basket has changed over the years, with a substantial rise in the relative share claimed by the motor vehicles subsector. The export of motor vehicles, parts and accessories is the largest manufacturing export category, with an increase of 9.30% in value terms last year, representing 23.50% of total manufacturing exports.

The increase in the automotive industry's exports is an indication that parts of the manufacturing sector are internationally competitive, former Trade and Industry Minister Rob Davies has said. The automotive sector contributes 33% of the GDP of the manufacturing sector and produces about 600 000 vehicles a year.

On an individual country level, the US and Germany are the main markets for South African-manufactured goods, but as a whole, the African continent is the biggest export market. The key markets are Namibia, Botswana, Zambia and Zimbabwe, which are all members of the Southern African Customs Union (SACU).

The Industrial Development Corporation (IDC) reports that the potential outside of the SACU countries remains largely untapped. Several sub-Saharan African countries that are not members of SACU present relatively sizeable overall imports markets, including Nigeria, Kenya, Ethiopia, Ghana, Tanzania, Côte d'Ivoire, Senegal and the Republic of Congo, yet these countries' imports from South Africa are negligible.

Improving economic prospects for many of these African economies could provide a solid basis for a stronger export performance and the enhancement of South Africa's manufacturing capacity. The average yearly growth for sub-Saharan Africa, excluding South Africa and Nigeria, is forecast at about 5% until 2024.

South Africa's trade deficit in manufactured goods widened to R310-billion in 2018, as the value of manufactured imports rose to R1.02-trillion.

MANUFACTURING AND ELECTRICITY

Uninterrupted and competitively priced electricity is an imperative to successful manufacturing.

State-owned electricity firm Eskom's price increases have outpaced inflation over the past decade and tariffs are continuing to rise sharply. The National Energy Regulator of South Africa has sanctioned increases of 9.41% for 2020, 8.10% for 2021 and 5.20% for 2022. These increases are in addition to the approved 4.41% hike for the next three years, following Eskom's regulatory clearing account application.

Businesses have warned that substantial tariff increases will have a major impact on cost structures while Seifsa economist Marique Kruger has said that the sharp increases will make it difficult for manufacturing companies to plan production processes and that more companies in the electricity-intensive subsectors could close down.

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In the metals and engineering (M&E) sector, electricity costs represent 3.08% of total input costs, but about 6% of the electricity-intensive subsector components of the M&E sector. The electricity cost component adds up to about R9.36-billion to the basic iron and steel products subsector and R2.23-billion in the basic nonferrous metals production industry.

The cost of electricity blackouts are also significant to the manufacturing industry and the larger economy.

Manufacturers report that two hours of load-shedding can translate into about five hours of downtime, as machines have to be reheated, while sudden power losses cause mechanical and electrical damage to machines. Workers also have to be compensated when they work overtime to make up for lost production. All these issues raise the cost of manufacturing products in South Africa and lessen the industry's competitiveness. Ongoing uncertainty about electricity supply is expected to have a dampening impact on fixed investment activity in 2019, indicating that the manufacturing sector is likely to remain under pressure.

POLICY DEVELOPMENTS

To tackle the decline in South Africa's industrial and manufacturing capacity, the DTI developed an Industrial Policy Action Plan (Ipap) and launched the first iteration in 2008.

In its first ten years, the Ipap managed to successfully ramp up production in the automotive sector, resuscitated the ailing tooling industry and boosted the clothing, textiles, leather and footwear industries.

Automotive exports have doubled over the past ten years, with the sector producing 600 000 vehicles a year and supporting 113 000 jobs. The clothing and textile sector, which was on its knees ten years ago, has also been revived. The clothing and textile sector currently employs 95 000 people, while 22 new factories have been opened in the leather sector, supporting 2 200 jobs.

The DTI is also pleased about its steps to rebuild the tooling industry. Through its National Tooling Initiative, many foundries, as well as tool, die and mouldmaking companies, have been assisted through various DTI programmes, while 1 800 students have been trained.

One of the flagships programmes within the Ipap is the Black Industrialist Scheme (BIS), which was launched in November 2015. The programme benefits from specifically targeted funding earmarked by the IDC and the National Empowerment Fund. By early 2019, a total of 131 projects had been approved, with black entrepreneurs having leveraged about R13.20-billion of private-sector investment. The 131 projects have created about 9 500 new jobs and retained 8 900 in a wide range of manufacturing subsectors.

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Government's initial goal was to financially assist 100 black industrialists and, with that goal having been surpassed, the DTI has set its sights on assisting another 100 black entrepreneurs over the next two years.

The BIS regards a black industrialist as a business that is more than 50% black-owned, or somebody who controls the business, takes personal risks with his participation and does business in the manufacturing sector.

Besides the BIS, the DTI also provides incentive packages to support local and foreign investments. The first major initiative was the 2012 launch of the Manufacturing Competitive Enhancement Programme, through which local manufacturers were able to discard obsolete and antiquated machinery and equipment for new investments valued at R30-billion. This was followed by the sector-specific incentives – the Automotive Incentive Scheme, the Aquaculture Development Enhancement Programme and the Business Process Services Incentive.

The Ipap is also using public procurement as a key lever for industrialisation and reindustrialisation by designating certain sectors or products for local procurement. To date, 23 sectors and/or products have been designated for local procurement, with varying minimum local content thresholds. Between 2015 and July 2017, about R60-billion was reported to the DTI as value for local content in procurement. This includes the rail rolling stock fleet procurement of about R49.50-billion. However, the challenge remains the verification of the real achieved value, and the South Africa Bureau of Standards has been given a mandate to conduct accurate content verifications.

CHANGING LANDSCAPE

As the Fourth Industrial Revolution (4IR) gathers momentum, manufacturers are under intense pressure to innovate. The sector faces a multitude of ever-changing disruptive digital technologies – predictive analytics, additive manufacturing and the Industrial Internet of Things (IoT), to name a few.

Amid the changing landscape, countries have to rethink their strategies and businesses have to adapt to the digital landscape, and align their operations and offerings with the new capabilities of a tech-centric ecosystem.

Management consulting and professional services firm Accenture states that the value-add of digital initiatives, such as blockchain, the IoT and artificial intelligence (AI) to industry could be as much as R2.50-trillion and could be unlocked by 2026. The highest potential for gains are in agriculture, manufacturing and financial services, with IoT likely to play the most important role.

In manufacturing, the implementation of technologies, such as IoT and connected devices, as well as AI throughout the value chain, has the potential to improve responsiveness to demand and allow for the introduction of many value-adding services, effectively turning production companies into service companies.

Positioning the South African economy for the digital industrial revolution, also known as 4IR or Industry 4.0, requires buy-in from the private and public sectors. Currently, South Africa is not well placed for the 4IR and, according to the DTI, the nation ranks between forty-sixth and seventy-fifth globally on a variety of metrics assessing readiness for 4IR.

The DTI argues that the key components of the digital revolution – IoT, big data, AI, automation, robotics, new processes and materials, additive manufacturing, logistics, marketing techniques and sales channels – will put pressure on areas where South Africa is already lagging or weak, such as education and skills, as well as enabling infrastructure such as broadband and communications.

However, as the continent's strongest production centre, South Africa's manufacturing industry has potential. The World Economic Forum lists South Africa's ability to innovate as one of the country's greatest strengths. The strong innovation culture and entrepreneurial activity is supported by a strong financial sector. Human capital, with a shortage of engineers, scientists and digital skills, remain the most pressing challenge for growing the country's manufacturing capabilities.

It is also critical for South Africa to improve its institutional framework to effectively respond to change, offer a stable policy environment and direct innovation.

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