Highlighting trends in the South African construction industry

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1. Executive summary

Highlights

	Current year R 'billions	Prior year R 'billions	Difference R 'billions	% Changes
Total revenue	171.7	157.8	13.9	9%
Net profit	3.9	4.1	(0.2)	(4%)
Net operating cash flows	4.5	7.2	(2.7)	(37%)
Distributions to shareholders	1.9	1.6	0.3	15%
Total assets	109.4	107.4	2.0	2%
Secured order book	181.9	157.1	24.8	16%

This is the second edition in our series of publications highlighting trends in the South African construction industry. We hope it will provide meaningful information to industry participants in evaluating performance and addressing risks. This year we have added the Johannesburg Stock Exchange (JSE) Construction & Materials Index to our analysis to provide greater insight into the dynamics of the industry.

The 2014 financial year started with a lot of promise, albeit under the cloud of adverse findings by the Competition Commission. Order books were strong and margins were recovering for the first time in five years. Unfortunately, the lack of economic recovery meant that this promise was not fulfilled and the 2014 was a tough year for most construction companies.

The construction industry had its fair share of labour unrest, internally and at clients, which resulted in substantial delays at some of the country's major construction projects, most notably Eskom's Medupi power station, which is scheduled to have its first unit (unit 6 generator) synchronised to the national grid in December 2014.

The past few years have highlighted the need for better coordination and monitoring within the construction industry – a challenge that the South African Government has welcomed with the roll-out its National Infrastructure Plan. Implementation of the plan will require significant construction input.

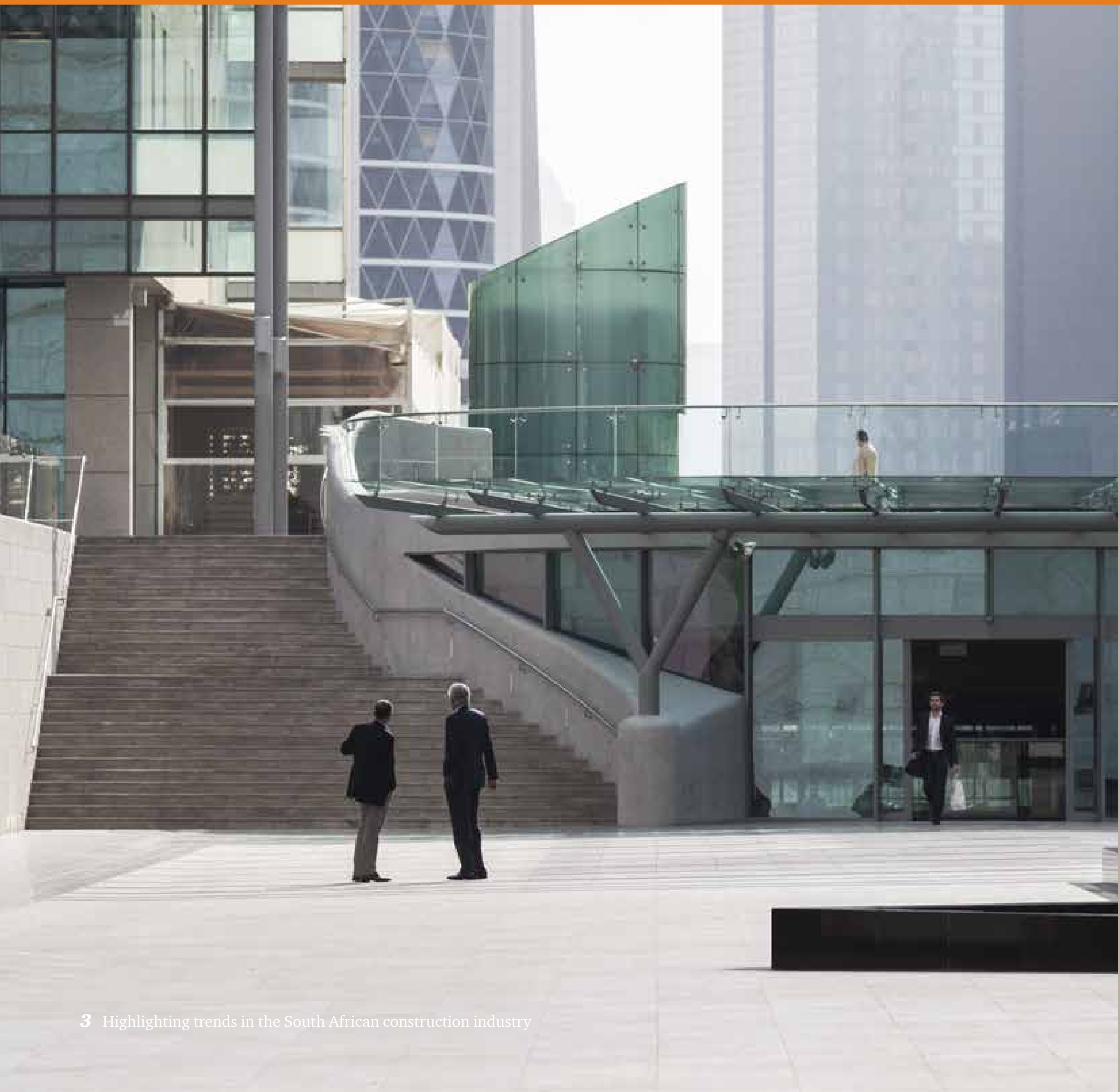
Scope

Our findings are based on the financial results of the leading construction and construction materials companies listed on the JSE. We excluded companies with suspended listings. Section 9 provides a comprehensive list of all companies included in our analysis.

The companies included in this report have significantly changed from the prior year. With Protech Khuthele being suspended and in liquidation, it has been excluded, while seven new entities from the construction materials sector have been included. These are PPC, Distribution and Warehousing Network (DAWN), Afrimat, Sephaku, KayDav, Masonite Africa and Mazor.

The findings in this report are based on publicly-available information, predominantly annual reports, for financial years ending no later than 30 June 2014. Where annual reports were not available, we used preliminary reviewed results.

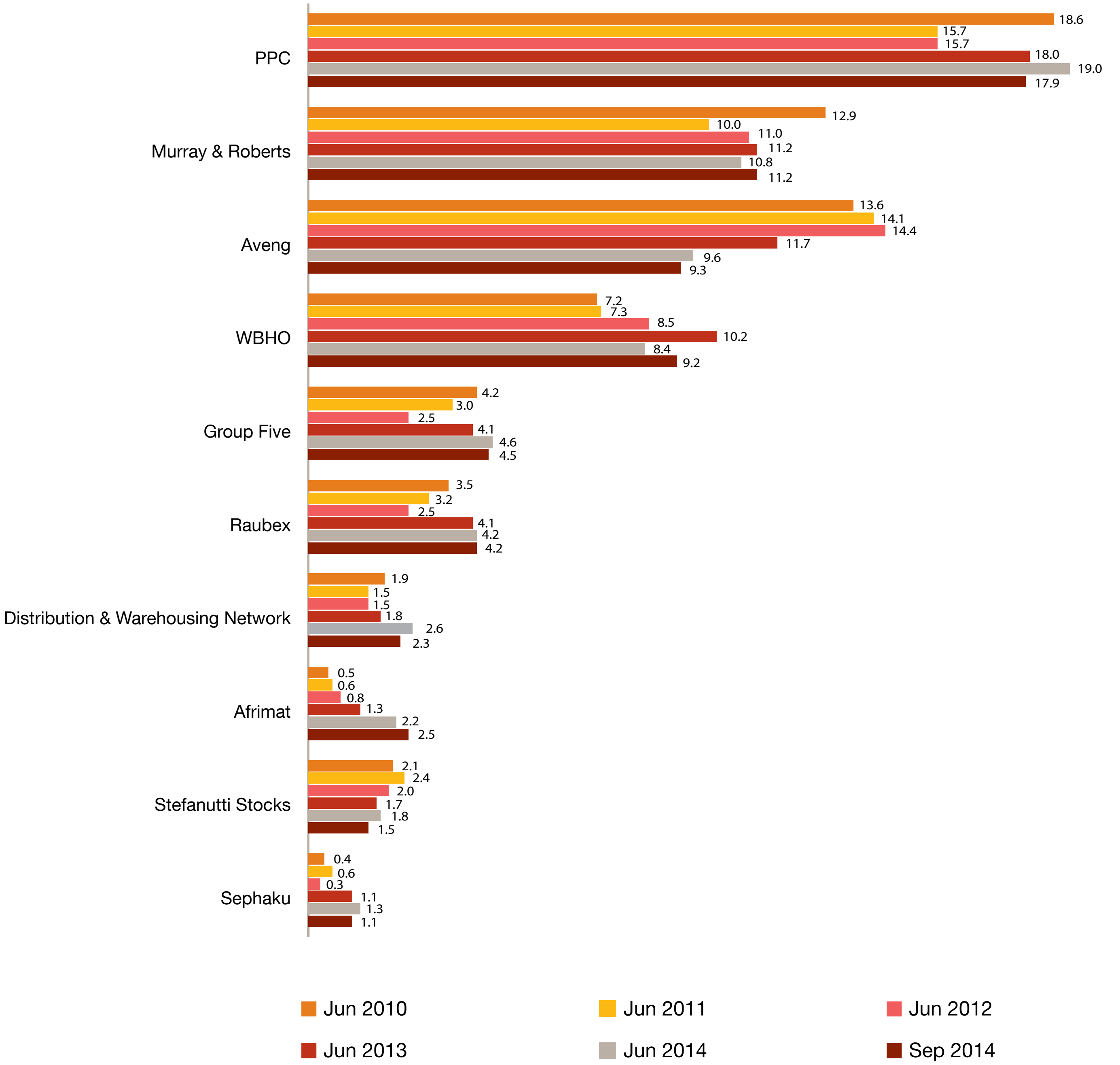
2. The South African construction industry



Market capitalisation

There is little doubt about the cyclical nature of construction activity. However, the 2014 market capitalisation of the heavy construction and building materials & fixtures companies reflected variable performance. Market capitalisation reflects the organic growth or regression, merger and acquisition activities as well as market expectations about the future.

Figure 1: Market capitalisation of the top-10 construction & materials companies (R' billions)



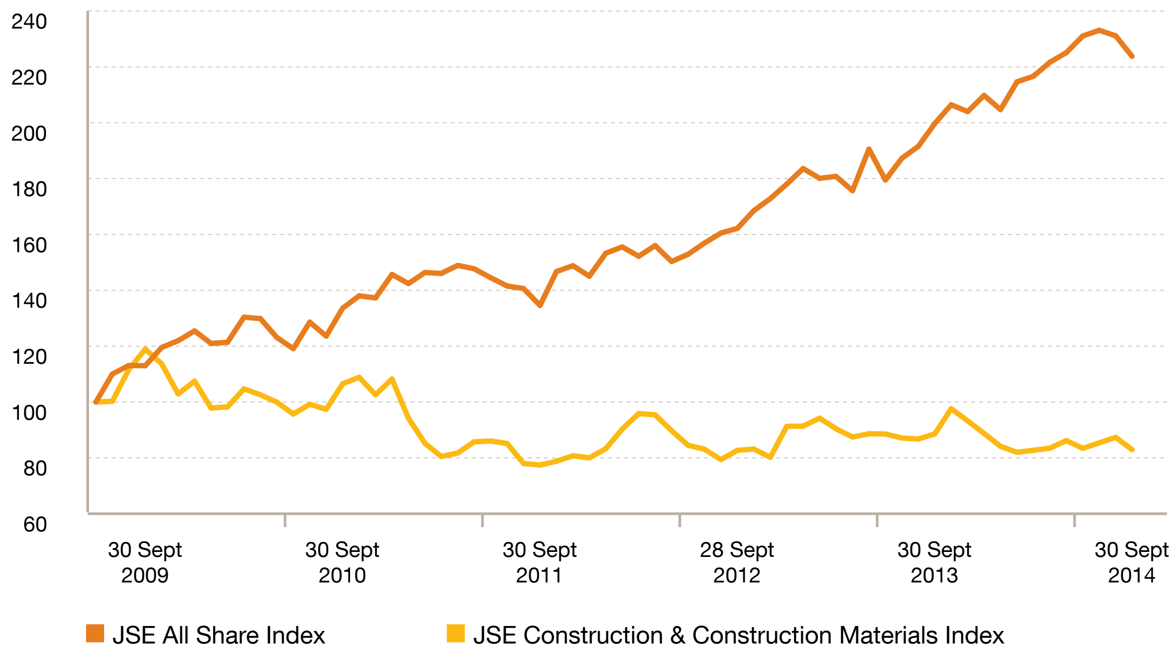
Source: I-Net Bridge

The 2014 financial year saw mixed results in the performance of market capitalisation. Ten companies reflected an increase and five a decrease. In aggregate, for the 16 companies analysed, market capitalisation had slightly decreased to R67.4 billion as at 30 June 2014 (R68.1 billion as at 30 June 2013). Aveng and WBHO showed the largest individual declines, while construction materials businesses generally reflected gains.

The market capitalisation of the 16 companies had decreased further after 30 June 2014 and as at 30 September 2014 had declined to R66.3 billion (a 1.6% decline in market capitalisation over the three-month period).

The difference in the performance of the JSE Construction & Materials Index and the JSE All Share index is unmistakable. The JSE All Share has reached record levels in the past year while the Construction & Materials Index struggles to maintain its market capitalisation level.

Figure 2: Market capitalisation: JSE vs Construction and Materials Index



30 June 2009 = 100

Source: I-Net Bridge

It is clear that the construction & materials industry has not performed in the past few years. The industry has produced poor financial performance in the past year and the short-term movement indicates that in the absence of positive economic indicators, the industry is on a slight downward trend. However, there are still a number of encouraging signs from the financial performance of individual companies, order book growth and public infrastructure commitments.

A good indicator of the industry's performance would normally be infrastructure spend by the public sector. The South African Government's ongoing National Development Plan and its continued commitment to public infrastructure investment of R847 billion over the next three years, are positive signals for future growth in the industry.

Public-sector spending

Capital expenditure by public-sector institutions increased by 4.8% in the 2013 calendar year, with total expenditure in the year amounting to R212 billion. The scale of this increase may be misleading, as new construction work contracted by 2.2% to R133 billion while plant, machinery and equipment purchased increased by 28% to R48 billion. This indicates that there has been a decline in the amount of capital expenditure on new construction works.

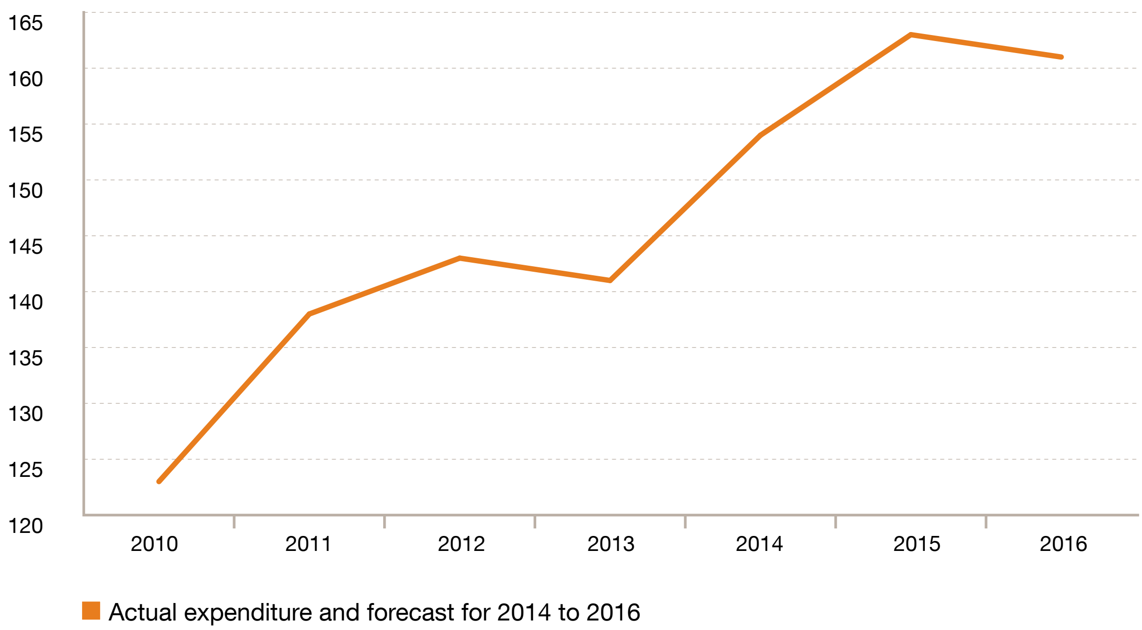
Figure 3 summarises the capital expenditure relating to new construction, cost of development of properties and major rejuvenation projects actually incurred by the public-sector for the financial year up to and including 2013 together with estimates for the 2014-2016 period. The graph shows a growth trend over the last few years.

Unfortunately, the effective growth from 2010 to 2014 was a mere 5.7%, which is less than inflation. When one looks forward to 2016 that number drops to 4.5%.

Construction input cost inflation was also well above Consumer Price Index inflation. The growth in public capital expenditure is due more to cost pressures than to new contracts for construction-related work.

With the pressure on margins experienced by the industry, it should be noted that the graph reflects growth for buyers of construction services, but not real growth for the construction companies themselves.

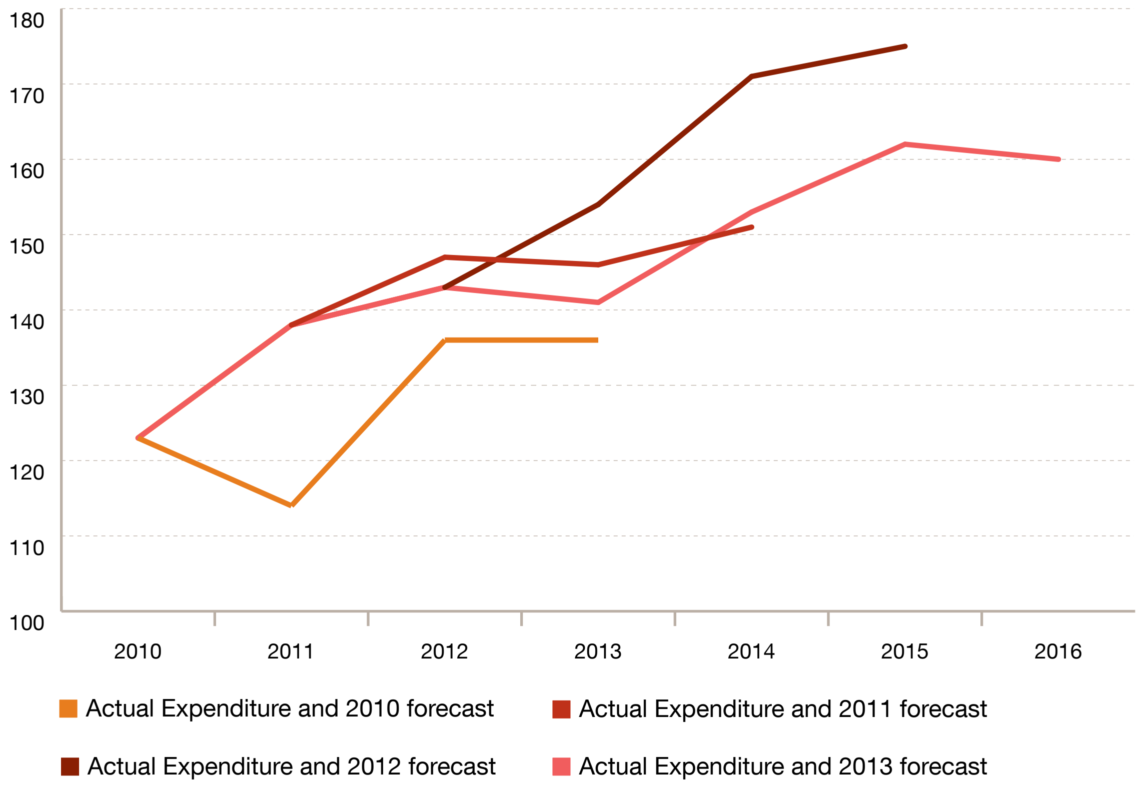
Figure 3: Public expenditure: New construction, property development and major rejuvenation (R 'billions)



Source: Stats SA

Government's ability to roll out capital and infrastructure programmes, as well as accurately forecast these, has been heavily criticised in the past few years. A comparison of actual construction expenditure with forecasts made into the last three years shows that although there was good correlation between actual and forecast spend in 2011 and 2012, actual expenditure is now lagging forecast in a similar fashion to what happened in 2009 and 2010 at the height of the credit crisis. Fiscal pressures in the lower economic growth environment is bound to impact on discretionary capital expenditure.

Figure 4: Comparison of actual construction expenditure with forecasts (R 'billions)



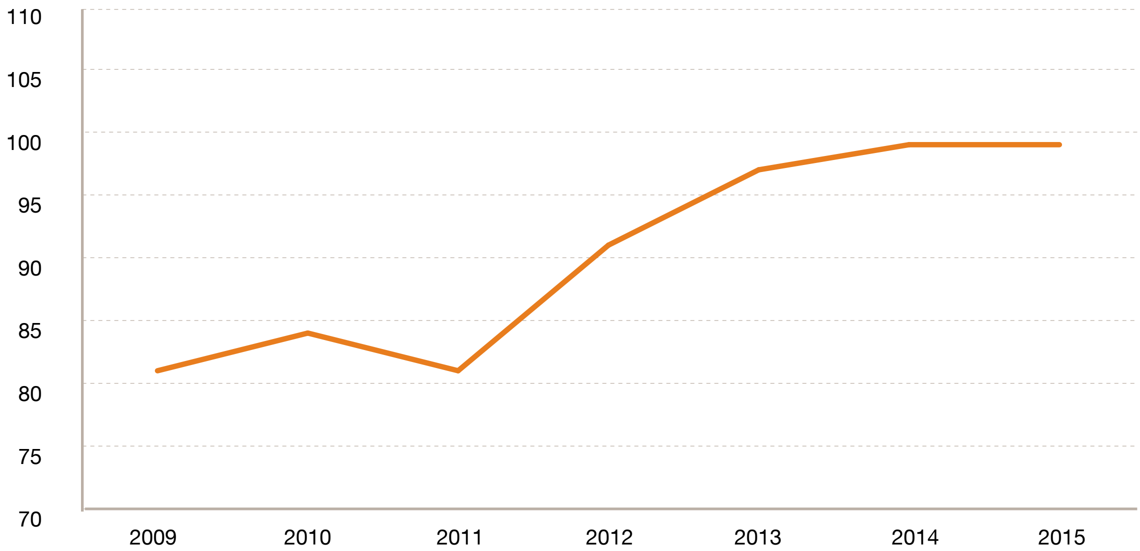
Source: Stats SA

Actual construction expenditure in 2013 was R12.7 billion below the 2012 forecast. This decrease in anticipated expenditure underlines the challenges experienced by the industry.

For new construction expenditure, the decreased level of expenditure was R3 billion. This was a result of R12.1 billion underspent by state-owned companies, which was partially offset by R4.5 billion higher expenditure by municipalities (R2.5 billion), Provincial (R2.1 billion) and National Government (R2.5 billion).

The bulk of public-sector capital spending is undertaken by Eskom, Transnet and SANRAL as well as ACSA. The data shown in Figure 5 is the aggregated actual and expected capital expenditure by these four entities. According to the 2014 budget review, the capital spend for Eskom and Transnet is set to grow moderately over the medium term.

Figure 5: Capital expenditure by Eskom, Transnet, SANRAL and ACSA (R 'billions)



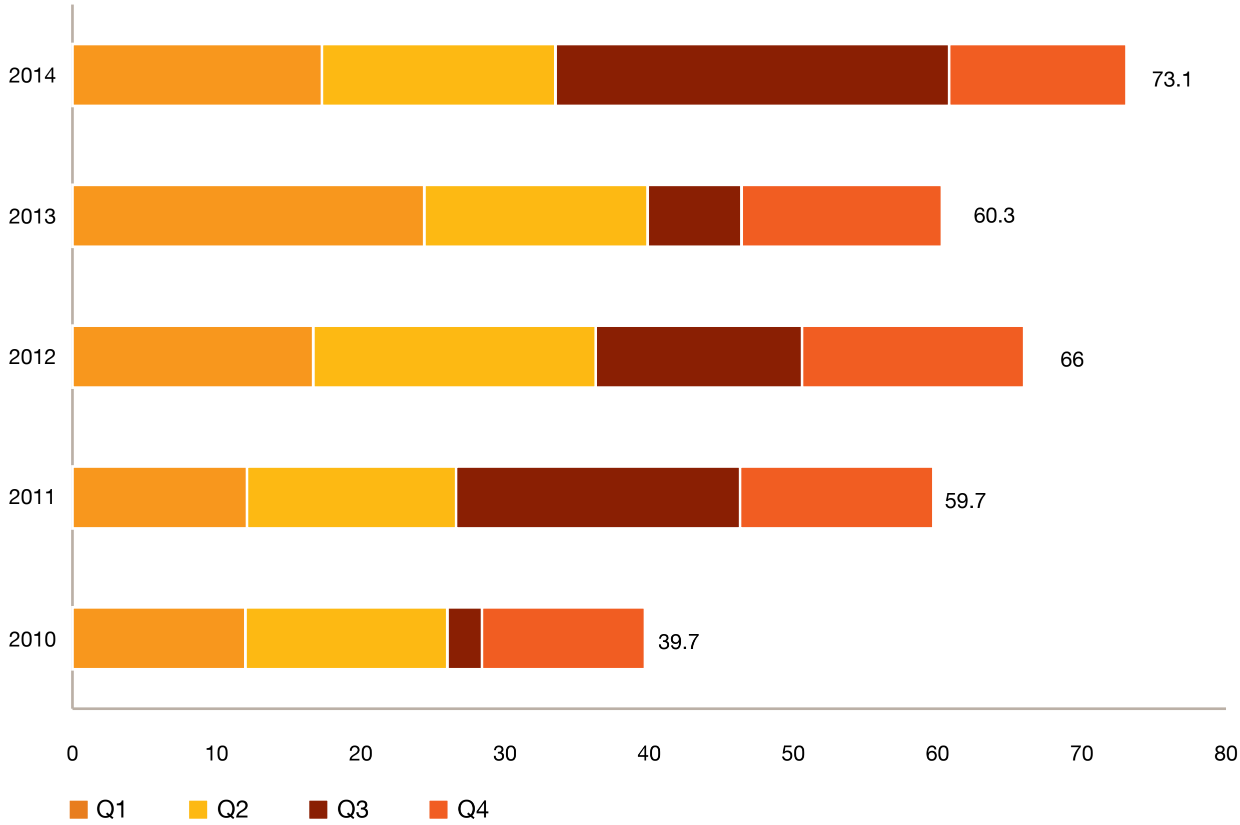
Source: PwC analysis, annual reports for Eskom, Transnet and ACSA

The South Africa National Roads Agency Limited (SANRAL) and Eskom have been reliable sources of work for the construction sector in the past number of years. Government remains committed to its significant capital expenditure on the construction of the Medupi and Kusile power stations. Unfortunately, over expenditure on the Eskom projects and the funding debate at SANRAL seems to be overshadowing real growth in infrastructure added.

As communicated in the 2014 budget, the Government intends to spend R847 billion on infrastructure over the next three years. According to the Medium-Term Expenditure Framework (MTEF) the major state-owned companies, which include Eskom, Transnet and SANRAL, are projected to spend R381.8 billion.

The private sector is another big player in the industry, often led by the mining industry, and has been a significant contributor to total construction expenditure. However, the severe pressure experienced in the mining sector, with shrinking margins due to volatile commodity prices and labour unrest, will no doubt have an impact on future demand. After a difficult year, mining companies have already reduced their capital expenditure by 19%.

Figure 6: Capital expenditure for the energy sector (R 'billions)



Source: Stats SA

The data in Figure 6 represents the energy sector's capital expenditure per quarter for years to June of the past five years. An amount of R73.1 billion was spent in 2014, which is well in excess of the comparable amount for prior years.

Sustainable energy investments in South Africa, mainly in the form of solar and wind farms, were a significant contributor to capital expenditure in the last year. The public-private sector partnership of the Renewable Energy Independent Power Procurement Programme (REIPPPP), which was introduced in 2011, has awarded 64 renewable energy projects to the private sector. The private sector has committed to invest approximately R120.2 billion into these projects. Since 2012, South Africa has ranked among the top ten countries globally in terms of renewable energy investments by independent power producers.

The US International Energy Agency (IEA) estimates that only a third of the population in sub-Saharan Africa has access to electricity leaving the remaining two-thirds, 620 million people, without electricity. Funding is paramount to the development of sustainable energy solutions to remedy this predicament. Sub-Saharan Africa lacks the financing to fund the necessary development and the IEA has recommended that R4.9 trillion be invested in the region's energy sector. If postioned well, then construction companies stand to benefit from this potential investment.

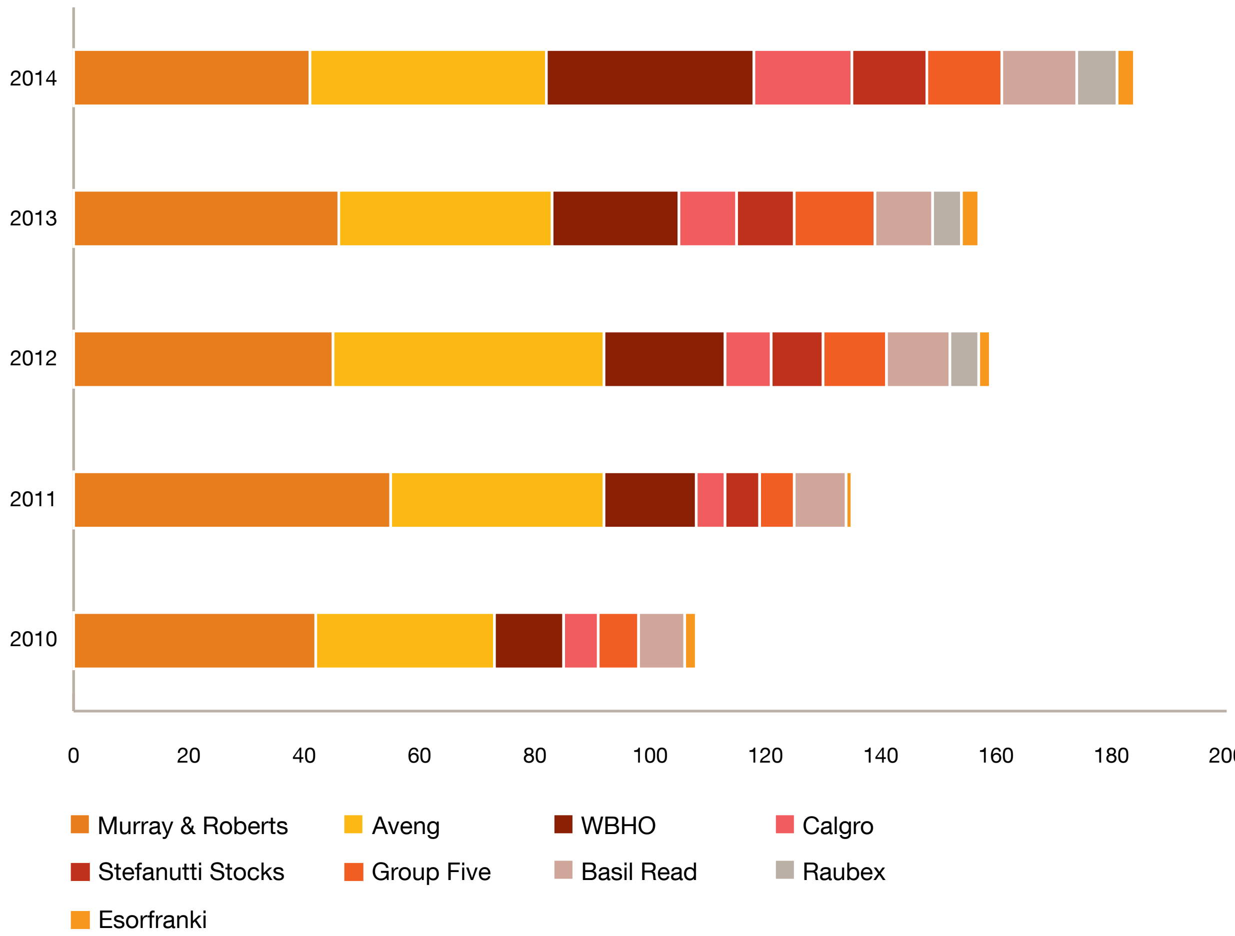
Heavy construction order book

Although various definitions are applied, and the consistency of information disclosed is not necessarily comparable, there seem to be good signs of growth. The current-year order book defies the negative growth sentiment experienced in the country and is hopefully an indication of better things to come.

Growth in the order book for 2014 was 16%, in line with the percentage experienced in 2012 after a flat 2013. The secured order book now covers 1.3 times current-year revenue, a marginal increase on 1.2 in the prior year, but still well below the 1.5 of 2012.

Companies indicate that a major factor contributing to this depressed growth has been the failure of the Government's infrastructure spend to materialise, which is a critical driver for recovery within the construction industry.

Figure 7: Secured order book (R billions)



Source: PwC analysis

Calgro's order book showed a healthy increase of 70% (2013: 25%) due to the increase in integrated development projects secured during 2014 in the governmental housing sector.

WBHO also demonstrated strong growth with an increase of 65% (2013: 5%) largely attributable to growth in the Australian book with a number of large-scale projects being secured during the year.

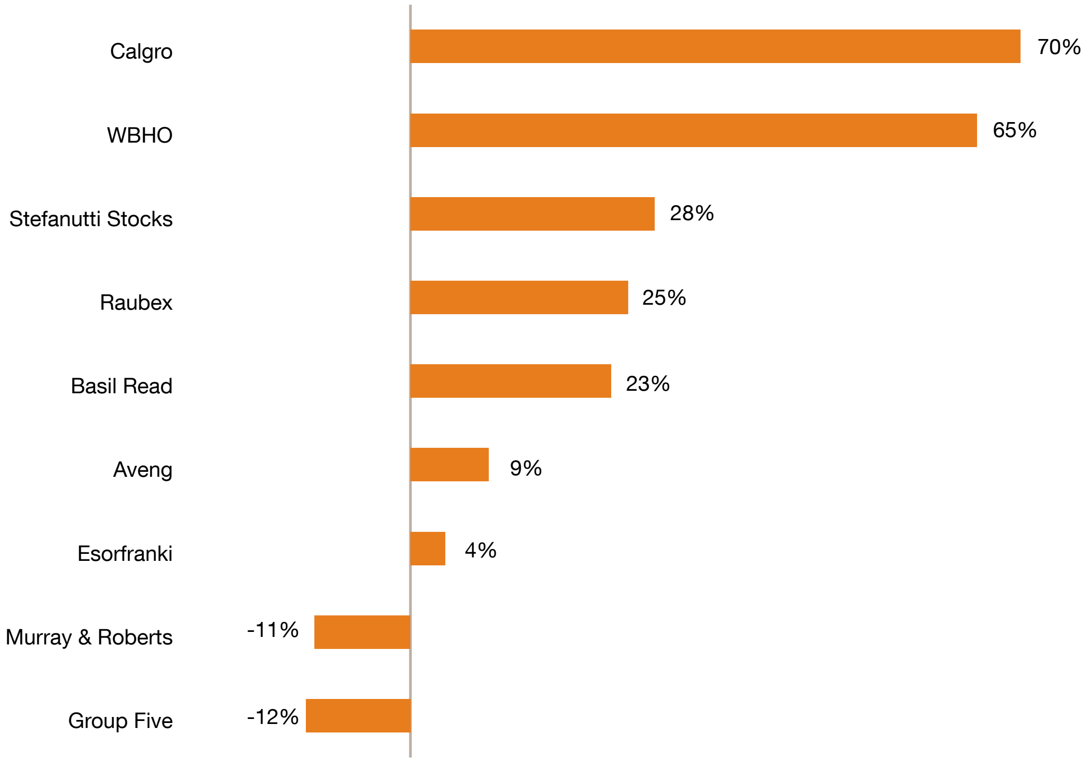
Basil Read showed a 23% increase in 2014 mainly due to newly-secured contracts within the mining sector.

Stefanutti Stocks and Raubex also demonstrated strong growth in excess of 20% in their respective order books during 2014.

The decrease in Group Five's order book of 12% from a high prior year base after completion of a number of energy projects, is largely attributable to the contracts within the civil engineering sector as a result of lower than expected activity levels in South Africa, which placed pressure on the segment.

Murray & Roberts experienced a decrease of 11% in the total order book due to the completion of contracts in the oil & gas sector during the 2014 period through its Clough operations, which demonstrated an increase in revenue of 18% during 2014.

Figure 8: Secured order book growth

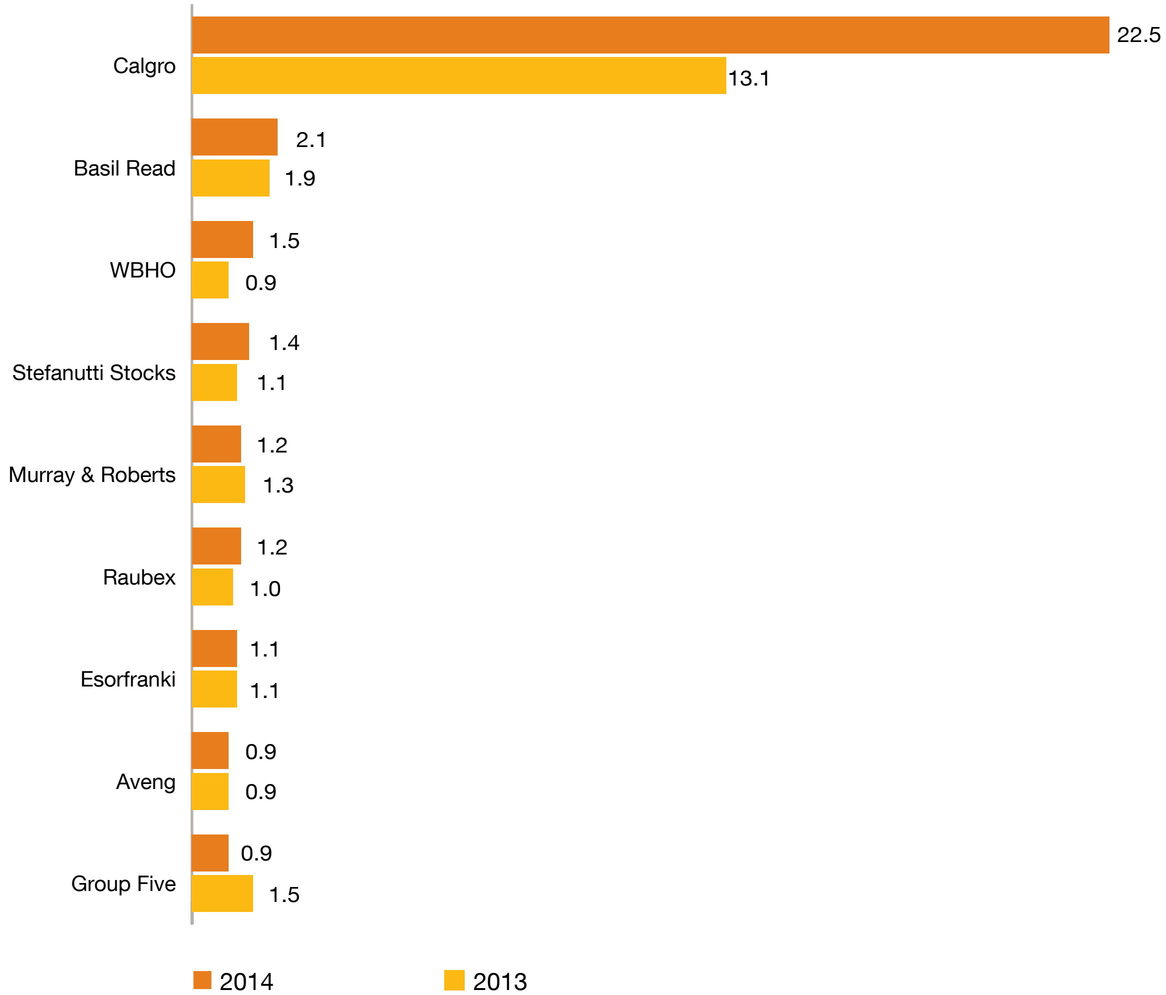


Source: PwC analysis

Apart from Calgro with a secured order book to construction revenue multiple of 22.5, all other companies' secured order books were between 0.9 and 2.1 of construction revenue (prior year: 0.9 and 1.9). Calgro's high multiple is as a result of equity accounted investments, which do not reflect income in revenue although they are included in the order book. When normalised for the impact of equity accounted investments, Calgro's multiple decreases to 14. However, only R10 billion of its R17 billion order book is expected to materialise in the next five years, which is an indication of the long-term nature of integrated housing development project roll outs.

Other than Murray & Roberts and Group Five, all entities improved their multiples. These increases were mainly due to real increases in order books on the back of stable revenue performance. For Group Five the decrease was a result of a significant increase in revenue in 2014 as the exceptional order book growth of 2013 came to fruition.

Figure 9: Secured order book as a multiple of construction revenue



Source: PwC analysis

3. *Intergrating risk for performance*

Risk management is a vital component of effective management in the construction industry. Not only is it essential that risks are appropriately managed, but risks also need to be appropriately priced when tendering. Companies now need to integrate risk and performance management and they need to evolve risk management to be more predictive in order to anticipate and plan for negative potential events.

The common key risks identified by the companies included in the analysis are set out below.

Common risks identified by construction and materials companies analysed

Challenges	Actions required by industry	Rating
Growth and expansion		
Growth in the South African construction industry has declined in recent years due to: • The decline in business confidence and the volatile labour market, which have resulted in reduced foreign investment in the country, especially in the construction industry; • Government's reduced spending on infrastructure projects; • Competition in the industry, which has continued to drive down margins. • Expansion into new markets, which has also been hampered by volatile commodity prices and exchange rates.	In order to address the risks posed to growth and expansion, companies need to: • Focus on effective contract negotiation on equitable terms and contract management; • Explore growth options in new and emerging markets; and • Align capacity with planned SA Government spend.	High
Labour force and trade unions		
Revenue generation and performance of construction companies is highly dependent on labour force stability. The volatile and sometimes violent industrial unrest in the South African construction industry has been the cause of significant project delays and disruptions, impacting the South African economy.	In order to mitigate the risk of labour unrest, open communication between unions and construction companies is essential in monitoring and resolving potential labour issues, in order to prevent significant project disruptions and delays.	High
Talent management and staff retention		
Loss of skills and expertise impacts the ability of companies to successfully complete contracts and undermines expansion. Growth strategies place a high demand on companies maintaining and retaining the appropriate leadership capacity.	A remuneration policy focusing on performance and retention of key talent is essential to the sustainability of a business. Regular succession reviews to identify potential talent retention risks and application of career planning strategies should be undertaken.	High

Challenges	Actions required by industry	Rating
Liquidity risk		
Cash constraints are a risk to companies' ability to make additional acquisitions and meet growth targets. The following factors have contributed to the liquidity problems experienced by construction companies: • The decline in margins and tough trading conditions across the industry; • Significant initial cash investments required in new projects; • Delays and disruptions in projects caused by industry unrest; and • Final commercial close out of projects resulting in significant amounts of cash lock up in working capital.	It is essential that cash flow requirements over the life of a contract be considered at the tendering stage. Close monitoring and management of outstanding claims and project overheads is also essential to mitigating liquidity risk.	Medium
Health, safety and environmental sustainability		
The construction industry poses an inherent risk to the health and safety of employees and subcontractors as well as posing a risk to the environment. Safety is key priority to stakeholders due to the impact on lives and delivery on contracts. Safety incidents pose the risk of loss of productivity, skills and morale of employees. Health, safety and environmental issues can ultimately impact the reputation of companies.	Health, safety and environmental statistics have improved in recent years. However, regular monitoring and reporting of statistics is required across the industry.	Medium
Project execution		
The competitive nature of the market as well as skill shortages, places pressure on companies to deliver on projects. This poses a risk to companies' ability to start projects efficiently, manage changes in projects, manage limited resources and complete and handover projects.	Implementation and monitoring of project management procedures and policies over the life cycle of a project and assignment of accountability is imperative in mitigating the risk posed to project execution.	Medium
Transformation		
In 2007, the Department of Trade and Industry brought into effect the Construction Sector Charter on Black Economic Empowerment. Compliance with the Charter by the Industry is seen not only as socially imperative but also economically imperative. Non-compliance with employment equity and BBBEE requirements could negatively impact companies in the following manner: • Reduce the ability to win tenders; • Increase the likelihood of client sanctions; and • Increase the possibility of penalties being imposed on South African projects if contractual BBBEE obligations are not met.	Monitoring of compliance with BBBEE codes and employment equity targets is imperative in the South African construction industry.	Medium

Challenges	Actions required by industry	Rating
Legislative and regulatory compliance		
The construction industry is highly regulated with legislation and regulations governing health and safety, the environment, competition, contract performance, taxation, labour and corporate governance. Non-compliance with legislation and regulations could result in: • Reputational damages to a company; • The imposition of penalties and fines; and • The loss of licences to tender for projects. Recent Competition Commission findings in South Africa have created mistrust between Government and the sector and have highlighted the negative impact that non-compliance can have on the reputation of a company.	Compliance with regulatory and legislative requirements is imperative in preventing loss to a business and maintaining a company's reputation in the industry.	Low
Tender risk		
The tendering process requires educated and highly judgemental views to be taken on pricing, mark up, geological conditions, quality and availability of materials. There is a risk of bidding and wining contracts on onerous terms and unacceptable commercial conditions.	To mitigate tender risk, extensive tender risk assessment procedures need to be undertaken at the tendering stage of each project.	Low
Credit risk management		
Challenging conditions in the South African construction industry have resulted in companies showing signs of distress due to competitive pricing and margins not covering operating risk. These conditions result in a higher level of credit risk exposure to construction companies.	Companies need to implement strict credit management policies and procedures to minimise credit risk of customers.	Low

In addition to the disclosed risks detailed above, we want to expand on the following risks:

- Barriers to improving construction safety in South Africa;
- Construction Charter compliance; and
- Talent management and skills shortage.

Barriers to improving construction safety in South Africa

The South African construction industry has unfortunately been plagued by a number of embarrassing safety incidents once again making news headlines in 2013/2014, despite the signing of the Construction Safety Accord in 2012 and the promulgation of new Construction Regulations in February 2014.

The industry remains under pressure from the public and regulators to significantly improve its safety performance. Although some companies have achieved remarkable improvements in safety governance and performance, it would be inappropriate not to acknowledge that challenges still prevail across the industry.

What then, can be described as some of the key barriers to achieving improved safety performance?

Construction safety starts at executive or business-owner level. Safety must be a core value of the company, with sincere management commitment embedded in the safety governance framework of the company. The attitude toward regulatory compliance and sound safety governance needs to be initiated and sustained at this level

Every participant in the hierarchy of a construction project (client, agent, primary contractor, subcontractor, and individual) is accountable for safety. Accountability should be a key pillar in the safety governance framework and should be embedded through effective training and awareness on a continuous basis. The effective implementation of this principle should create the necessary safety culture within the organisation/project.

Training remains a key intervention in creating awareness and improving competence in safety management. Inadequate, inappropriate and ineffective safety training is a significant threat to implementing and achieving the objectives of an organisation's safety governance framework.

Training effectiveness can influence the safety culture of an organisation/project. It has been claimed by some in the industry that training in South Africa is 15 years behind the level of developed countries.[1] Comparing the construction industry with the mining the industry, which has achieved significant safety improvements in past 10 years, raises the question: Why is the same traction not being achieved in the construction industry?

Safety training should typically reflect the safety legal liability, project safety planning requirements, safety procedural aspects and project, task, activity and equipment-specific safety requirements. It is important that safety training is adequate and appropriate at the correct level of staff within the organisation/project and this should be evaluated on a continuous basis. Appropriate key performance indicators (KPIs) should be identified to evaluate the effectiveness of safety training with a view to continuously improving it.

With a diverse workforce representative of different nationalities, languages, literacy and levels of education, effective safety communication remains one of the biggest challenges in the South African construction industry.

[1] "Deaths and accidents in the construction industry can be reduced" Protect in - Africa. http://www.protectin.co.za/about-safety/33-deaths-and-accidents-in-the-construction-industry-they-can-be-prevented.html

South Africa, however, is not unique in facing this challenge as the US Department of Labor cited language barriers in construction as a high-risk area in workplace safety using the Hispanic construction workers in the US as an example.[2] Europe is also not exempt from the diverse workforce challenge. The European Agency for Safety and Health at Work (EU-OSHA) highlights the following:

The effects of migration are positive as well as negative; however, there are serious consequences for OSH owing to, for example, language comprehension, risk perception, values about work and characteristics of the job.[3]

"Inferior (substandard) building and incorrectly specified materials to meet design criteria" have increasingly been labelled as root causes in building collapses and other incidents. Director of the Aggregate and Sand Producers Association of South Africa (ASPASA), Nico Pienaar, recently highlighted this concern in Engineering News. He also cautioned that:

when mixing concrete on site, the project manager should oversee material use and ensure mixtures are correct and ratios are as specified. Failure to do so may have catastrophic consequences.[4]

Solutions for improved safety performance in the South African construction industry remain elusive. It is a complex challenge which requires 'out-of-the box' thinking if the industry is going to achieve major improvements in safety performance.

Construction Charter compliance

In 2007, the Department of Trade and Industry brought into effect the Construction Sector Charter on Black Economic Empowerment. The Charter represents a shared approach, reflecting significant stretch targets to facilitate the rapid transformation of the construction sector.

In the past the Construction Industry has experienced declining investment and increasing demand volatility, combined with an unstable employment environment. However, the sector is now seeing an upward trend with expansion closely linked to the prospects of new investments. The Charter is therefore seen as a stimulus for development and job creation in the economy.

Compliance with the Charter in the Industry is seen as not only socially imperative but economically imperative. It provides the opportunity for facilitation of business growth, sustainability of entities businesses as well as increasing shareholder value.

[2] "The Latino Labor Force at a Glance". United States Department of Labor (2012). http://www.dol.gov/_sec/media/reports/HispanicLaborForce/HispanicLaborForce.pdf

[3] "Diverse cultures at work: ensuring safety and health through leadership and participation". European Agency for Safety and Health at Work. (2013) https://osha.europa.eu/en/publications/reports/diverse-cultures-at-work-ensuring-safety-and-health-through-leadership-and-participation

[4] Natalie Greve, "Substandard, incompatible building materials could cause future building collapses". (November 22, 2013) Engineering News. http://www.engineeringnews.co.za/article/substandard-incompatible-building-materials-could-cause-future-building-collapses-2013-11-22

The objectives of the Construction Sector Charter reflected below are aligned with many of those of the companies included in our analysis. These include:

- Transformation and growth of the sector;
- Improvement in the competitiveness and efficiency of the sector;
- Achieving a substantial change in the racial and gender composition of the ownership, control and management within the sector;
- Addressing the skills shortage and development, specifically with regards to woman;
- Enhancing entrepreneurial development; and
- Addressing the malpractice experienced within the industry.

Construction Charter Scorecard

The table below summarises the results disclosed by companies included in our analysis.

Scorecard for the Broad-Based Socio-Economic Empowerment Charter for the South African Construction Industry

Element	Description	Measure	Compliance target
Ownership	Minimum target for effective HDSA ownership	Voting rights, Economic interest, Ownership fulfilment	25
Control	Board to be appropriately representative	Black people (Woman) represented by the board and executive management	10
Employment Equity	Diversification of the workforce to reflect the country's demographics to attain competitiveness	Black people (Woman) represented by senior, middle and junior management	10
Skills Development	Development of requisite skills to address skills shortage within the industry	Training costs, learnerships, bursaries, mentorship	15
Procurement	Procurement spent on BEE entities.	BEE companies as a % of procurement	20
Enterprise development	Development of small and micro businesses within the sector	% of input, total turnover ratio, and output	15
Corporate Social Investment	Contribute to the amount and effectiveness of CSI in the industry	CSI as a percentage of payroll	5

Source: PwC analysis

Indications, from the annual reports for the companies analysed, are that companies are on track to meet most of the Construction Charter requirements. However, skills development and shortages still present a challenge to most entities and should be a key focus area.

The Construction Charter calls for transformation of ownership within entities. Many of the companies have successfully implemented share-based employee participation plans. This not only enables the entity to pursue and maintain targets set by the Charter, but also to attract, retain and reward employees, allowing them to participate in the economic benefits generated from the scheme. This enhances the entity's ability to align its interests with those of its employees.

As part of the Charter's objectives to appoint historically disadvantaged South Africans (HDSAs) within the higher levels of management, entities should strive not only to comply with these requirements, but to create truly empowered HDSAs who are economically active within the sector.

Employment equity and skills development are identified as key areas for action. As such, entities should have a culture of transformation with additional resources allocated to building awareness and facilitating training. Entities should ensure that discrimination on any level is not tolerated and that appropriate disciplinary action is enforced.

Despite the progress made to date, it goes without saying that there is still significant room for improvement.

Talent management and the skills shortage

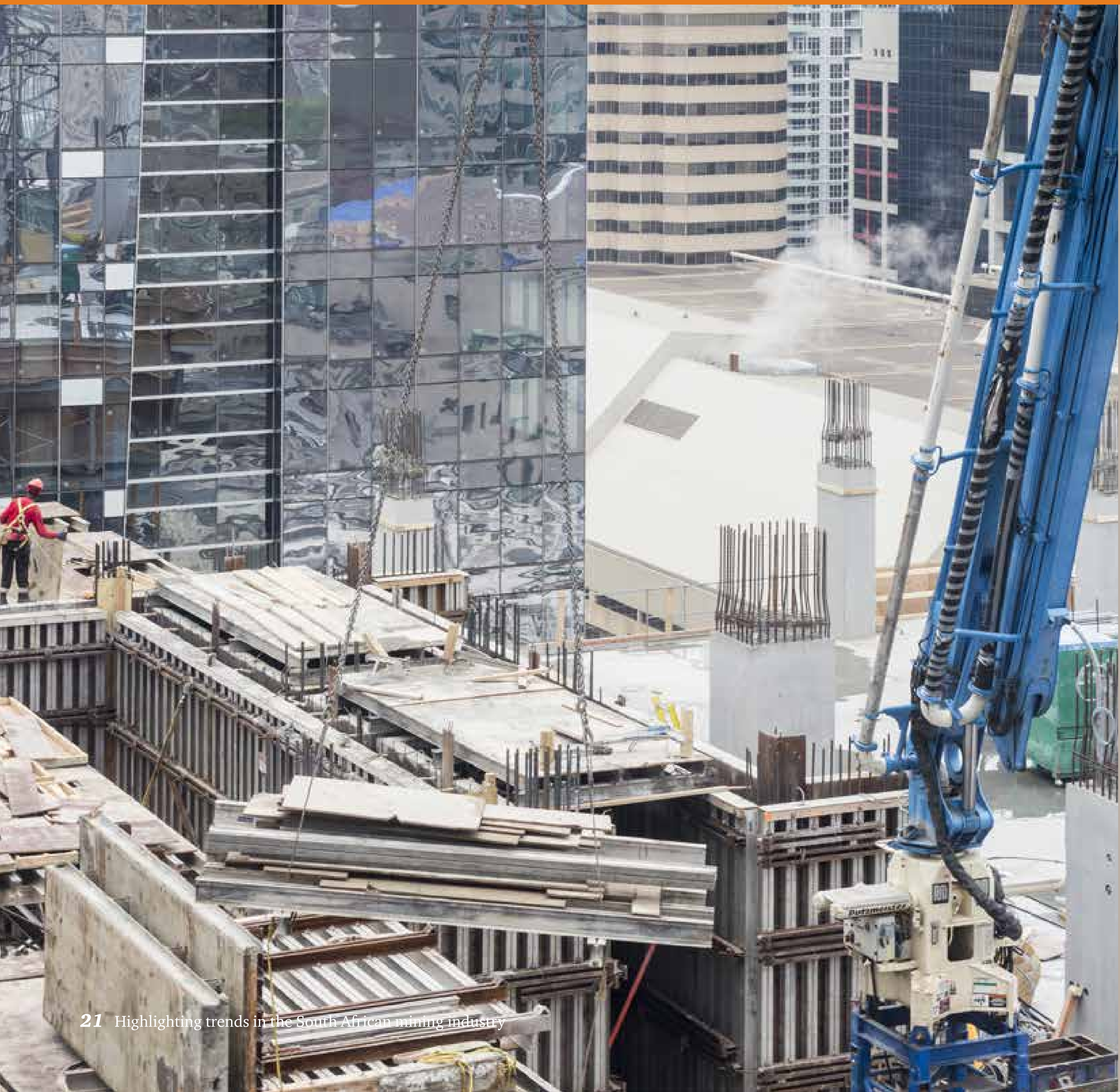
In PwC's latest Annual Global CEO Survey released in 2014, more than two-thirds of CEOs in the construction sector said they were extremely concerned about their access to key skills. In addition, 70% express concern about rising labour costs in high-growth markets and 37% believe that creating a skilled workforce should be a government priority. However, only 17% believe governments have been effective and 62% that they have made upskilling the workforce an internal business priority.

Lack of workforce expertise not only affects a company's ability to compete for and complete contracts, but also adds to the growth risk it faces. Similarly, staff retention is critical to the sustainability of a company. In line with the requirements of the Construction Charter, construction companies recognise the development of skilled labour as critical to their sustainability.

Entities included in our analysis confirm that they remain committed to investing heavily in skills development, with a significant portion of their expenditure being directed towards bursaries and learnerships.

Candidates are selected both on the basis of academic merit as well as a strong emphasis on students from historically disadvantaged backgrounds. This contributes to addressing the challenge of skills shortages and achieving the objectives of the Construction Charter.

4. Value added

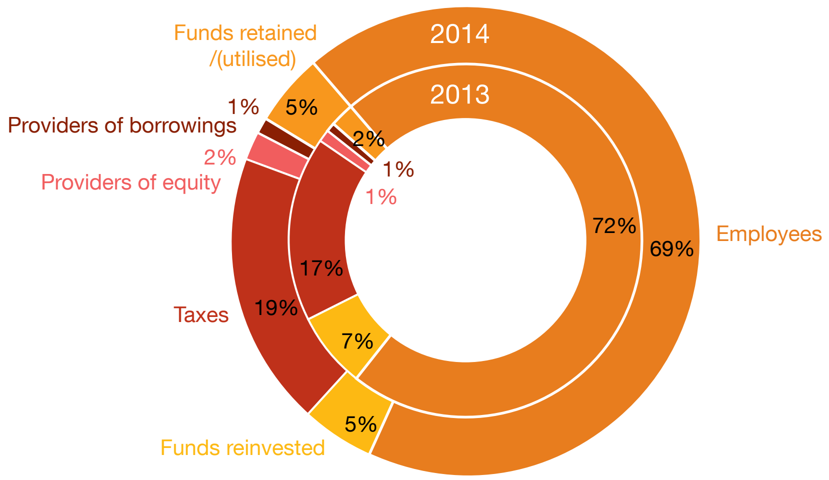


The construction sector and the construction materials sectors add significant value to our country and its people. Stakeholders in these industries include employees, their families, unions representing them, the Government as regulators and custodians of the tax income for the country, investors, suppliers and customers. The monetary benefit received by each of these stakeholders is often summarised by companies in their value added statements.

Seven of the nine companies in the heavy construction analysis and six of the seven companies included in the construction materials analysis, representing 63% and 97% respectively of the revenue for all companies considered, provided readily available value added statements.

Figures 10 and 12 show how the value created, being the difference between income and direct purchases, was distributed to the various stakeholders.

Figure 10: **Heavy construction value added distributed to stakeholders**

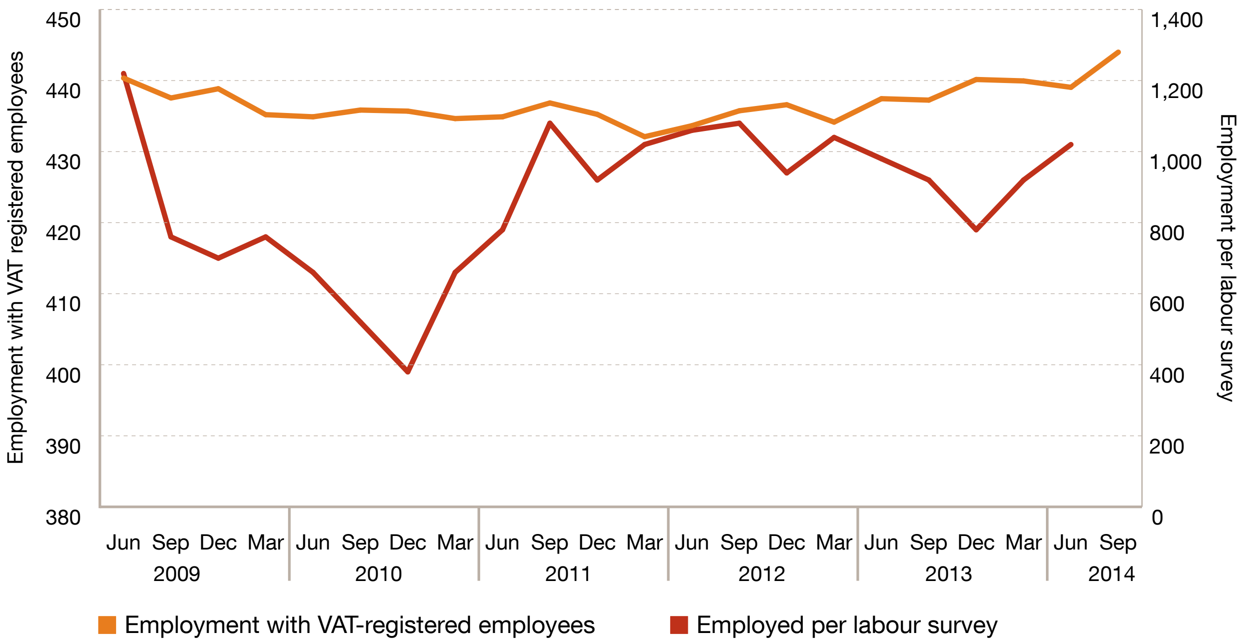


Source: PwC analysis

The value received by employees represented 69% (2013: 72%) of the value created. This is a significant contribution to the labour market. According to the Quarterly Labour Force survey, which is conducted by Stats SA on a household-based sample for activities conducted by individuals aged 15 to 64, more than 1.18 million people are employed by the construction industry either on a contract basis or permanently.

Compared to the prior year this was the industry that showed the largest increase in employment year on year. The number of employees per registered VAT vendor in the construction industry shows a similar trend. Levels of employment largely depend on the scale of construction activity in the country and can vary with the economic cycle, as illustrated in Figure 11.

Figure 11: Number of employees in the construction industry



Source: Stats SA

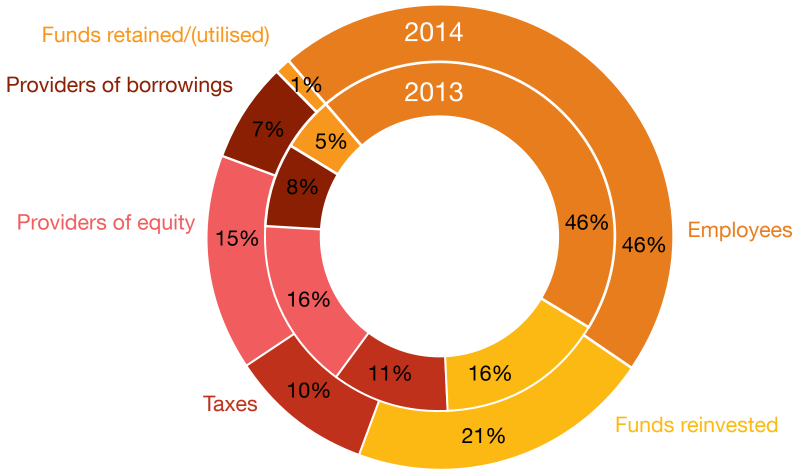
The percentage of value created that is collected by providers of debt capital has remained consistent with the prior year at 1%. This low percentage reflects the fairly conservative levels of gearing in the South African construction industry.

The 2% (Prior year 1%) received by providers of equity capital remained consistent from prior year and reflects the current low levels of return for shareholders. The marginal increase was mainly due to an increase in the dividends paid by Esorfranki, Group Five and Basil Read.

Reinvestment levels reduced slightly to 9% from 11% in the prior year. Without reinvestment construction companies will not be able to take on the multi-billion rand projects required for their growth and that of the country.

The state received 19% (2013: 17%) of value created in the form of direct taxes. The reality is that the state receives significantly more if one takes into account the tax on employee income deducted from employees' salaries and net indirect taxes like VAT.

Figure 12: Construction materials value distributed to stakeholders



Source: PwC analysis

For construction material companies, the value received by employees represented 46% (prior year: 46%) of the value created, which is more in line with mining and manufacturing levels.

The percentage of value created that is collected by providers of debt capital has remained consistent with the prior year at 7% (prior year: 8%). This percentage reflects the gearing structure that is more leveraged towards debt financing.

The 15% (prior year: 16%) received by the providers of equity capital remained consistent from the prior year and potentially puts the low return to shareholders of heavy construction companies in perspective.

The decrease in both providers of debt and providers of equity was mainly due to an increase in value that was retained for reinvestment.

The state continued to receive value in the form of taxes at 10% (prior year: 11%). This percentage would again be significantly higher when taking indirect taxes into account.

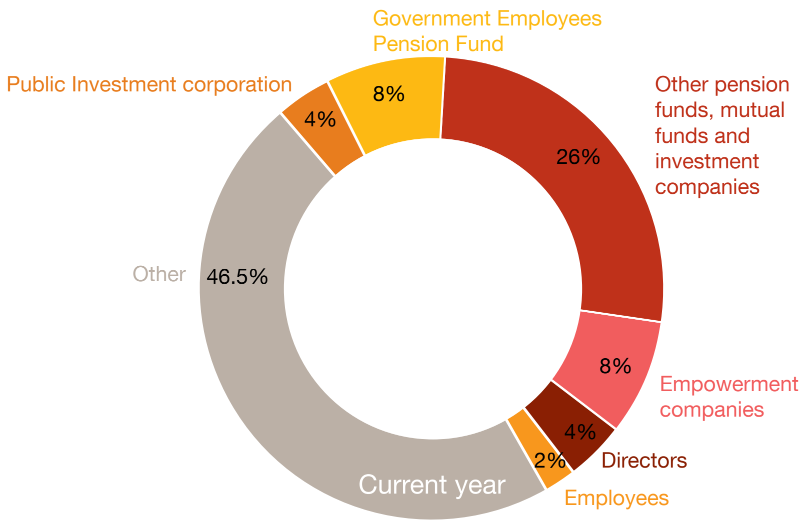
Shareholders

A reasonable return to shareholders is needed in order to attract sufficient investment into an industry. In analysing the shareholding (5% or larger) in construction companies, the significance and importance of this industry to the South African economy is clear. Investment in the industry not only supports domestic economic growth and job creation, but also contributes to the creation of wealth for pensioners and investors.

Figure 12 shows the extent of investments by public-interest investors such as the Government Employees Pension Fund (GEPF) and the Public Investment Corporation (PIC) in the South African construction industry. Together, their investment represents 12% (17% of heavy construction) of market capitalisation in the sector represented by the 16 companies included in our analysis. Major investment by other pension funds, mutual funds and investment companies makes up a further 26% of the total investment in the industry.

Although inconsistent disclosure and limitations to what is being disclosed mean that the graph is by no means a complete or even accurate reflection of individual shareholder categories, it does reflect the importance of the industry for the population at large.

Figure 13: Shareholder profile



Source: PwC analysis

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5. *Tax developments*

As has already been mention, construction activities contribute significantly to the fiscus. The following indirect tax implications are especially relevant for construction companies in the near term.

New withholding tax on service fees on cross-border projects

A new withholding tax on service fees will be introduced on 1 January 2016. It will affect all South African tax residents making payments to persons outside of South Africa.

This new withholding tax may impact the pricing of projects conducted outside of South Africa's borders, in particular where services are outsourced by the South African tax resident party. It is not uncommon for units within a construction entity to outsource certain parts or specified services in terms of a construction contract to third-party contractors in the jurisdiction in which the construction project is situated.

It is also customary for multinational groups to outsource certain aspects of a construction contract to other entities within the group, specifically where the other entity has unique expertise or special knowledge of a particular jurisdiction. Where foreign entities within a multinational group act as subcontractor to a local South African entity, payments in terms of such arrangement may be subject to the new withholding tax on service fees.

It is therefore crucial that the withholding tax be factored into the contract pricing at inception of the contract, as it impacts on the overall cash flow of the project. The withholding tax may result in an additional cost to the foreign entity in instances where that entity is unable to obtain relief from double taxation.

It should also be noted that it is not uncommon for contracts to provide for a gross up of any payments to a subcontractor where those payments are subject to a withholding tax in the jurisdiction from where they are paid. In such cases, the gross up clause would result in an additional cost to the South African entity that subcontracted services to a foreign entity.

A large number of South African construction companies are engaged in projects throughout Africa as a result of the expansion of business opportunities on the continent. It is therefore important for the South African companies to understand in which instances the new withholding tax on service fees will apply to ensure proper cash flow planning and project pricing.

Section 51B of the Income Tax Act, No. 58 of 1962 (the Act) provides that a withholding tax of 15% will apply where ***a service fee is paid*** by any person, ***to or for the benefit of any foreign person***, to the extent that the amount is regarded as having been ***received by or accrued to that foreign person from a source within the Republic.***

It is evident that there are three main criteria for the withholding tax to be applicable:

- A service fee must be paid;
- To a foreign person; and
- The amount must be regarded to be from a source within South Africa.

Service fee

Section 51A of the Act defines the term service fee as:

any amount that is received or accrued in respect of technical services, managerial services and consultancy services but does not include services incidental to the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information.

The terms 'technical services', 'managerial services' and 'consulting services' are unfortunately not defined in the Act. We submit that the terms should be interpreted by having regard to their ordinary meaning, which denotes that the term service fee would include fees paid for a wide range of services.

Typically, payments for architectural, engineering and design services would all fall within the ambit of the definition of 'service fees' as defined in section 51A of the Act. Services such as cost consulting, project management, environmental impact studies and associated specialist consultancy associated with construction projects would also constitute service fees for purposes of section 51A of the Act.

Foreign person

The term 'foreign person' is defined as any person that is not a South African tax resident (refer to section 51A of the Act).

Payments to subcontractors that are tax resident in a foreign jurisdiction would therefore be regarded as payments to a foreign person for purposes of section 51B of the Act.

South African source

The source of income for South African income tax purposes is determined with reference to the provisions of section 9 of the Act, as well as case law. While section 9 provides a prescribed set of source rules for a specific list of income streams (refer to sections 9(2)(a) to 9(2)(l) of the Act), it is important to emphasise that the principles set out in South African case law still remain entrenched as a residual method for determining the source of certain categories of income that fall outside the main categories of income addressed by section 9(2) of the Act.

The source of service fees should be determined by having regard to case law, as the provisions of section 9(2) of the Act do not include income streams arising from services. Due to its nature, the source of service fees is generally connected to the place where the actual service is rendered, i.e. where the work is done.[5]

If the work is done outside of South Africa, the source of the service fee would be outside of South Africa. However, where the service is rendered

[5] In in CIR v Lever Bros & Another, 14 SATC 1, and Essential Sterolin Products (Pty) Ltd v CIR, 55 SATC 357 it was held that in determining the source of an amount, the first step is to determine the originating cause of the income and once the originating cause of the income is determined, the second step would be to locate the geographical location from where it originates.

in South Africa, for example desktop studies, procurement services, or architectural designs that are performed in South Africa, the source of the fee would be in South Africa.

It therefore seems that most of the services that construction companies would typically outsource to persons, who are tax resident in foreign jurisdictions, would be rendered in that country as the staff rendering those services would generally be located in the foreign country.

The new withholding tax on service fees would consequently only be applicable in instances where the services are rendered in South Africa. When having regard to services that are typically outsourced within the construction industry, it seems that the bulk of those outsourced services would be rendered in the foreign jurisdiction and not in South Africa, resulting in the withholding tax not applying to payments made to the foreign persons rendering those services.

However, in instances where the services are rendered in South Africa, for example engineering consulting services rendered in South Africa, the parties should also have regard to the specific exemptions contained in section 51C of the Act as well as any double tax agreement between South African and the country in which the foreign person is tax resident.

Exemptions

Section 51D of the Act provides that a foreign person would be exempt from the withholding tax on service fees if:

- That foreign person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the 12-month period preceding the date on which the service fee is paid;

- The service in respect of which that service fee is paid is effectively connected with a permanent establishment of that foreign person in the Republic if that foreign person is registered as a taxpayer in terms of Chapter 3 of the Tax Administration Act; or

- That service fee constitutes remuneration paid by an employer to an employee.

Double tax agreement

Where foreign persons are tax resident in jurisdictions with which South Africa has concluded double tax agreements, the application of the double tax agreement may result in the reduction of the withholding tax on service fees.

Section 51E of the Act nevertheless provides that an exemption from withholding tax or a reduction in withholding tax will only apply where the foreign person has, on or by the date of the payment, submitted to the person making the payment a declaration in a form prescribed by the Commissioner for SARS that the foreign person is exempt from the withholding tax on service fees or that service fee is subject to a reduced rate of tax as a result an applicable double tax treaty.

The foreign person must thus be cognisant of the fact that the administrative requirements set by SARS should first be complied with before the relief afforded by the double tax agreement would apply.

Contracts secured by foreign entities and outsourced to South African taxpayers

Multinational groups should also be aware of the potential application of the withholding tax on service fees in instances where a South African tax resident makes payment to the foreign company under a contract secured by that foreign entity, but where services are outsourced to a local South African tax resident entity within that multinational group.

Where the services in relation to such a contract are rendered in South Africa, even where it is outsourced to a South African entity, there is an argument that the source of such services is located in South Africa and accordingly the withholding tax on services would apply.

However, in certain cases the foreign entity may be eligible for relief from double taxation if there is an in-force double tax agreement between South Africa and the jurisdiction in which that entity is tax resident.

African countries with which South Africa has concluded double tax agreements

Persons who receive service from South African tax residents and who are tax resident in the African jurisdictions listed below may potentially benefit from the application of the double tax treaty.

Double tax agreement countries

Algeria	Botswana	Democratic Republic of Congo
Egypt	Ethiopia	Ghana
Lesotho	Kenya	Malawi
Mauritius	Mozambique	Namibia
Nigeria	Rwanda	Seychelles
Sierra Leone	Swaziland	Tanzania
Tunisia	Uganda	Zambia
Zimbabwe		

VAT developments

Documentation - Import VAT

Under the current VAT legislation, an input tax deduction is allowed where a bill of entry or other documents together with the proof of payment of tax on importation of goods are held by the vendor or agent at the time of furnishing a VAT return.

The requirement, effective 1 April 2014, to defer the claim to the tax period in which payment was actually made to SARS Customs, has resulted in input tax claims being delayed by a further one to two months causing negative cash flow implications for the importing vendor.

To align with the customs modernisation programme, an input tax deduction will now be allowed, effective 1 April 2015, in the tax period during which the goods are released by Customs.[6]

[6] In Explanatory memorandum to Tax Laws Amendment Bill, 30 October 2014

It is understood that the reason for including the requirement of release by Customs is to prevent the deduction of input tax when the bill of entry/customs declaration is passed, which could be done by the importer prior to the goods arriving in the Republic (This is the pre-clearance functionality offered by Customs) .

Documentation Agents

Currently, importation of any goods into the Republic by an agent (acting on behalf of the principal) is deemed to be made by the principal and not the agent. However, the agent may hold the relevant importation documents.

Section 54(3) of the VAT Act requires the agent to notify the principal of the supply received declaring the particulars contemplated in paragraphs (e), (f) and (g) of section 20(4) (i.e. description, quantity, value, tax charged and consideration).

The above provision does not require an agent to provide the principal with any particulars in relation to the proof of payment of VAT on importation of any goods. Consequently, there has been uncertainty as to which documentation is acceptable to SARS as proof of payment in order for the principal to claim an input tax deduction in respect of VAT paid on the importation of goods.

With effect from 1 April 2015, the statement that the importing agent must provide to the principal must include the receipt number of the payment of such tax. It is recommended that taxpayers ensure that their service level agreement with importing agents take cognisance of these changes.

Electronically supplied services and other developments

The vatable nature of supplies of electronic services could be easily overlooked in the construction and mining sectors. In the past, typical e-commerce transactions were taxed in terms of a ‘reverse charge mechanism’, where the onus was on the consumer to pay VAT on imported e-commerce goods and services. This system has been practically unenforceable and compliance levels were low.

With effect from 1 June 2014, all supplies of electronic services require the supplier thereof to register for VAT in South Africa. The VAT registration threshold is set at R50 000. There is no time limit attached to it. The registration liability is triggered once you reach this limit.

What is ‘electronic services’?

The definition of electronic services, contained in the Regulation 37489 dated 28 March 2014, specifically includes the supply of electronic services by a person from a place in an export country to a recipient that is a resident of South Africa, or where any payment to that person in respect of the electronic services originates from a South African bank.

The services must be supplied by means of one of three mediums, namely:

- Any electronic agent;
- Electronic communication; or
- The Internet.

The Regulation relies on the definitions of electronic agent, electronic communication or the Internet as contained in the Electronic Communications and Transactions Act.

The Regulation further categorises and lists the types of services caught by this new legislation. These include:

- Educational services;
- Games and games of chance;
- Internet-based auction services;
- Miscellaneous services; and
- Subscription services.

It is important to note that the ambit of these electronic services is wide and does not draw a distinction between business-to-business (B2B) and business-to-consumer (B2C) transactions.

How does this relate to the mining/construction sector?

Educational services include distance teaching programmes, educational webcasts, Internet-based courses, Internet-based education programmes, or webinars (provided that the educational services are not regulated by an educational authority in the export country).

Similarly, any subscription paid to a blog, publication, webcast, webinar, website web application or web series falls within the ambit of subscription services and would require the foreign supplier thereof to register for VAT in South Africa if the consideration received exceeds R50 000.

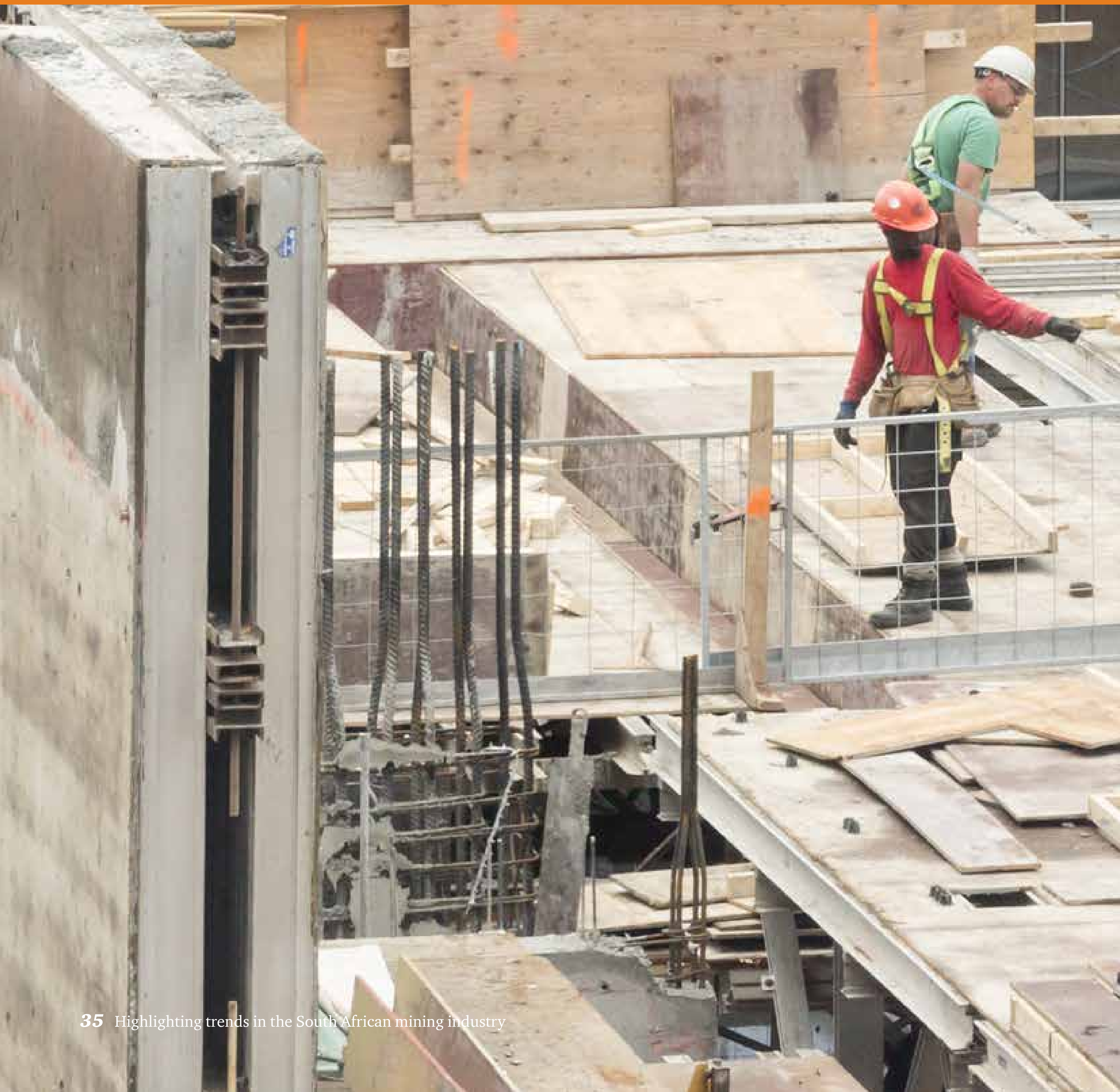
This means that multinational groups that historically shared costs that were generally labelled ‘management fees’, will now have to be analysed in much more detail to determine if such fees include the recovery of costs relating to educational services (e.g. any form of training such as online training provided as part of the global support services) or subscription services (for example to systems or application software) supplied via an electronic agent, electronic communication or the Internet. The lack of definition of terms in the Regulation creates uncertainties and possibly VAT risks to the businesses impacted.

This change in the way certain services acquired from non-residents should be treated for VAT purposes will not only add to the cost of the compliance burden, but create challenges in the way accounting and business systems are set up to extract relevant information.

As many taxpayers can testify to, non-compliance with any tax legislation exposes one to severe penalties and interest under the new Tax Administration Act, effective 1 October 2012. Understatement penalties, generally levied starting at 25% of the capital tax underpaid, are only mitigable under a voluntary disclosure prior to any SARS notice of investigation or audit.

Given the untested meaning of many of the concepts included in the Regulation, a prudent approach is recommended to taxpayers to obtain clarity from SARS (e.g. in the form of VAT rulings) to determine whether a VAT registration liability is triggered for foreign suppliers of the services contemplated in the Regulation.

6. *Board room dynamics*



The role of the board and executive management came under scrutiny this year in a number of industries including the construction industry. Finding the correct balance between management not being puppets of the board and the board not merely rubber stamping management decisions remains a challenge.

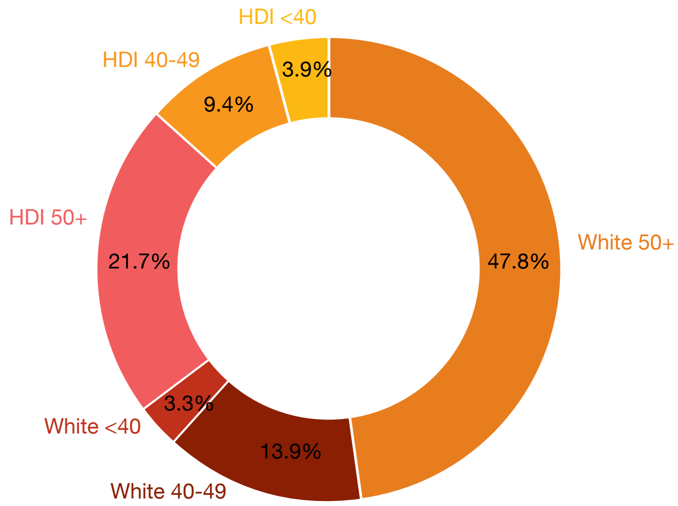
Board composition

An analysis of the group of companies in the heavy construction and construction materials industries, suggests that 35% of board members (down from 38.7% in 2013) are historically disadvantaged individuals (HDIs).

The Construction Charter requires a minimum of 40% representation of HDIs at board level. The industry participants have a seven-year period in which to achieve compliance with an effective date of June 2009. The analysis suggests that the industry has lost some momentum when compared to the prior year's statistics and requires a focused and dedicated effort in the next two years in order to achieve the objectives set out in the Construction Charter.

In drawing a comparison of the board's composition by age and race, it is noted that a slightly higher percentage of board members younger than 40 years are HDIs. This is encouraging for the long-term transformation of boards.

Figure 14: **Board composition by race**



Source: PwC analysis

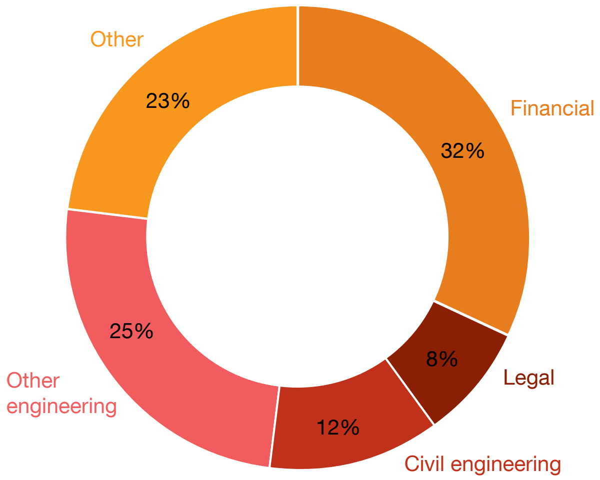
In the construction and construction materials industries, female representation at board level is currently 18.9%, of which 13.9% are HDI. This is substantially below the minimum requirement of 20% HDI representation of women set out in the Construction Charter.

The changing construction and governance environments require a changed skill set. The average board size for the companies analysed was nine, which allows for an adequate spread of skills. The smallest board had five members and the largest board had 21 members.

Notwithstanding that professional qualifications are not the only factor in determining expertise and experience, the following analysis of board members by their primary professional qualifications indicates a diverse spread that provides boards with a wide array of expertise.

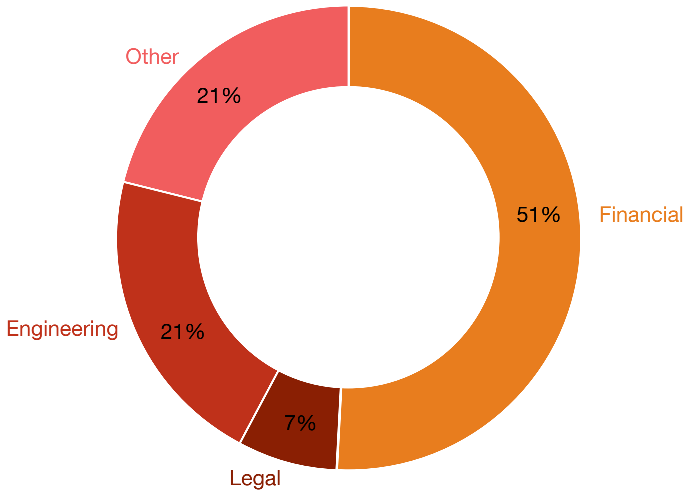
In comparing the skills representation of boards across the two industries, it is evident that 37% of the boards in the construction industry and 21% of the boards in construction materials industry are made up of engineers. This appears to be consistent with the need for a greater level of specialist engineering skills required in the construction industry, relative to the construction materials industry.

Figure 15: Construction industry: Skills represented on board



Source: PwC analysis

Figure 16: Construction materials: Skills represented on board



Source: PwC analysis

7. *Financial performance*

Income statement

	Current year	Prior year	Difference	% change
	R 'millions	R 'millions	R 'millions	
Construction revenue	141 051	132 004	9 047	7%
Other revenue	30 671	25 814	4 857	19%
Total revenue	**171 722**	**157 818**	**13 904**	**9%**
Operating expenses	(165 518)	(151 365)	(14 153)	9%
PBIT	6 204	6 453	(249)	(4%)
Net finance costs	(689)	(552)	(137)	25%
Tax expense	(1 994)	(2 161)	167	(8%)
Equity accounted for earnings	199	268	(69)	(26%)
Discontinued operations	225	105	120	114%
Net profit	**3 945**	**4 113**	**(168)**	**(4%)**
PBIT margin	3.6%	4.1%	(0.5%)	
Net profit margin	2.3%	2.6%	(0.3%)	
Effective tax rate	36%	37%		

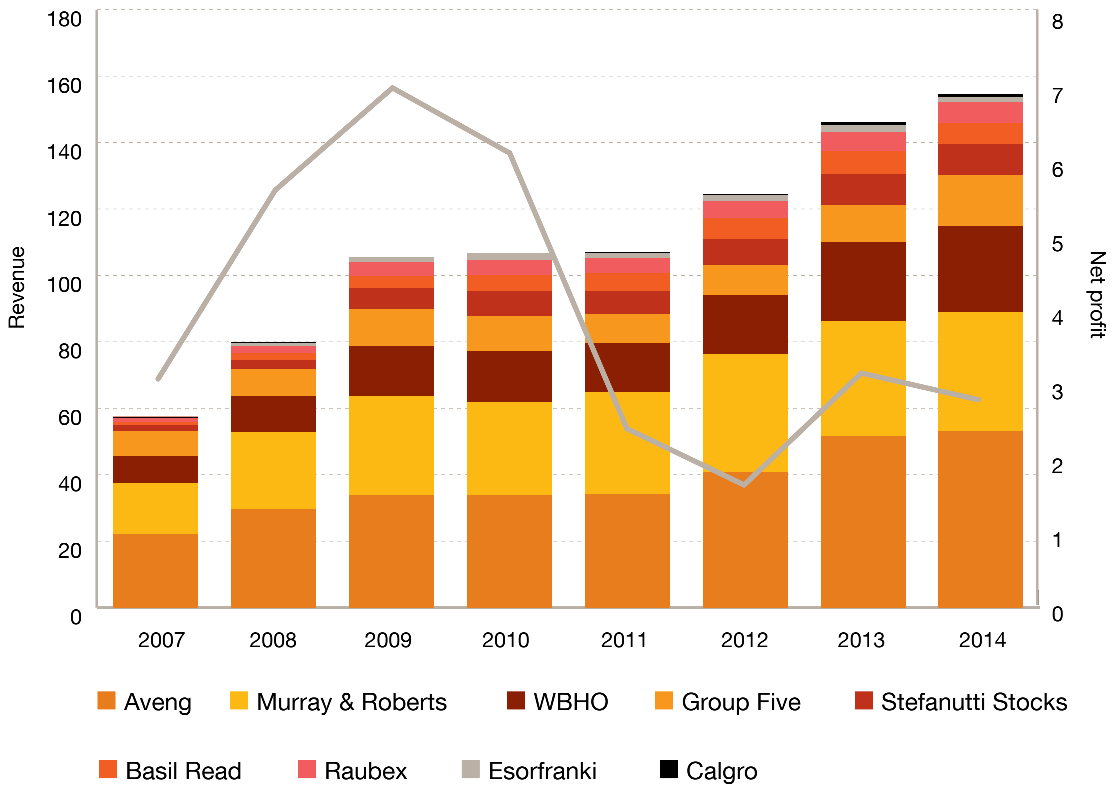
Source: PwC analysis

Construction revenue

Construction revenue increased by 7% on the prior year mainly as a result of an increases of R4.1 billion from Group Five, R1.5 billion from Murray & Roberts and R1.3 billion from Aveng. These increases were largely as a result of increased revenue from energy, oil and gas projects and a weaker rand partially offset by weaker demand from the mining sector.

The increased revenue was unfortunately realised with lower margins resulting in a decrease in construction profitability. Construction profits seem to be following the same double dip experienced by most industries after the 2008 economic crises.

Figure 17: Construction revenue vs net profit (R' billions)



Source: PwC analysis

Other revenue

Other revenue mainly consists of the sale of construction and related materials. The increase is as a result of R1.4 billion growth at WBHO, R1 billion at PPC and substantial contributions from DAWN, Sephaku Holdings and Afrimat. The bulk of this revenue growth was acquisition based with only PPC showing reasonable organic growth.

Operating expenses

Total costs increased by 9.4%, marginally higher than revenue growth, resulting in a slightly lower profit margin.

For the heavy construction companies, staff costs continued to represent a significant component of operating costs constituting 28.3% of total operating costs (2013: 27.8%) and increased by 10% on the prior year. The increase noted in the current year is higher than the 7% increase in construction revenue year on year.

Retention of key skills to serve prospective contracts is one of the construction companies' biggest investments in anticipation of the potential upswing. Although tender activity has been very high according to a number of companies, there were limited tenders awarded. Companies therefore have to decide whether they can continue carrying excess staff or whether they need to downsize. Announcements of various levels of retrenchments were made by most of the heavy construction companies.

Construction material companies were still impacted by above-inflation energy cost increases and steel prices. Although Eskom's increases for next year will be higher, the decrease in oil prices and global steel prices should assist with next year's input costs.

Net finance costs

The low level of finance costs reflects the traditionally low levels of gearing maintained by most South African construction companies. R0.4 billion of the net finance costs can be attributed to PPC. Only five of the 16 companies analysed were in a net borrowings position.

Taxation

The effective tax rate of 36% is only marginally lower than the prior year effective tax rate of 37% and well above the statutory rate of 28%.

This increase is as a result of the inability to recognise deferred tax assets for losses made in some instances and differential in tax rates in foreign jurisdictions. The higher effective tax rate in the prior year is also impacted by the non-deductibility of the Competition Commission penalties.

Net profit

Net profit decreased by 4%. This reflects the 8% decrease of the heavy construction companies partly offset by the 8% increase in the net profit of construction material entities.

The construction industry is and has always been a very low margin industry. The net profit margin for the heavy construction companies decreased from 3% to 2.5%.

Although six of the heavy construction companies increased their net profit, the R835 million decrease in net profit from Aveng and R254 million from Esorfranki resulted in an overall decrease.

Basil Read improved its net profit by R297 million while Stefanutti Stocks and Group Five improved their net profit by R281 million and R152 million respectively.

*Top-five heavy construction companies**

	Current year	Prior year
Calgro	13%	11%
Raubex	6%	6%
Murray & Roberts	4%	4%
WBHO	3%	3%
Group Five	3%	3%

** Top performers by net profit margin*
Source: PwC analysis

Five of the seven construction materials entities improved their profitability.

*Top-three construction material companies**

	Current year	Prior year
PPC	11%	12%
Afrimat	9%	8%
Mazor	6%	7%

** Top performers by net profit margin*
Source: PwC analysis

Cash flows

	Current year R 'millions	Prior year R 'millions	Difference R 'millions	% change
Cash flows related to operating activities				
Cash generated from operations	7 856	9 963	(2 107)	(21%)
Other	(592)	(523)	(69)	13%
Income taxes paid	(2 721)	(2 190)	(531)	24%
Net operating cash flows	**4 544**	**7 250**	**(2 706)**	**(37%)**
Cash flows related to investing activities				
Purchases of PPE	(4 718)	(5 394)	677	(13%)
Purchase of investments	(4 897)	(775)	(4 122)	532%
Sale of investments	2 774	2 009	764	38%
Other	85	612	(527)	(86%)
Net investing cash flows	**(6 756)**	**(3 548)**	**(3 208)**	**90%**
Cash flows related to financing activities				
Proceeds from ordinary shares issue	33	145	(112)	(77%)
Proceeds from interest-bearing liabilities	4 855	2 478	2 376	96%
Repayment of interest-bearing liabilities	(2 552)	(2 564)	11	0%
Distribution to shareholders	(1 878)	(1 638)	(240)	15%
Other	(143)	(141)		
Net financing activities	**315**	**(1 720)**	**2 034**	**(118%)**
Net (decrease)/increase in cash and cash equivalents	(1 898)	1 982	(3 880)	(196%)
Cash and cash equivalents at the beginning of period	19 153	17 171	1 982	12%
Cash and cash equivalents at the end of the year	17 255	19 153	(1 898)	(10%)

Source: PwC analysis

Cash flows from operating activities

Net decrease of R2.7 billion (37%)

Cash generated from operations decreased by 21% to R7.9 billion. This decrease is significantly worse than the decrease of 4% in profit before income and tax (PBIT) and reflects the working capital challenges experienced by a number of heavy construction companies. The R2.7 billion decrease in cash flow from operations by heavy construction entities, was partially offset by a R0.6 billion improvement in construction material cash flows.

Only five of the 16 companies reflected an improvement in cash flow from operations with PPC's R0.6 billion and Stefanutti Stocks' R0.3 billion reflecting the best improvements.

The most notable negative movement in cash flow from operations were:

- WBHO: R972 million, which included R550 million higher investment in working capital;
- Murray & Roberts: R720 million, which included a R641 million higher investment in working capital;
- Basil Read: R613 million, which included a R122 million higher investment in working capital and a R288 million adjustment for profit on sale of TwP;
- Group Five: R596 million, which included a R519 million higher investment in working capital; and
- Calgro: R304.5 million, which included a R309 million higher investment in working capital.

Tax paid increased by 24% on last year from R2.2 billion to R2.7 billion and is notably higher than the R2 billion tax expense reflected in the income statement. The higher tax paid is generally as a result of settling outstanding tax from prior years rather than significant deferred tax positions.

Cash flows from investing activities

Net outflow increase of R3.2 billion (90%)

Additions to plant and equipment of R4.7 billion consisted of R3.4 billion relating to heavy construction entities and R1.3 billion relating to construction material entities. Construction material companies are committed to expanding their production capacity with PPC spending nearly R1 billion with a significant increase forecast for the next financial year. The R0.5 billion additional investment made this year by construction material entities was more than offset by the R1.2 billion decrease in heavy construction entities' capital expenditure.

Purchases of investments increased from R0.8 billion in the prior year to R4.9 billion in the current year mainly as a result of Murray &Roberts' R4.4 billion acquisition of all shares held by the non-controlling interest at Clough.

Cash flows from financing activities

Net inflow of R0.3 billion after a R1.7 billion outflow in the prior year

Net proceeds from borrowings was R2.3 billion in the current year. Murray & Roberts and Aveng increased their borrowings by R1.3 billion each. Basil Read decreased its borrowings by R0.5 billion on the back of its disposal of TwP.

Distribution to shareholders increased marginally to R1.9 billion. PPC was the biggest dividend payer with R0.8 billion. WBHO (R0.3 billion) and Basil Read (R0.2 billion) were other notable dividend payers.

Financial position

	Current year	Prior year	Difference	
	R 'millions	R 'millions	R 'millions	% change
Non-current assets				
Property, plant and equipment	23 891	23 320	571	2%
Investments at fair value	3 573	2 927	646	22%
Deferred tax asset	2 503	2 529	(27)	(1%)
Non-current receivables	6 101	5 183	918	18%
Other non-current assets	6 763	7 414	(651)	(9%)
	42 830	41 373	1 457	4%
Current assets				
Inventories	6 895	6 503	391	6%
Contracts in progress	15 557	14 742	814	6%
Trade and other receivables	21 064	19 774	1 290	7%
Cash and cash equivalents	18 303	20 559	(2 256)	(11%)
Other current assets	2 642	1 798	845	47%
	64 460	63 376	1 084	2%
Assets held for sale	2 146	2 657	(510)	(19%)
Total assets	109 436	107 406	2 030	2%
Equity and liabilities				
Equity				
Share capital	10 087	9 343	744	8%
Other equity	30 389	30 574	(185)	(1%)
Non-controlling interest	1 030	1 972	(942)	(48%)
Total equity	41 506	41 889	(383)	(1%)
Liabilities				
Non-current liabilities				
Interest-bearing borrowings	8 304	6 715	1 588	24%
Deferred tax liabilities	2 164	2 075	90	4%
Other non-current liabilities	3 286	3 500	(214)	(6%)
	13 754	12 290	1 463	12%
Current liabilities				
Excess billings over work	5 522	5 319	203	4%
Trade and other payables	33 801	34 736	(935)	(3%)
Interest bearing borrowings	5 316	3 379	1 937	57%
Other Current Liabilities	8 564	8 907	(343)	(4%)
	53 202	52 340	862	2%
Liabilities held for sale	975	887	88	10%
Total liabilities	67 930	65 517	2 413	4%
Total equity and liabilities	109 436	107 406	2 030	2%
Key ratios	**Current year**	**Prior year**		
Solvency ratio	1.6	1.6		
Liquidity ratio	1.2	1.2		
Acid ratio	1.1	1.1		
Gearing ratio	12%	9%		

Sound financial position?

Solvency and liquidity ratios remained strong and have remained in line with the prior year at 1.6 and 1.2 respectively. Although the gearing ratio increased from 9% in the prior year to12% in the current year (heavy construction 6% to 9%), the ratio is still low and points to the fact construction is not only working capital intensive but often also working capital funded.

These ratios are all derived from historical cost-carrying amounts and therefore do not necessarily reflect the true fair-value trends. A better indication of investors' perception of these carrying amounts and potential future growth is the market value of these entities. The market capital as a multiple of the net asset value, less non-controlling interest, remained constant at 1.7. However, for heavy construction it reduced from 1.3 in the prior year to 1.2 in the current year. This indicates a decrease in confidence in the financial position as reflected in the financial statements.

At an individual company level as at 30 June 2014, there were four (2013: four) companies with net asset values exceeding the market capitalisation of the company. In the prior year Protech was included in this list and was subsequently liquidated.

Market capitalisation on 30 June 2014 as a percentage of net asset value excluding non controlling interest (NCI)

	Current year	Prior year
Esorfranki	20%	57%
Basil Read	46%	56%
Aveng	72%	88%
Stefanutti Stocks	83%	85%

Source: PwC analysis

The preceding table shows a disconnect between the market perception of value for these companies and management's perception of the fair value of the underlying assets. The reason for this difference may be attributable to incomplete information available to the market, differing perceptions over contract successes and close outs and different views on the profitability of order books. These companies face a tough task convincing the market of their value.

Non-current assets

Property, plant and equipment (PPE) increased marginally by 2% as the increased capital expenditure was offset by depreciation.

Non-current receivables, relating to contractual debtors where payments are expected after 12 months, have increased by R0.9 billion (18%). This increase is indicative of the additional investment required in working capital and the resultant cash constraints this creates.

Other non-current assets, made up significantly of goodwill and other investments, have reduced by R0.7 billion. The reduction is largely as a result of impairment of goodwill of R756 million recognised by Aveng on the Grinaker and LTD merger that was concluded in 2001.

Working capital

Heavy construction contract working capital position

	Current year R 'millions	Prior year R 'millions	Difference R 'millions	Difference %
Contracts in progress	15 526	14 700	826	6%
Trade and other receivables	18 410	17 604	806	5%
Excess billings over work	(5 522)	(5 319)	(203)	4%
Trade and other payables	(31 085)	(32 428)	1 343	(4%)
Working capital position	(2 671)	(5 443)	(2 772)	(51%)
Cash and cash equivalents	16 358	18 534	(2 176)	(12%)

Source: PwC analysis

The construction working capital position reflects a fairly balanced position. Four of the entities are in a negative working capital position. These positions often relate to advance payments received when projects are undertaken in higher-risk environments.

If working capital is managed well it can be an excellent source of capital for a construction company. However, these positions will unwind as contracts come to completion and if these entities do not have replacement projects or funding in place this could result in significant negative liquidity issues. Compounding the liquidity issue is the often protracted time taken for final commercial close out of a contract, which can result in a further lock up of cash in working capital.

Cash position

The cash position remains strong and allows these companies to take on large-scale projects. The difference between this cash balance and that of the cash flow statement is over drafts included in short-term borrowings on the balance sheet.

Financing for sustainability

The companies evaluated were all in a net cash position, in order to comply with the requirements of large construction projects. Guarantees are usually backed by the cash balances and no changes are expected to occur in the near future.

The construction industry is well placed to cope with new growth requirements. However, managing short-term liquidity needs will be crucial.

Financial impact of IFRS 11 Joint Arrangements

IFRS 11 Joint Arrangements (IFRS 11) became effective for financial periods beginning on or after 1 January 2013 and therefore for the financial years covered by this publication. The standard is applied retrospectively.

IFRS 11 requires an entity do determine whether or not it shares joint control with other investors. This assessment has, perhaps surprisingly, not resulted in many changes from the previous assessment of joint control under IAS 31 Joint Ventures for the companies included in our analysis. Only 22% of construction companies in our analysis showed a significant change on adoption of IFRS 11.

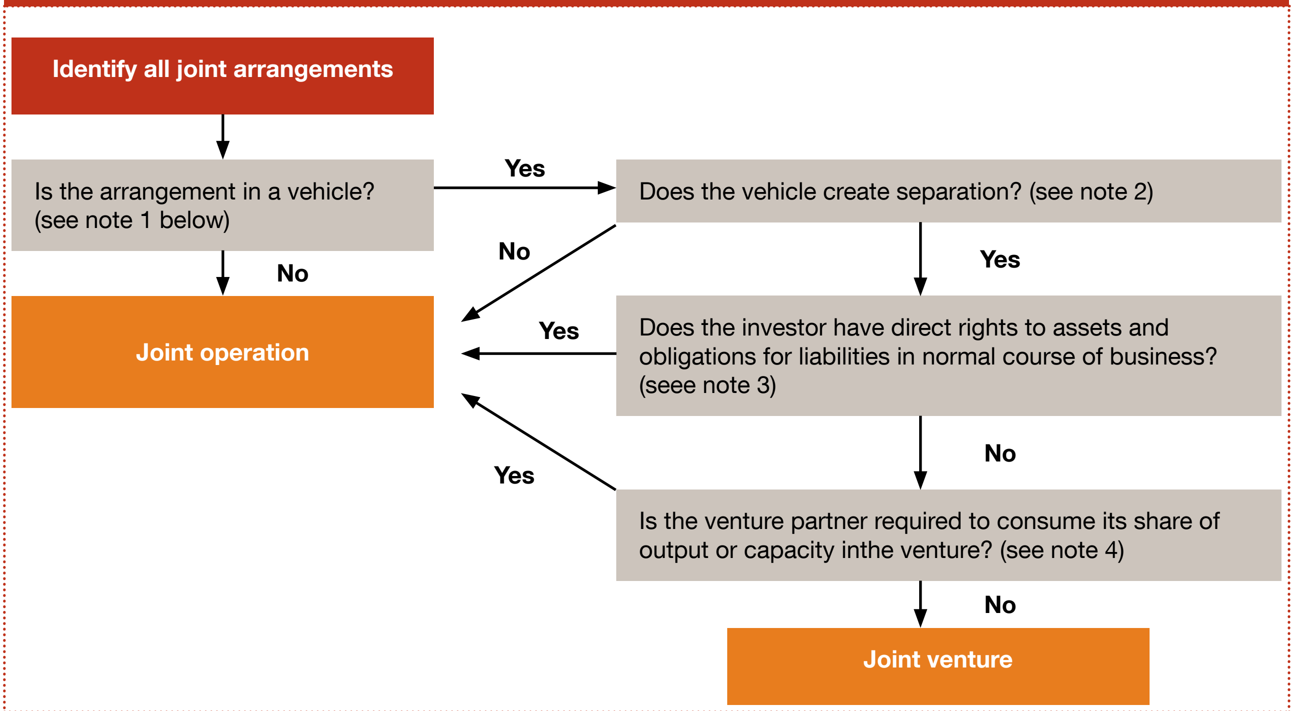
Determination of the type of joint arrangement is a complex process under IFRS 11. From the point that the determination of the type of joint arrangement has been made, there are no accounting options available. There are two types of joint arrangement under IFRS 11: joint operations and joint ventures. A venturer accounts for its interest in a joint operation as its share of assets, liabilities, revenue and costs. A joint venture is accounted for under IAS 28 Equity Accounting.

The increasing risks and complexity of engineering and construction operations have resulted in more joint arrangements being structured through legal entities. A legal entity is preferred to a partnership particularly where the venture partners are seeking to limit their potential liability to prospective creditors and other obligations, such as guarantees. IAS 31 allowed a policy choice for accounting for incorporated entities.

Venturers frequently accounted for their interest in incorporated joint ventures using proportionate consolidation. On transition to IFRS 11, some construction entities could not continue with their existing accounting practices, resulting in restated financial statements. Our analysis shows that 56% of companies now reflect investments in joint operations, where 89% of companies are party to joint operations that result in the investor accounting for their share of the assets and liabilities, income and expenses of the joint operation.

An entity must determine the type of joint arrangement in which it is involved by considering its rights and obligations arising from the arrangement. A joint arrangement that is not structured through a separate vehicle is a joint operation. All joint arrangements in separate vehicles are not, however, automatically joint ventures. A joint arrangement in a separate vehicle can still be a joint operation. It depends on the rights and obligations of the venturers arising from the arrangement in the normal course of business and is further influenced by the economic purpose of the joint arrangement.

The flow chart be.low illustrates the decision-making process and the factors that need to be considered in properly classifying joint arrangements as operations or ventures.



Classification of joint arrangements

1. There are many different types of vehicles used for joint arrangements in the construction industry, including partnerships, unincorporated entities, limited companies and unlimited liability companies. Ventures must assess all their joint arrangements and identify those that are operated through separate vehicles. Joint arrangements that are not operated through a separate vehicle are joint operations.
2. The legal structure of the vehicle or the contractual terms between the venturers may not provide for legal separation of the venture from the venture partners. In other words, the venturers remain exposed to direct interest in the assets and liabilities of the venture. In South Africa, general partnerships, for example, may not achieve separation from the partners because the contractual terms of the partnership agreement provide direct rights to assets and expose the partners to direct obligations for liabilities of the partnership in the normal course of business. Similarly, unlimited liability entities provide the venture partners with direct rights to the assets and revenue of the joint operation as well as obligations for the liabilities and expenses of the joint operation. Joint arrangements conducted in vehicles that do not create separation are joint operations.
3. A joint venture established by contract does not have a legal persona in the South African legal system. There is therefore no legal separation between the separate vehicle and the parties to the arrangement. The most logical point of departure to determine separation would probably be to ascertain who would be cited as defendants/respondents in legal action by third parties against the joint arrangement. The concept of a joint arrangement does not exist in South African law and joinder procedure in terms of the Court Rules will be applied to join venture parties to a law suit. The parties will be cited in the same fashion as one would do for a partnership. Clauses limiting liability and excluding 'partnership consequences' from the venture are of no force and effect vis-a-vis third parties. If the legal form of the separate vehicle does not confer separation between the separate vehicle and the parties, the standard would indicate that the arrangement is a joint operation.
4. The parties' rights and obligations arising from the arrangement are assessed as they exist in the 'normal course of business' (IFRS 11 paragraph B14). Legal rights and obligations arising in circumstances that are other than in the 'normal course of business', such as liquidation and bankruptcy, are, therefore, much less relevant. A separate vehicle may give the venture partners rights to assets and obligations to liabilities as per the terms of their agreement. However, in case of liquidation of the vehicle, secured creditors have the first right to the assets and the venture partners only have rights in the net assets remaining after settling all third-party obligations. The vehicle could still be classified as a joint operation as, in the 'normal course of business', the venture partners have direct interest in assets and liabilities. Separate vehicles that give venture partners direct rights to assets and obligation for liabilities of the vehicle are joint operations. We have found that it is difficult to overcome the legal separation created by legal wrapper, for example, a private company, by including additional paragraphs to that effect in contracts and agreements.
5. IFRS 11 paragraph B33 explains that, in addition to the above, 'other facts and circumstances' must be considered when classifying an arrangement. One of these specifically mentioned in the standard, refers to the output of the arrangement. Separate vehicles structured such that all of their outputs must be purchased or used by the venture partners may also be joint operations. However, the contractual terms and legal structure of the vehicle need to be carefully assessed. There must be a contractual agreement or commitment between the venture parties that requires the parties to purchase or use their share of the output or capacity in the venture. If the venture can sell the output to third parties at market prices, this criteria is unlikely to be met.

The IFRS Interpretations Committee received a request to clarify how the assessment of 'other facts and circumstances' described in IFRS 11 affects the classification of a joint arrangement as a joint operation or a joint venture.

The Interpretations Committee considered whether the assessment of 'other facts and circumstances' should be undertaken with a view only towards whether those facts and circumstances create enforceable rights to the assets and obligations for the liabilities or whether that assessment should also consider the 'design and purpose' of the joint arrangement, the entity's business needs and the entity's past practices. The IFRS Interpretations Committee concluded in May 2014 that there is sufficient guidance in IFRS 11 that requires the classification of a joint arrangement to depend on the rights to the assets and the obligations for the liabilities and that these rights and obligations are, by their nature, enforceable. Consequently, the Interpretations Committee noted that the assessment of 'other facts and circumstances' should focus on whether those facts and circumstances create rights to the assets and obligations for the liabilities.

IFRS 11 implementation issues continue to remain on the IFRS Interpretation Committee agenda. We look forward to keeping you up to date in this regard.

8. *Glossary*

Acid ratio	(Current assets less inventory)/Current liabilities
ACSA	Airports Company of South Africa Limited
Adjusted EBITDA	EBITDA adjusted for impairment charges
ASPASA	Aggregate and Sand Producers Association of South Africa
B-BBEE	Broad-Based Black Economic Empowerment
DAWN	Distribution and Warehousing Network
EU-OSHA	European Agency for Safety and Health at Work
GEPF	Government Employees Pension Fund
HDI	Historically disadvantaged individual
HDSA	Historically disadvantaged South African
IEA	International Energy Agency
IPP	Independent power producer
JSE	Johannesburg Stock Exchange
KPI	Key performance indicator
Market capitalisation	The market value of the company calculated as the number of shares outstanding multiplied by the share price
MTEF	Medium-Term Expenditure Framework
NCI	Non-controlling interest
Net borrowings	Interest-bearing debt, less cash
PBIT	Profit before income and tax
PIC	Public Investment Corporation
PPE	Property, plant and equipment
REIPPPP	Renewable Energy Independent Power Procurement Programme
SANRAL	South African National Roads Agency Limited
SARS	South African Revenue Service

9. Other information

Companies included in the analysis

	Heavy construction	Company year end
1	Aveng Limited (Aveng)	30 June 2014
2	Basil Read Limited (Basil Read)	31 December 2013
3	Calgro M3 Holdings Limited (Calgro)	28 February 2014
4	Esorfranki Limited (Esorfranki)	28 February 2014
5	Group Five Limited (Group Five)	30 June 2014
6	Murray and Roberts Holdings Limited (Murray & Roberts)	30 June 2014
7	Raubex Group Limited (Raubex)	28 February 2014
8	Stefanutti Stocks Holdings Limited (Stefanutti)	28 February 2014
9	Wilson Bayly Holmes-Ovcon Limited (WBHO)	30 June 2014

Construction materials & fixtures

1	Afrimat Limited (Afrimat)	28 February 2014
2	Distribution and Warehousing Network Limited (DAWN)	30 June 2014
3	KayDav Group Limited (KayDav)	31 December 2013
4	Masonite (Africa) Limited (Masonite)	31 December 2013
5	Mazor Group Limited (Mazor)	28 February 2014
6	PPC Limited (PPC)	30 September 2013
7	Sephaku Holdings Limited (Sephaku)	31 March 2014

Basis for compiling this report

The data set out in this publication was drawn from information publicly available for the period ended 30 June 2014. The information was taken from the annual reports of the Construction and materials companies listed on the JSE.

The results aggregated in this report have been sourced from information that is publicly available, primarily annual reports or reviewed results made available to shareholders. Companies have different year ends. The information included is based upon aggregated results of those construction and materials companies reported on.

For companies with year ends other than 30 June, their latest available annual reports with year ends in the 12 months prior to June 2014 were used. Therefore results for September 2013, December 2013, February 2014 and March 2014 were also included. No adjustments have been made to take the different year ends into account.

All currency figures in this publication are reported in South African rands, except where specifically stated otherwise. Some diversified companies undertake part of their activities outside the construction industry. No attempt has been made to exclude such non-construction activities from the aggregated financial information.

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