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Business pulse: Loadshedding continues to stifle activity

Highlights

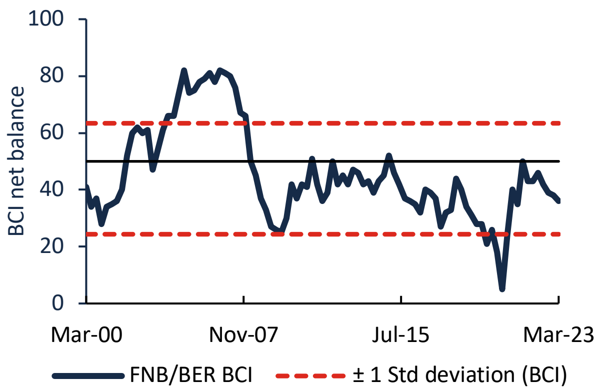
- Business confidence, measured by the FNB/BER Business Confidence Index (BCI), worsened to 36 points in the first quarter of the year.
- Weaker confidence in manufacturing (down by nine points) and retail (down by eight points) mainly drove the decline.
- Business sentiment is still low against the backdrop of persistent power cuts, low growth in private sector fixed investment, challenges in the logistics network and concerns about current and future weather conditions.
- Energy insecurity is greatly impeding the business environment. Because of loadshedding, businesses are procuring large volumes of diesel each month to ensure that they remain operational during power cuts. The monthly cost is in the region of millions, which negatively affects businesses' bottom line. While large businesses have shown financial resilience despite the rising costs, small businesses are affected the most because they cannot afford to acquire alternative sources of energy.
- Gross fixed capital formation (GFCF) as a share of gross domestic product (GDP) is close to all-time lows. Real growth in fixed investment by the private sector declined by 1% quarter-on-quarter (q/q) in the third quarter of 2022, which is not good for overall GFCF because the private sector contributes the most to growth in fixed investments.
- Government's energy reforms are expected to support private sector fixed investment. However, this is only expected to gain momentum from next year onwards. This is informed by Treasury's estimate of 1.3% this year and 3.8% in 2024 as well as delays in implementing some of the reforms as reported in the Operation Vulindlela (a programme fast-tracking certain structural reforms) progress report.
- Seasonally adjusted (sa) mining production decreased by 3.4% q/q in the fourth quarter of 2022. This sector is expected to remain constrained if higher levels of loadshedding persist given that the sector is more energy intensive. However, the re-opening of China may provide a slight boost through higher commodity prices.
- The decline in the ABSA Purchasing Managers' Index (PMI) to 48.8 points in February 2023 signals lower activity in the manufacturing sector during that month. Moreover, the significant decline in the expected business conditions and business activity sub-indices indicate that the sector will likely experience lower activity in the coming months.
- The q/q growth rate in the value of business plans passed in the fourth quarter may support activity in the construction sector.
- Despite growing challenges in the agriculture sector (concerns about El Niño, trade restrictions and animal disease outbreaks), production remains agile.

- The worsening BCI suggests that business conditions are expected to be constrained. Furthermore, downside risks that informed the decrease in BCI are expected to remain. Consequently, we expect pedestrian growth of around 1% this year and around 1.5% in 2024.

Business confidence deteriorated for the fourth consecutive quarter

The BCI deteriorated by two points from 38 in the fourth quarter of 2022 to 36 points in the first quarter of this year. According to the Bureau for Economic Research (BER), this outcome is, nevertheless, better than expected given the energy crisis and lower business activity.

Chart 1: BCI deteriorated further



Source: BER, Global Insight, Momentum Investments

Three out of the five underlying industries surveyed were increasingly pessimistic about prevailing business conditions. Manufacturers' confidence fell from 26 points in the last quarter of 2022 to 17 points. This is the worst level since the peak of the pandemic in June 2020. The BER attributes this to loadshedding, poor infrastructure and lower fixed investment due to weaker demand and reprioritising funds toward alternative sources of energy.

The second driver of lower BCI was the retail sector. Confidence from participants in this sector declined by eight points to 34 points, reflecting the disruptions that power outages caused, as well as constrained household finances.

Building contractors were also slightly more pessimistic with confidence levels falling by three points to 43 points in the first quarter of 2023. The BER does however note that the inclusion of sub-contractors in this category leads to greater confidence levels supported by an increase in backup power projects.

An improvement in sentiment by three points was registered from wholesalers and new vehicle dealers. However, the respective indices remain below the 50-neutral mark.

These outcomes indicate that loadshedding weighed on sentiment in some sectors but provided a lift in other sectors focused on backup power projects. Nevertheless, the outcome and risks of loadshedding remain tilted to the downside.

Mounting cost pressures on businesses due to loadshedding

Loadshedding was more severe and lasted longer during the fourth quarter of 2022. The total hours of national loadshedding increased to 1 944 (81 days) in the fourth quarter from 1 061 (44 days) in the third quarter. As such, South Africa (SA) experienced the worst loadshedding to date in the second half of last year.

One of the consequences of the ongoing power cuts is the increasing costs that businesses incur to mitigate the impact. The two main costs reported by different companies include significant amounts spent on diesel to power generators as well as procuring back-up generating capacity, although the latter is not a recurring cost.

As detailed in Table 1 below, the monthly cost of diesel is high and adds up to as much as R560 million over six months in the case of Shoprite.

Table 1: Companies report excessive monthly spend on diesel

Retailer	Cost per month*
Shoprite	R93 million
Pick n Pay	R60 million
Woolworths	R15 million
Dis-Chem	R6 million

Source: Business Day, Momentum Investments
** This is the average monthly cost over the second half of 2022*

There is a significant difference in the monthly spend on diesel due to the nature and size of the businesses. For instance, food retailers spend more on diesel in comparison to other retailers because they require more energy to keep fridges on during power cuts. Other organisations, such as Dis-Chem, use the generators mostly for lighting which does not require as much diesel. Another possible reason for the differences in costs may be due to the structure of the business. Shoprite is structured as a co-operative while the other businesses in Table 1 have or used to have a franchising structure so not all the stores are owned under one group. Therefore, the franchisor may not be liable to cover the costs of diesel in franchise stores thus making the group costs lower. While the additional costs related to mitigating the impact of loadshedding creeps into margins, most of the big retailers reported strong profit growth in 2022.

We do, however, believe that the impact of loadshedding is mostly felt by small businesses that cannot afford to shelter themselves during power cuts. Moreover, small businesses will likely not be in a position to take advantage of government's proposed incentive of a 125% deduction for renewable energy projects.

Larger businesses may also encounter some challenges in the pursuit to install rooftop solar photovoltaic (PV). Businesses that own the majority of their rooftop spaces (for example, Shoprite) are better positioned to ramp up the installation of solar PV. According to *Business Day*, Shoprite increased solar capacity by around 82% in 2022 and they plan on adding more. On the other hand, companies that do not own most of their rooftop space will be limited to take up this incentive and would, therefore, need to take extra measures. For example, Pick n Pay mentioned that they would need to negotiate with landlords to maximise the installation of solar or alternatively, request that landlords allocate a bigger share of the electricity generated through their renewable energy. This introduces a risk of higher operating costs which could be inflationary for consumers if costs are passed on.

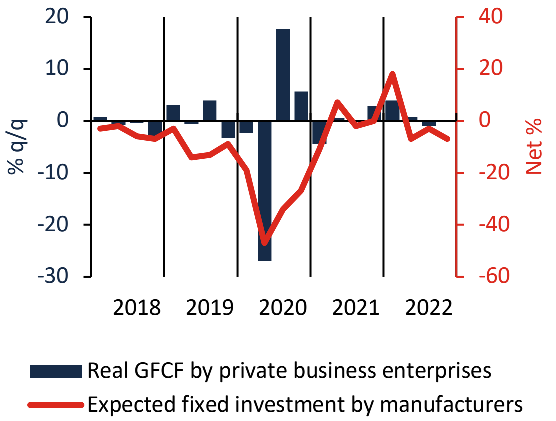
Government's incentive for businesses and households to invest in renewable energy is a step in the right direction. However, it will probably not reduce energy demand significantly during this year. Therefore, loadshedding will remain a prominent feature for business operations and costs throughout 2023. Against this backdrop and with the risk of more outages during winter, businesses will have to look into alternative ways of navigating these conditions. Pick n Pay identified actions to adapt to this environment, which include limiting the use of electricity through reducing lighting and air-conditioning, investing in inverters and battery storage as well as reprioritising capital investments.

Private sector investment unlikely to ramp up in 2023

Real GFCF by private businesses declined by 1% q/q in the third quarter of 2022. This was the first decline since the small decline of 0.3% in the third quarter of 2022 as illustrated in Chart 2. According to the SA Reserve Bank (SARB), this was due to the decrease of investment in machinery and equipment outpacing the increase in capital outlays in transport equipment and residential buildings.

The fourth quarter sub-index of expected fixed investment by manufacturers, according to the manufacturing survey, retreated to negative 7% following a slight improvement to negative 3% in the third quarter.

Chart 2: Manufacturers' fixed investment expectations point to lower GFCF

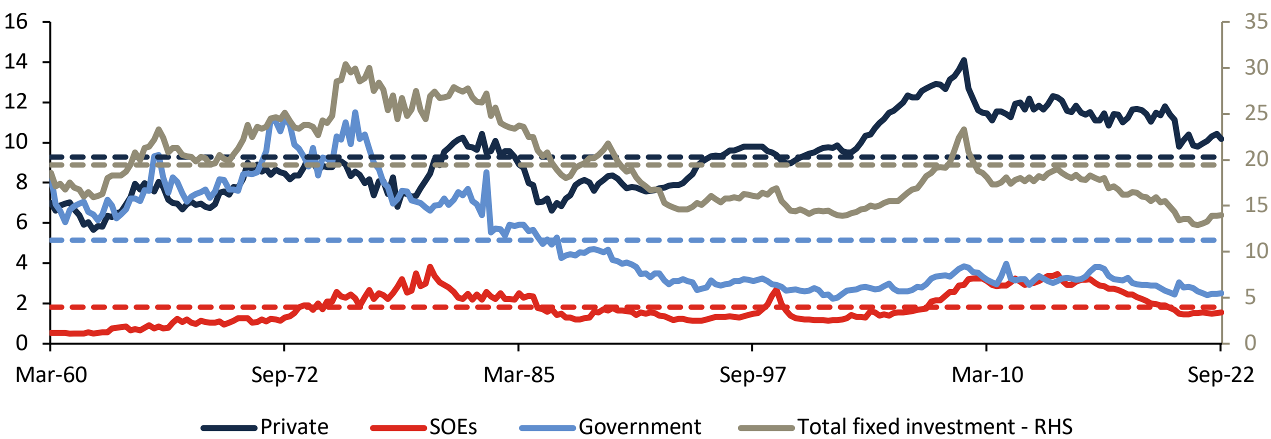


Source: BER, Momentum Investments, SARB, data until third quarter of 2022 for real GFCF and until the fourth quarter of 2022 for investment intensions

Low levels of growth in actual investment and negative sentiment from the private sector do not bode well for GFCF (outside of critical energy infrastructure spending) and ultimately trend growth given that the private sector accounts for the bulk of fixed investment in SA.

As seen in Chart 3, total fixed investment as a share of GDP is very close to historical lows at 14%. This is largely due to the rapid decline in government fixed investment which is trending well below its long-term average of 5.1%. Although private sector fixed investment as a share of GDP has also been on a downward trend since the global financial crisis and is below pre-pandemic levels, it is still growing above the long-term average of 9.3%. GFCF by the private sector may be supported by reforms announced to address the energy crisis.

Chart 3: Fixed investment to GDP (%) close to all-time lows*



Source: Iress, Momentum Investments

* *Dotted lines represent the respective long-term averages*

Government has expressed that greater private sector participation is required to resolve the energy crisis. The government has introduced tax incentives to encourage the private sector to invest in renewable energy. The R5 billion energy tax incentive was extended for two years in the Budget Review. Moreover, government has eased some regulatory red tape that had otherwise restricted the pace of registering projects. The licencing threshold for embedded generation projects was raised from 1 MW to 100 MW and this has led to a pipeline of more than 100 projects (9 000 MW) of new generation capacity.

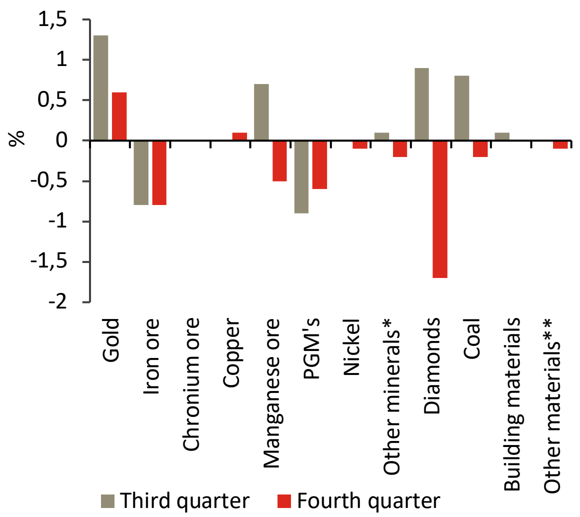
These reforms are expected to lead to more meaningful participation from the private sector. However, we note that it will take time given the uncertain operating environment due to loadshedding and political concerns, the high cost of borrowing, capital requirements and pedestrian growth. While some reforms, such as finalising the Electricity Regulation Act, are reported to be on track in the third quarter Operation Vulindlela progress update, other reforms such as implementing the Energy Action Plan and enabling municipalities to procure power from independent power producers are experiencing delays which will also stall growth in private GFCF.

Treasury estimates that total gross fixed-capital formation will grow by merely 1.3% this year and improve to 3.8% in 2024 and 3.5% in 2025.

Mining production expected to remain under pressure as loadshedding persists

Mining output decreased by 3.4% q/q, sa in the fourth quarter of 2022. This follows growth of 1.7% q/q (revised) in the third quarter. As illustrated in Chart 4, the lower growth rate in the fourth quarter was broad-based across eight of the 12 mineral groups and minerals. The largest negative growth was due to diamonds (negative 32.4% q/q, contributing negative 1.7%), iron ore (negative 6.8% q/q, contributing negative 0.8%) and Platinum Group Metals (PGMs) (negative 2.5% q/q, contributing 0.6%).

Chart 4: Broad-based decrease in mining production growth



Source: Global Insight, Momentum Investments
**Other metallic minerals*
*** Other non-metallic materials*

Electricity outages are adversely affecting the mining sector during higher stages of loadshedding (above stage 4). This is because in most cases, mines must halt production to adhere to health and safety standards whereas sectors such as retail can still operate. During the fourth quarter of 2022, the country experienced 159 hours of stage five loadshedding, up from 138 hours in the third quarter and 118 hours of stage 6, up from 59 in the third quarter. Moreover, hours of stage five and six loadshedding in the first quarter of this year (data until 7 March 2023) are higher than the fourth quarter which indicates that we can expect a further decrease in mining production during the first quarter and a detraction from gross value that the mining sector adds.

Given that we anticipate loadshedding to persist during 2023, the mining sector is expected to remain under pressure particularly in instances of more severe loadshedding. Sieberana Research estimates that almost 30% of annual PGM production would be lost if miners do not go underground during stage six and higher.

More challenges on the domestic front stemmed from constraints that Transnet faced, which resulted in a decline in the volume of exports and thus production. According to the Minerals Council of SA, the mining sector could have earned R150 billion more in exports in 2022 which could have boosted fiscal revenues by R27 billion. Therefore, it is paramount that issues such as the unavailability and reliability of locomotives are addressed to create a more conducive environment for the mining sector.

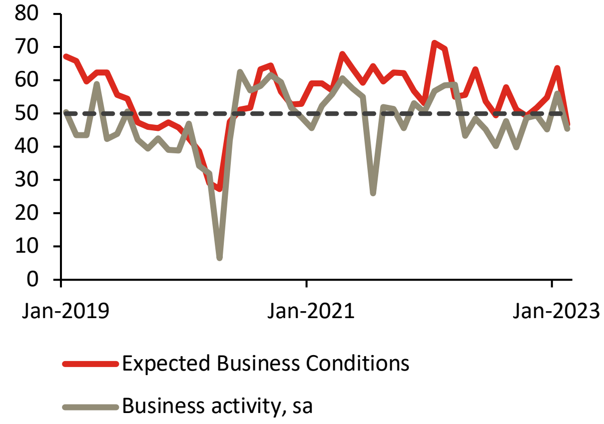
The re-opening of the Chinese economy is expected to be supportive of commodity prices which may be slightly positive for the sector's contribution to GDP. However, given that production did not respond significantly to the post-pandemic commodity boom, it is unlikely that the re-opening of China would lead to a massive increase in production. Moreover, RMB Morgan Stanley cautions that some commodities stand to gain more than others from the re-opening. Copper, nickel and steel are expected to rally the most while the demand for palladium is expected to be lower than in 2021. This commodity mix makes it more favourable for Latin America than SA.

Manufacturers express pessimism about business conditions in 2023

Manufacturing production was weak in the fourth quarter of 2022. The production index decreased in November and December by 1.8% y/y and 4.7% y/y, respectively, following growth of 1% y/y in October. Moreover, manufacturing production decreased by 1.6% q/q in the fourth quarter of 2022 relative to the third quarter. This was contrary to the movement in the ABSA PMI which averaged 51.9 index points, sa (expansion territory) in the fourth quarter, up from an average of 49.6 index points in the third quarter of 2022. This marks the second consecutive instance of an opposing movement between these two indicators since June 2021. This could be attributed to the uncertainty of loadshedding which could result in manufacturers understating or overstating the nature of business conditions. For instance, the total national hours of loadshedding in the first half of December was around 341 and this escalated to almost 440 hours in the second half of the month.

The ABSA PMI fell to 48.8 index in February 2023, the lowest point since September 2022. This signals weak outcomes in manufacturing activity during February. The sub-indices that deteriorated the most were business activity and the expected business conditions index, which measures manufacturer's expectation of business conditions in six months' time. This points to a constrained environment in manufacturing over the coming months.

Chart 5: Sharp declines in these sub-indices signals lower activity in the manufacturing sector (index level)



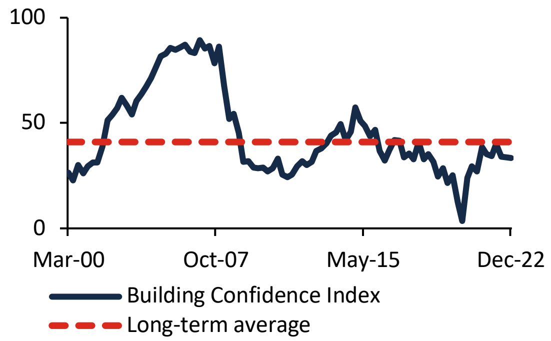
Source: Global Insight, Momentum Investments

The business activity sub-index fell sharply by 10.5 points to 45.5 points, reflective of the severe loadshedding during the month. The index measuring manufacturers' expectations of business conditions also deteriorated sharply by 17 points from a healthy 63.8 points to 46.8 points. Interpreting this in conjunction with the deterioration of manufacturers' expectation of business conditions in 12 months in the third quarter BER Manufacturing Survey, from negative 17 to negative 20, indicates that manufacturers' pessimism about the operating environment stretches over a longer period.

Growth in value of building plans passed signals to increased construction activity

The FNB/BER Building Confidence Index declined slightly from 34 in the third quarter of 2022 to 32 in the fourth quarter. The index was dragged down by retailers (negative 17), architects (negative 16) and sub-contractors (negative 15). The pessimism of architects in the fourth quarter reversed all the gains from the third quarter. Manufacturers and contractors displayed the most optimism during this period with the confidence index of contractors returning to 46, the only category with sentiment above the Building Confidence Index long-term average of 41.

Chart 6: Building Confidence Index remains below long-term average



Source: Global Insight, Momentum Investments

The real value of building plans completed contracted by 4.9% q/q, sa in the fourth quarter following a significant contraction of negative 21.5%, sa (revised) in the third quarter. This was largely due to a smaller contraction in additions and alterations of negative 18.5% q/q, sa (third quarter: 52.5% q/q, sa).

On the other hand, the value of building plans passed recorded an increase of 6.6% q/q, sa following two consecutive contractions. However, these were of a lesser degree than the contractions in plans completed.

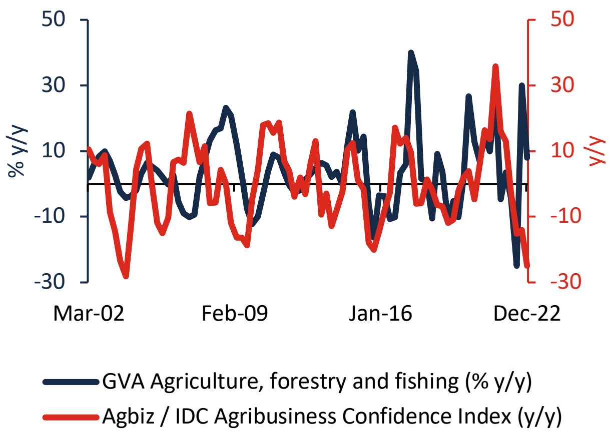
The growth in the value of plans passed was due to residential buildings (11.8% q/q, sa) and non-residential buildings (18.6% q/q, sa). A decline was recorded for additions and alterations (negative 8.1% q/q, sa).

The growth in the value of plans passed does garner some support for the sector. However, the high vacancy rates in non-residential and residential property will limit growth in the sector.

Agriculture activity decreased in the fourth quarter following a surge in the third quarter

The agriculture sector registered a surprisingly strong performance in the third quarter of 2022. This strong performance contradicted the Agbiz/IDC Agribusiness Confidence Index which deteriorated by seven points in the third quarter. However, the sector decreased by 3.3% in the fourth quarter (contributing negative 0.1% to GDP). The fourth quarter outcome was aligned with the further decrease in the Agribusiness Confidence Index.

Chart 7: Agriculture surprised to the upside in the fourth quarter



Source: Agricultural Business Chamber of SA, Momentum Investments and SARB

The Agbiz/IDC Agribusiness Confidence Index fell for the fourth consecutive quarter in the last quarter of 2022. The index dropped to 49 points, below the 50-neutral mark for the first time since the second quarter of 2020. The reasons for the renewed pessimism are high input costs, continuous power outages, outbreak in animal diseases, an increase in trade protection and disruptions in the logistics network.

The drop in the Agribusiness Confidence Index was broad-based with seven of the 10 sub-indices recording declines. The sub-index measuring volumes of exports plunged by 20 points to 50. The institution cited reasons related to reduced access of certain products to the European Union and Namibia and the animal disease outbreak, which affected production. We also believe the difficulties that Transnet faced may be contributing to the depressed sentiment on exports.

The sub-index measuring general agricultural conditions was also below the 50-neutral level at 40 points and the general economic conditions index remained well below the neutral level at 25 points. Concerns cited include unfavourable weather conditions. The more immediate concern is above-normal rainfall which delays and damages plantings. In the first half of February 2023, government declared a national state of disaster because of flooding in seven of the nine provinces in the country.

There is, however, growing concern around the pending El Niño season which is expected during the SA winter. El Niño increases the likelihood of drought which is a threat to production and would decrease harvest expectations. On the other hand, El Niño conditions are more favourable for crop production in the United States.

Agrimark Consulting notes that although the sector faces numerous challenges, food security is expected to be stable over the next two years.

Business operating conditions remain challenging

Seasonally-adjusted real GDP in the fourth quarter revealed that growth in eight of the 10 sectors decreased on a q/q basis on the production side. These included the agriculture, mining, manufacturing and construction sectors. While all the sectors were confronted with different industry-specific headwinds, the impact of loadshedding cut across all of them. Therefore, resolving the energy crisis is essential to boost economic activity across the sectors and improve business sentiment. Moreover, government's energy reforms will create an opportunity for more private sector fixed investment which could provide a much-needed boost to economic growth and employment over the medium to long term.

Bigger organisations have shown resilience in their financial position despite rising costs associated with lessening the impact of power cuts. However, smaller companies are not performing as well.

The number of liquidations and insolvencies decreased to 159 cases in December 2022 from 166 in the previous month. The drop to 81 cases in January 2023 was surprising given media coverage of how loadshedding is crippling small businesses. The *Sowetan* published a front page article in January which listed numerous small businesses that were struggling and on the brink of closing because of loadshedding. As such, we may see a rise in liquidations and insolvencies given soft business conditions. Moreover, we acknowledge that a large part of the economy would not be covered in the liquidation and insolvency statistics.

The weak BCI outcome indicates that business conditions are still expected to be challenging. This is on the back of loadshedding persisting, an underperforming logistics network, uncertainty around the pace of policy implementation and suppressed consumer confidence. As such, we expect lower economic growth of around 1% in 2023 and a slight improvement to around 1.5% in 2024 as more renewable energy comes online.