INTUITION
26 NOVEMBER 2021

Infrastructure investment: the foundation has been laid

The decline in South Africa's infrastructure has been well-documented over the past 20 years. A rule of thumb suggests that a country should invest 25% of its GDP into infrastructure to remain competitive. Measured quarterly, we have achieved that milestone only once in the democratic era. Following the revision higher of our GDP statistics (as discussed in Intuition on the 3rd September) our ratio of fixed investment to GDP has declined to just 13%. Nonetheless, there is evidence that the tide is turning, to the point where infrastructure investment is one of our key themes for the SA economy over the next 5 years.

SPEED READ

- **Following the revision of our GDP statistics, the ratio of fixed investment to GDP has fallen to just 13% - half of the 25% level required to maintain a competitive economy.**
- **After years of false starts, there is growing evidence of a change in trend, to the point that infrastructure investment is a key theme to watch in SA over the next five years.**
- **Two companies that stand to benefit are Afrimat and Reunert.**

Michael Porter

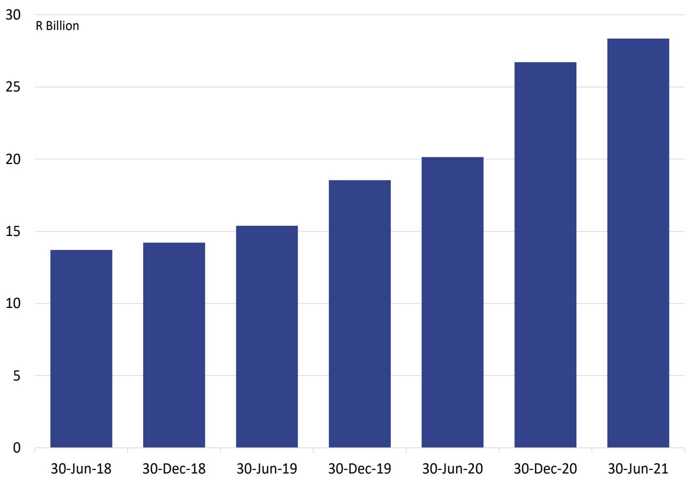
Sadly, evidence of the lack of investment in infrastructure is all around us – potholed roads, broken water pipes, leaking sewage, not to mention endless candle-lit dinners (and not the romantic kind!) For many years, South Africa has neglected its infrastructure and allowed it to deteriorate, to the point where it feels like the country is literally falling apart. Economists have a rule of thumb that a country should invest 25% of its GDP into infrastructure to provide the base for the economy to grow and thrive. When measured quarterly, we have come close to this goal just once – in Q3 2009 – in the democratic era. That was ahead of the FIFA 2010 World Cup when we invested hugely in stadiums, airports, the Gautrain, the Gauteng Freeway Improvement Project, and many others. Post the World Cup, the hangover set in. Infrastructure investment has plummeted, and the sector along with it. Once proud SA icons, such as Murray & Roberts and Grinaker LTA, are shadows of their former selves.

> "The SA construction contracting industry is a shadow of its former self – former household names have all but disappeared"

Fortunately, there are tentative signs that better times lie ahead. In part, this is simply driven by a resumption of spending from key clients such as SANRAL after a long hiatus, but it has also been driven by reforms. Interestingly, there has been more structural reform in the economy over the past 6 months than probably over the past 20 years. We will leave the general topic of reform for another day, but the changes to the electricity sector are the most important for our construction-related industry. Between the increased threshold for self-generation from 1MW to 100MW, the closing of the 5th round of renewable energy projects, and the pressure (and partial funding) to transition to a greener source of power, industry analysts suggest that we could spend up to R1 trillion on electricity infrastructure over the next ten years – a combination of new renewable power stations and strengthening the National Grid. This may well be greeted with a groan of scepticism – well-deserved given the track record – but the difference now is that the bulk of this will be funded by the private sector, not the government. Given that the cost of renewable power has fallen so dramatically, coupled with Eskom's woes that refuse to go away, there is a huge incentive for large industrial users to invest in their own power generation – to the benefit of the entire country.

Evidence that the tide is turning is illustrated in the chart below. The SA construction contracting industry is a shadow of its former self – former household names have all but disappeared. But two listed stalwarts have survived – WHBO and Raubex. The chart below tracks their order book for SA construction projects over the past 3 years. In June 2018, both companies combined had an order book of new projects worth just R14 billion. That has now jumped to R28 billion and is expected to rise further. This is just a small snapshot into the activities of two listed companies – other data also suggest that activity is rising across the economy.

SA CONSTRUCTION ORDER BOOK



After weathering a tough decade after the 2010 World Cup, the local construction industry is finally showing some signs of life. New projects are coming to market, driving up order books for the first time in years.

Intuitively, one might think that the best way to capitalize on the better times is by investing in the listed construction companies themselves. That is not necessarily the case. Construction companies are geared towards rising revenues, but they are volatile and risky, given that large projects carry risk. One wrong foot can erase all the profit and more. Such has been the case for WBHO in Australia where a massive road upgrade project has been beset by delays, cost overruns and hence large losses. For that reason, we prefer entry into the sector via other channels.

Afrimat

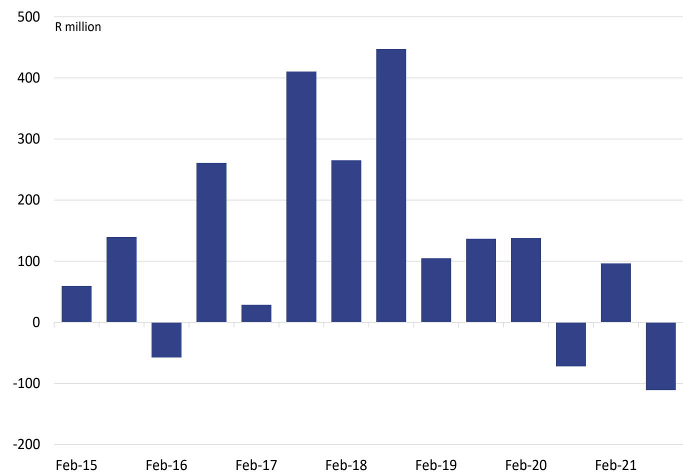
Afrimat was listed in 2006 ahead of the World Cup boom, but far from being a one-hit-wonder, it has grown consistently to become a formidable supplier of aggregates and building materials. The company regards itself as an expert in opencast mining – that foundation came from its long history of operating quarries – and has consequently diversified away from construction materials to include industrial minerals (such as dolomite and silica) and bulk commodities (iron ore and anthracite.)

Afrimat's predecessor company, Prima, was established in 1963 and the business has been growing ever since.

Given the combination of tough local conditions and buoyant commodity prices, many investors view Afrimat as just another small mining company – not related to the local construction industry at all. Whilst we can appreciate this argument, 35% of Afrimat's revenue is still derived from construction materials – and this is after some of the toughest conditions imaginable. We expect this ratio to rise as commodity prices stabilise at more realistic levels and local construction conditions improve.

Afrimat reported a rise in headline earnings of 60% for the 6 months ending August 2021. However, shareholders were not rewarded to the same extent. The dividend only rose by 14% - rather disappointing at first glance. But digging deeper, we believe that this is exactly why the company is so attractive. Let me explain. Over the past few years, Afrimat has made several acquisitions – expanding their presence in iron ore, anthracite and a new venture into manganese. Combined, these acquisitions cost over R1 billion, all funded through debt, not the issue of new shares. These acquisitions will lay the foundation for future growth, but excessive debt can drown even the ablest swimmer, especially in a rising interest rate environment. Given record commodity prices recently, Afrimat has used the windfall from these high prices to pay down debt rather than reward shareholders. This demonstrates a long-term

AFRIMAT NET DEBT



Afrimat's management team are known for their conservatism. Despite spending over R1 billion on acquisitions, the company is in a net cash position, which reduces the risk of volatile commodity prices.

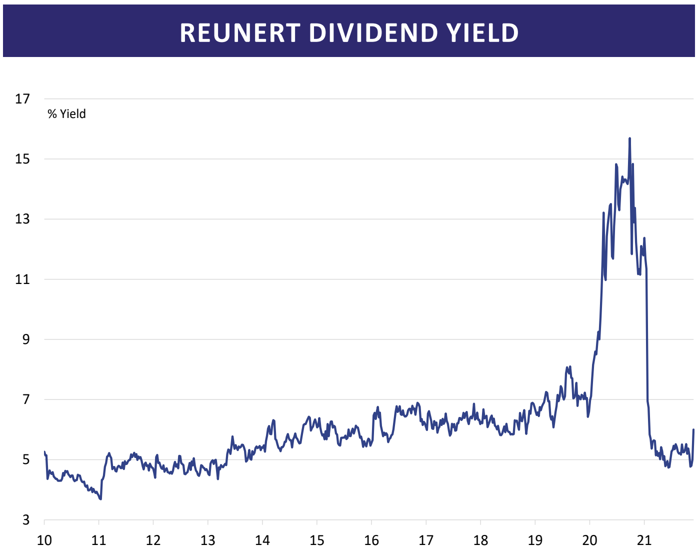
rather than short term focus. Whereas the business may have been at risk with high debt levels and weakening commodity prices, that risk has been largely mitigated. The management team at Afrimat are considered to be some of the best in the business, and this is a prime example. The team has delivered a compound annual growth rate of 24% over the past 10 years, despite the SA environment. We believe they can do the same looking forward.

Reunert

Reunert is one of SA's oldest industrial companies. It was established in 1888 and listed in 1948. Yet despite its heritage, it has largely fallen off the radar screen in recent years as our economy suffered death by a thousand cuts. Yet despite the tough times, the company has steadily grown its earnings (except for the impact of Covid) and rewarded shareholders with generous dividends.

Reunert is a multi-disciplinary firm, offering various forms of cabling (high and low voltage electric cables, and fibre), low voltage switches and circuit breakers, fibre services to the end consumer, renewable energy solutions and defence products, amongst others. Given the reform to the electricity sector, as well as the steady rollout of fibre across the country, we believe Reunert is uniquely positioned to benefit from this reform through its electrical engineering and applied electronics divisions. Together, these account for 75% of revenues, but a smaller percentage of profits given the tough recent conditions.

Included in the Applied Electronics cluster is a business called Terra Firma Solutions, one of the country's leading providers of turnkey renewable energy solutions. Core to their offering is their (B-O-O offering – build, own, operate). Over the past 3 years, their ownership of solar assets has grown by 144% per annum. Examples of their projects would be solar installations at shopping centres and large office blocks, where they provide the solar infrastructure and battery storage to ensure a seamless service. In addition, they have launched a joint venture to target similar opportunities across Africa. Given the deregulation and reform, there is almost unlimited opportunity in this segment.



Reunert has a long track record of paying solid dividends to its shareholders.

Like Afrimat, Reunert is conservatively managed. The company has no debt, and strong cash flows. It reinvests into its facilities to maintain efficiencies, and then generally pays the excessive cash out to its shareholders. On that basis, Reunert has a solid dividend history that has rewarded shareholders over time.

Both Afrimat and Reunert have demonstrated their ability to navigate the toughest of times in SA. They exit that period in a strong position that bodes well should local conditions improve as expected. But equally, they can weather another tough year should the promise fail to materialize. Let's hope for all our sakes that that is not the case.

Reunert has a long and storied history in South Africa as one of our country's leading industrial firms but has been off the radar of late.

Now that we have moved back to Level 1, we are delighted to once again be able to host clients at our Insight Seminars. We will hold our next seminar in December, which will focus on the outlook for 2022 amd the key themes that we expect to unfold. For those based in the Midlands, please note the change of venue. The presentation will be followed by drinks and snacks. Seating is limited and subject to regulation, so please ensure that you book.

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Topic: **2022: a brighter year?**

Natal Midlands	
Date:	2nd of December
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	13th January 2022
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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