Productivity remains under pressure

The main culprit here is unit labour costs, due to soaring real wage growth in key production and government-led sectors - Jeff Schultz

Conventional wisdom blames lack of fixed investment for SA's disappointing growth. Private firms are not investing, we have been told, because business confidence has sunk to 15-year lows thanks to uncertainty on the political and regulatory front. There is also the fact that demand conditions, both at home and abroad, have been too weak to warrant business expansion.

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But this is only half the story.

The main culprit

BNP Paribas economist Jeff Schultz has dug deeper into the health of SA's corporate sector to try to understand its consistently poor economic and investment performance. His results aren't encouraging.

Large swathes of SA's once-profitable firms and factories are experiencing faltering turnover, squeezed industry profitability, waning capital-replacement ratios and, typically, poor returns on assets, he finds.

"While weak cyclicality is partly to blame, the narrowing gap between real turnover growth and employment costs indicates that company productivity is under pressure," writes Schultz in a research note. "The main culprit here is unit labour costs, due to soaring real wage growth in key production and government-led sectors."

Profits under pressure

Schultz's starting point is to examine trends in company turnover.

Stats SA's latest "Quarterly Financial Statistics" report shows that corporate sales shrank by 5,2% q/q in the first quarter of the year - the worst quarterly drop in five years. On an annual basis, SA's corporate sector recorded unusually slow real sales growth of just 1,4% compared to the double-digit turnover growth enjoyed before the 2008 financial crisis.

Profitability - another key driver of firms' willingness to undertake capital expenditure - is also under pressure. Worst hit has been the mining sector, whose profit margin was down 17,8 percentage points (pp) in the first quarter compared to its 10-year average.

The transport, storage and communications sector was down 6,3pp, utilities 10,4pp, manufacturing 2,2pp, real estate and business services 1,1pp and construction 1,0pp.

According to Schultz's analysis, the average pretax profit margin for the economy as a whole is 7,1%. It remains below its long-term average of just over 9%, having struggled to bounce back to the double-digit levels enjoyed before the crisis.

Capital-replacement ratios taking knocks

Given slowing top-line growth and crimped margins, it's not surprising that SA companies' capital-replacement ratios have also taken a knock, says Schultz. When compared to its 10-year average, the ratio of total capital expenditure to the book value of fixed assets is down nearly 11%.

The industries that experienced the largest drop in their ratios in the first quarter relative to their 10-year mean were real estate and business services (-31,6pp), mining (-29,1pp), transport, storage and communications (-27,3pp) and utilities (-25,8pp).

"The generalised deterioration in capital replacement ratios is concerning" says Schultz. "New capital expenditure has not kept up with the depreciation and amortisation of existing fixed assets in the key infrastructure areas of mining, transport and utilities, entrenching the deterioration in SA's potential growth rate since the global financial crisis."

Return on assets sliping

He also calculates the return on assets (ROA) for each sector since a higher rate should prompt firms to expand operations. Again, the findings are downbeat. Schultz estimates that the corporate sector's ROA has slipped almost 40% from its precrisis, five-year average.

Again, the weakest performances were from mining, manufacturing, transport, storage and communication and utilities. On the other hand, the community, social and personal services sector, the trade sector, and real estate and business services collectively continue to yield a very healthy average ROA of nearly 25%.

Staggering trends

To shed further light on whether the deterioration in SA's corporate health is structural or merely cyclical, Schultz looks at trends in labour productivity and employment costs. The results are staggering.

On average, companies' real turnover growth has barely been able to keep up with the rampant rise in their real

employment costs over the past five years, outstripping them by just 0,6pp on average. Exorbitantly high growth in real employment costs since 2009 means that some of the largest negative deviations have occurred in community, social and personal services (a proxy for government) and mining.

Manufacturing comes out tops, with the largest spread. Though this is surprising, given that falling company turnover and rising labour costs characterise the sector, Schultz explains that the shift by many firms to a more capital-intensive growth path has allowed the sector to temper the decline in its productivity. This has been at the expense of 252,000 jobs, however.

SA's diminished potential growth rate

This is hardly good news in the light of SA's high unemployment rate and the fact that government's economic growth policies rely heavily on the manufacturing sector to create millions of new jobs, Schultz notes.

The bottom line, according to Schultz, is that "sharp increases in labour costs, which have not been matched by the requisite productivity gains, lie at the heart of SA's diminished potential growth rate".

Sanlam Investment Management economist Arthur Kamp agrees that weaker productivity growth and material supply-side constraints explain the current weakness in real economic activity and corporate profits.

Source: Financial Mail