OLD MUTUAL MULTI-MANAGERS

WHAT IS HAPPENING WITH FIXED INVESTMENT?

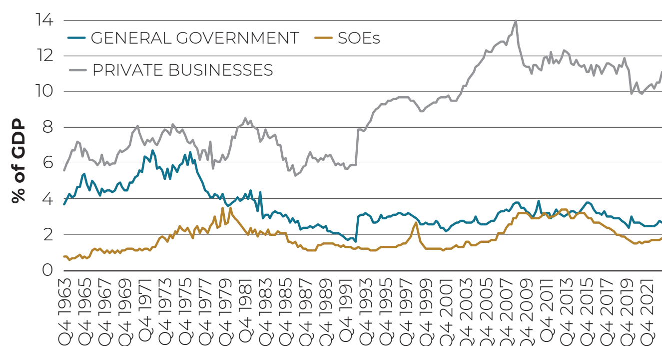
QUARTER 3, 2023

IZAK ODENDAAL
INVESTMENT STRATEGIST
OLD MUTUAL MULTI-MANAGERS

The 2012 National Development Plan was ignored by policymakers almost as soon as it was published, a fact that explains much of the country's woes since then. One key metric stands out: the goal to lift fixed investment spending to 30% of GDP. An economy that consistently invests a large share of national income in its productive capacity can sustain rapid economic growth. Economies that do not are subject to boom-bust cycles. South Africa is a case in point. Investment spending is still only 15% of GDP, a worryingly lower ratio than in 2012, and therefore its fortunes rise and fall with global commodity cycles, rather than being driven by a consistent internal engine.

As chart 1 shows, two thirds of investment spending (also known as gross fixed capital formation) is done by the private sector, with the remainder by general government (including municipalities) and state-owned enterprises (SOEs). These latter two categories have come under pressure due to financial and managerial constraints and there is little sign of it turning around. The largest SOEs (Eskom and Transnet) teeter on the edge of bankruptcy, while budget cuts mean government will not be able to meaningfully raise its investment spending. At the municipal level, the capacity to spend the money properly is often a bigger challenge than getting the money. The consequences are visible everywhere, for instance in Johannesburg's recent water cuts.

Chart 1: Fixed investment spending as a share of GDP



Source: SA Reserve Bank

Realistically then, it is the private sector – local and foreign companies – that will have to raise investment levels if we are to achieve sustained higher economic growth rates. Sometimes companies invest for defensive reasons to protect market share or improve the resilience of operations. But for the most part, companies will invest when they are optimistic, when they see future growth in demand for their products, or when there are significant opportunities in new markets. Investments need to make financial sense and clear an expected return hurdle. No one will invest in a risky long-term project if they do not expect to earn substantially more than what they can by just leaving money in the bank. Finally, companies will also consider the regulatory environment and the general ease of doing business. If there are too many potential obstacles, or if the relevant laws and regulations can change abruptly, it might be too risky to embark on the investment.

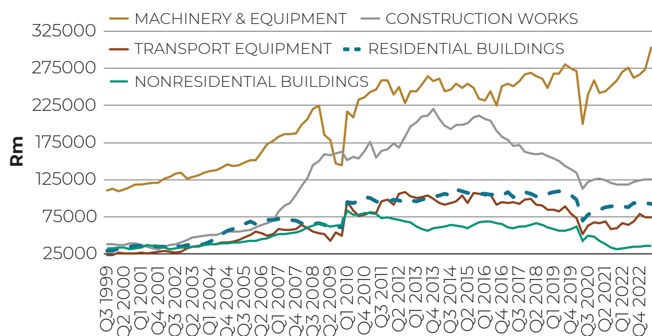
These factors explain why private investment is so low. High interest rates raise the hurdle rate for any project to proceed. The regulatory environment is full of uncertainty and red tape. Confidence in the economy is low. The business environment is challenged by high levels of crime, loadshedding and transport bottlenecks. And the opportunities are not always obvious since the country is already relatively developed. Some of the most obvious opportunities, as we'll discuss below, have until recently been monopolised by the state. This is starting to change.

Despite all this, private investment spending still runs around R770 billion per year in nominal terms. It is too low, for sure, but it is certainly not small change.

That said, what are the recent trends? Chart 2 shows the real (inflation adjusted) level of investment spending based on different types of assets up to the second quarter of 2023.

The biggest category is investment spending on machinery and equipment. It broke decisively higher in late 2021 in real terms, driving the overall fixed investment spending encouragingly higher. This coincides with regulatory changes allowing private companies to generate their own electricity, a move precipitated by rapidly deteriorating Eskom supply. Private businesses and households can now spend as much as they want on their own electricity supply, and clearly, they are spending a lot. The only downside here is that most of this equipment is imported, and the import data reflects this. Nonetheless, the installation work is done locally, so there is still a big boost to economic activity and employment, and of course in the end it is about having reliable electricity.

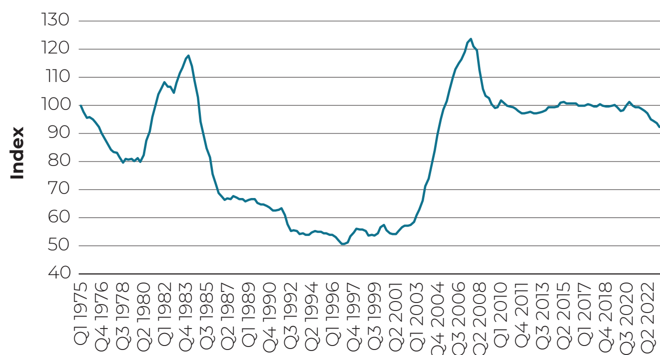
Chart 2: Real fixed investment spending by asset



Source: SA Reserve Bank

Another big category is investment in residential buildings. This surged during the pre-2008 housing boom but showed little growth thereafter. This mirrors the movement of real house prices, which remain below 2008 on a nationwide basis (regionally, the picture will look a bit different, notably in the Western Cape). Lacklustre house price growth means few people are excited about residential property as an asset class, and this shows in the muted investment in this sector.

Chart 3: Real house price index



Source: LSEG Datastream

Investment in non-residential buildings remains deeply depressed. The country has enough shopping malls and office buildings, though Western Cape is again a possible exception. However, while historically weak, this sector is still investing R35 billion per year. It is not peanuts.

Transport equipment refers to trains, trucks, and planes. It has basically moved sideways over the past decade. The airline industry was gutted by the pandemic, and procurement of trains has been a shambles (including Chinese trains with no spare parts and Spanish trains too tall for the rail network). There are visibly a lot more trucks on the road these days. This is good news if you are a truck driver (though they always seem very unhappy) but bad news for congestion and the state of roads. Moving bulk goods by truck is usually much less efficient than by rail, and much more expensive. The lost revenues, particularly in the mining sector, due to the poor state of our railways has been widely documented.

Finally, the second largest category, construction works. This includes big projects like roads, dams, bridges, power stations and so on. After several years of strong growth (including 2010 World Cup preparations), it has fallen sharply. Much of this spending is done by State Owned Enterprises (Eskom, Acsa, Sanral, Transnet) and we know the operational and financial challenges there. These challenges also exist at many municipalities and provincial departments.

This is also a key area to pay attention to. Greater private sector involvement can unlock a lot of spending in this space. Local pension funds are eager for infrastructure exposure, a very popular asset class internationally since it is associated with steady and predictable returns.

But it is not straightforward. Investors require a return that is adequate for the risk they are taking. This requires a clear framework where the risks are clearly identified and managed, including who bears responsibility for what. Sometimes, the responsibility might fall on local government, and we know the capacity constraints in most municipalities, or it might fall over all three tiers of government, leading to battles over turf or a 'not my problem' mentality. Large infrastructure projects can be very complex, after all.

Importantly, it also means that users should pay for use of the infrastructure. That immediately rules out certain types of assets, for example bridges in rural areas or suburban roads. Government will have to continue building and maintaining these, as there is virtually no way the private sector can do so profitably. But even areas where the user-pay principle is standard globally, such as tolled highways, can be contentious as we saw with the Gauteng e-Tolls saga.

A slightly different example is Eskom, whose unbundling and partial privatisation was mooted in the late 1990s, but never occurred, in part because electricity tariffs were too low to make private investment profitable. It is a failure that haunts us today, but tariffs have risen sharply in the past two decades. They are now high enough to incentivise private generation either for sale at a profit or simply to save on input costs.

The good news is that South Africa now has an infrastructure strategy in the form of the National Infrastructure Plan 2050 (NIP2050), which was approved by Cabinet in 2022. It focuses on four specific areas of infrastructure development: energy, water, digital infrastructure, and freight. These are all areas where the private sector can play a key role and investors can look to earn a return. Now, we all know that South Africa is good at making plans and bad at implementing them, so a healthy level of scepticism is warranted. Nonetheless, there is reason to believe that investment in infrastructure will increase in the years ahead.

All this suggests fixed investment spending should increase in the years ahead, rising as a share of GDP and also boosting GDP growth itself. The beauty of this form of spending is that it stimulates the economy while it takes place, and then facilitates economic activity over time as the machinery, roads, trucks and so on are used. But to put it slightly differently, South Africa is unlikely to ever experience sustained higher growth rates if we do not lift investment spending. So, watch this space.