FROST & SULLIVAN

Post-Covid Growth Prospects for South Africa

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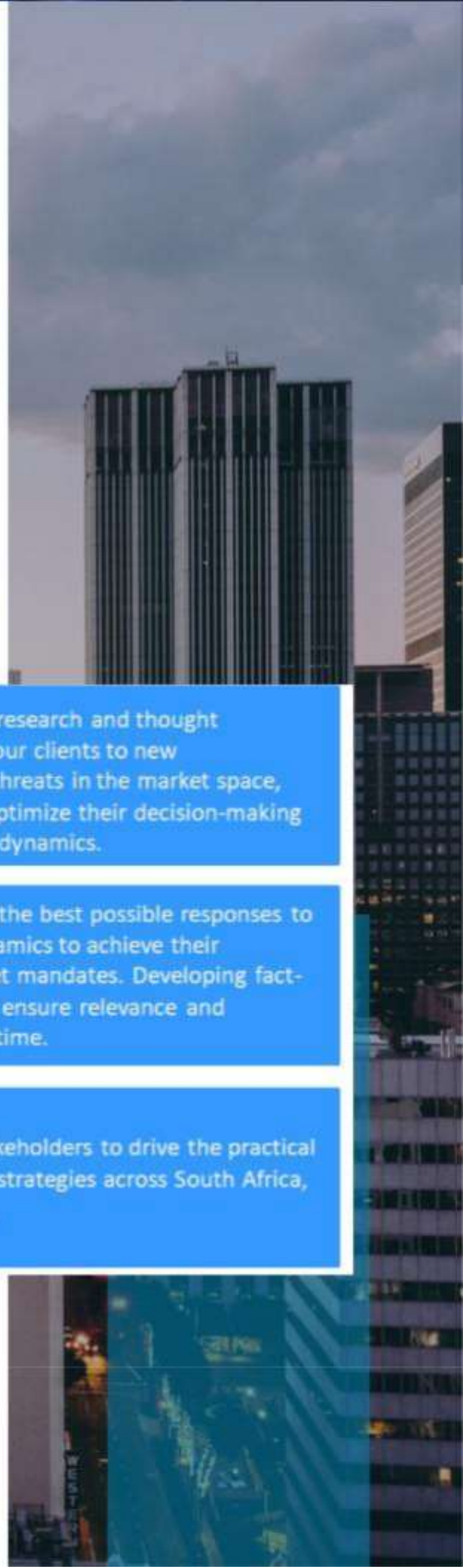
Advising clients on the best possible responses to these external dynamics to achieve their objectives and meet mandates. Developing fact-based strategies to ensure relevance and effectiveness over time.

Connecting key stakeholders to drive the practical execution of these strategies across South Africa, Africa and beyond.



Introduction

In June 2020, Statistics South Africa conducted a business impact survey of the Covid-19 pandemic in South Africa. Its findings indicated that approximately 80% of businesses were trading below normal turnover and 26% had to lay off staff. Small, Medium and Micro Enterprises (SMMEs) were the most affected due to the Level 5 Lockdown regulations. Ninety-six percent of SMMEs made less than 75% of their usual turnover, with 70% of SMMEs not able to operate at all during that period. This led to approximately 30% of SMME staff being retrenched.

But the growth prognosis for South Africa in the next five years is not all doom and gloom. The private sector can grow and create jobs if allowed to function and operate in an open environment.

Proper information for all participants, effective (but not restrictive) regulations, access to technology partners, stability of the currency, sound fiscal fundamentals and controlled input costs, will be the keys to success.

This report will assess the growth prospects of various sectors in South Africa and determine whether there are opportunities for growth in the next five years.

1 Covid-19 Impact and Growth Story

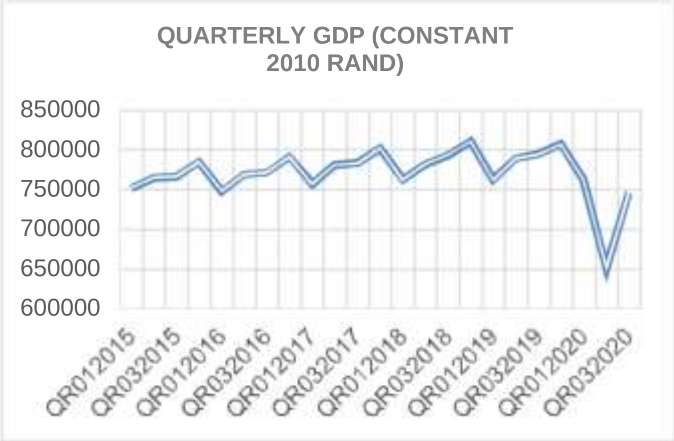
1.1 Economic Growth Prospects in Context

Prior to the onset of the lockdown restrictions in South Africa, the economic outlook was under pressure from a lack of investor confidence and rising household debt levels. The economy was also suffering the continued negative impact from numerous rolling blackouts that were necessary to alleviate the pressure on the constrained power grid.

The reason the context of economic activity before the lockdowns is important, is that it will have a direct impact on the level and speed of recovery of the economy moving forward. The level of rebound that can be experienced in some countries that previously had sound economic policies and growth prospects will not translate to the South African context, as the growth-fundamentals necessary were not there prior to the crisis.

Figure 1 shows the quarterly GDP at constant prices and during the second quarter of 2020, there was a significant dip in output. There was a recovery in the third quarter, however, this was not enough to place GDP back at the level of the previous year.

Figure 1: Quarterly GDP (Constant 2010 Rand)

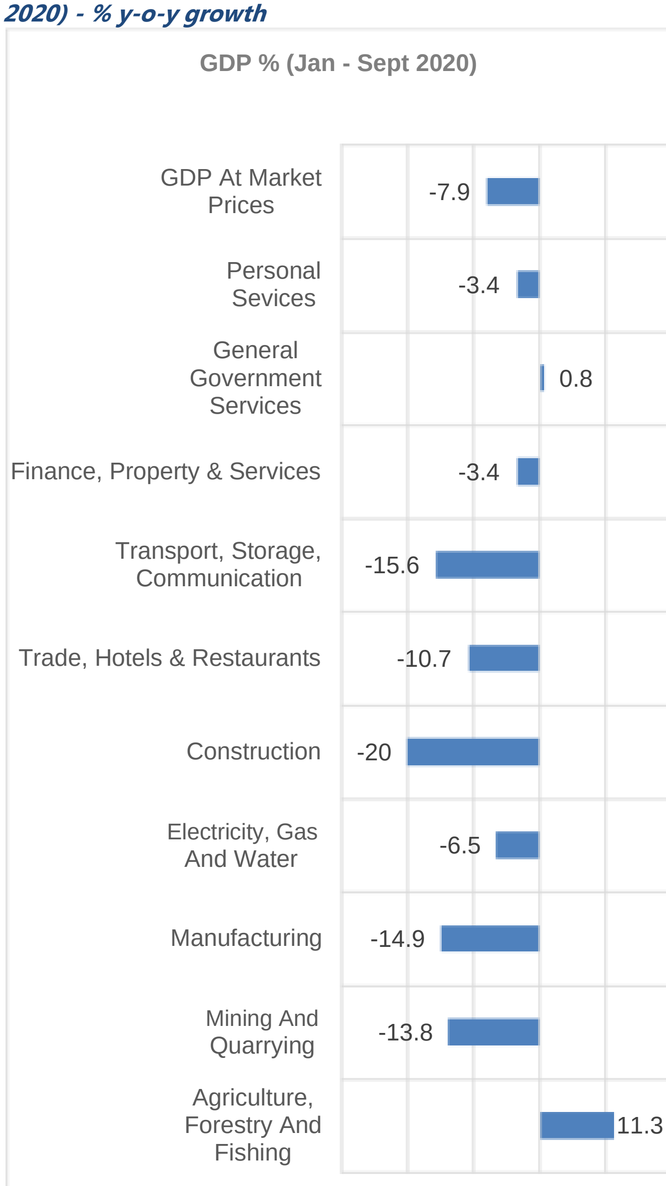


Source: StatsSA

The outlook for 2020 is that GDP will contract between (7.5%) and (8.5%) due to the shutdown of almost all sectors of the economy during periods of strict lockdown and the muted turnover of businesses during softer lockdown periods. The spillover effects of constrained consumption expenditure will also continue to hamper the recovery in the trade and tertiary sectors of the economy.

1 . Covid-19 Impact and Growth Story

Figure 2: Sector GDP Comparison South Africa (Jan-Sept 2020) - % y-o-y growth



Source: StatsSA

Sectors that have large value chain contributions to the economy, (with many linkages) suffered the most, as they could not attain full productive levels, even under eased lockdown regulations. Construction, transport and manufacturing, in particular, were the sectors that saw the greatest year-over-year (YOY) declines in output.

Expenditure levels and trade also significantly declined and is depicted in Figure 3 below.

Figure 3: South Africa Growth in Consumption, Capital Formation and Exports (Jan-Sept 2020)

	Percentage Change (Jan - Sept)
Household Final Consumption Expenditure	-7%
Gross Fixed Capital Formation	-17.8%
Exports	-12.3%

Source: StatsSA

Figure 4: South African Investment Inflows (2019 vs. 2020)

	Rand Billion
FDI Inflow (Jan - Sept 2019)	56.2
FDI Inflow (Jan-Sept 2020)	29.83

Source: South African Reserve Bank

In October 2019, the International Monetary Fund (IMF) expected South Africa's growth outlook to be 1.1% for 2020, following from 1.5% in April 2019. There had been a decline in the growth outlook prior to the pandemic which was based on fundamentals, such as, investor confidence and fiscal policy. Considering these constraints, the growth recovery for South Africa post-pandemic will be longer than in those countries that saw rising growth prospects prior to the lockdowns, as their macroeconomic fundamentals were positively contributing to the growth sentiment.

1.2 Growth Fundamentals and the Lessons from the Lockdowns

The key question is, what will it take for the South African economy to recover and grow?

One of the takeaways from the pandemic is the significant changes in the economic landscape, particularly in the microeconomy. The way businesses allocate resources and interact has changed, with technology and connectivity becoming increasingly important in the growth roadmap for individual firms and countries.

Companies have developed unique solutions to not only mitigate risk, but also transform their business models to achieve even greater growth. For example, Fujifilm transformed from a company specialising in photography, to one providing healthcare and medical imaging products. Similarly, Philips was an electronics company mainly focused on lighting products, and has also transformed into a major healthcare technology company. Seeing the disruptive elements in connectivity, Netflix shifted from delivering DVDs by mail into the largest video streaming service and original content provider. These companies took bold steps and have certainly reaped the rewards for adapting their business models.

In the past year, many companies have implemented risk mitigation measures, but they must not forget that there are also opportunities that they can take advantage of. It is still necessary to keep building a powerful growth pipeline and strengthen key relationships with customers and suppliers. Measures to improve efficiency are also of key importance where companies can identify their competitive edge, integrate new business models and embed new technologies in their business processes.

A significant area of disruption is in the supply chain industry which has impacted the value chains of various sectors in the economy. This required a fundamental change in the business models of companies dealing with its suppliers and customers.

The key to implementing successful business transformation during times of uncertainty lies in leadership, agility and effective change management. Leadership needs to communicate the reality of a situation, at the same time instilling a sense of hope and confidence in the organisation. Moving away from rigidity in operations and management styles is crucial when adapting to the 'new normal' in uncertain times.

In the new digital age, it is important to take advantage of new innovations, such as moving to the cloud, improving agility and access to customers. The use of cloud technology allows employees to access data more effectively, work anywhere and adapt to the needs of customers which is also important for field service management. Many companies also bolstered their online marketing and sales platforms to allow trade during lockdown periods.

1 . Covid-19 Impact and Growth Story

For sustainable macroeconomic growth moving forward, is the need to promote sectors that have the highest value chain impact on the economy and those that will boost SMME growth again. Not only must the economy generate income for the citizens, but the vital tax revenue will be needed to alleviate the significant debt-burden the government now has after implementing the relief funds.

SMMEs, formal, informal-trader and service providers should be prioritised as they provide significant job creation potential for the country. E-commerce platforms are a major way to increase market penetration for small business, especially now that Covid-19 has increased the willingness of consumers to shop and browse online. There is space in the market for more last-mile delivery options that can provide quick and relatively cheap delivery. The larger traders have their own delivery staff and infrastructure, but without economies of scale small businesses must rely on traditional logistics providers that are sometimes more expensive. The major dichotomy here is that sending a package within a metro area or from Cape Town to Johannesburg with a traditional logistics provider costs relatively similar. There is an opportunity for providers offering solutions to small businesses that operate at a metro or regional level.

Coming back to the declining output levels prior to lockdown, it is now key to raise business confidence levels by promoting certainty in the markets. Too much uncertainty at a political level has hindered many businesses from investing or expanding operations. The key priority now is to implement policy and a stance toward improving business confidence. The private sector has been functioning well and should be given the opportunity to grow without restriction.

South Africa can also take advantage of new technologies. The recent lockdowns globally have significantly altered many companies' perceptions on the use of automation and artificial intelligence to keep value chains operational. The logistics industry will most likely see the greatest disruption with the use of automation, but even greater than that will be the trend of near-shoring. Many companies are looking to decrease their dependence on global supply chains or multi-country supply chains thereby giving South Africa a renewed comparative advantage of becoming the manufacturing hub for Africa. Security of supply is an important consideration in the future global economy, and this pertains to many products, especially pharmaceuticals, food and basic goods.

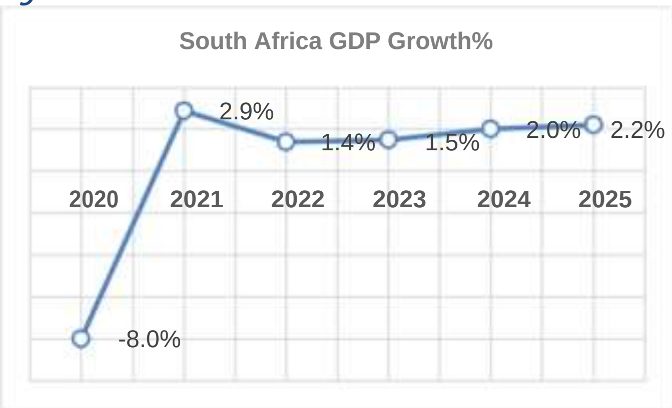
For South Africa to take advantage of this and become a manufacturing hub, the government needs to keep input supply costs at competitive levels for local manufacturers, including electricity, fuel and transportation costs. Industry 4.0 has the potential to improve efficiency and reduce manufacturing costs, however, the government needs to support the fundamentals necessary for a competitive and lucrative manufacturing environment.

South African President, Cyril Ramaphosa, recently stated that this is the time to reset the economy. Increasing business confidence and less political interference will be an important start. The private sector will create jobs if allowed to function and operate in an environment conducive to capitalism. Proper information for all participants, effective (but not restrictive) regulations, access to technology partners, stability of the currency and sound fiscal and monetary fundamentals. Controlling input costs, as previously mentioned, is a key factor for success. The greatest influencer of supply-driven inflation is the currency This impacts transportation and import costs which can drastically stifle growth. In 2021 and onwards, the ever-increasing cost of electricity should also be a priority to be addressed, as limiting further increases will significantly promote investment and confidence in manufacturing prospects in the country.

2 The Road Ahead

South Africa's growth prospects remain strained moving forward, with only a small rebound in growth expected in 2021. From 2022, growth will remain subdued till 2025. The major factors that will impact growth prospects will be private sector investment, strained government spending, high household debt and supply-driven inflation.

Figure 5: South Africa GDP Growth Forecast to 2025



Source: IMF & Frost & Sullivan

The primary sector (mining and agriculture) will continue to struggle and growth in the manufacturing sector will be highly dependent on investment and export demand. The level of local consumption expenditure is expected to remain muted with high household debt and unemployment which will increase South Africa's manufacturing growth's dependence on export demand in the next 5 years. Local consumption will, however, allow recovery of trade and accommodation sectors. It must be noted that domestic air travel will be impacted for a long while and the expectation is that a rebound in this industry will not be quick. Due to new working conditions, it is very likely that the demand for domestic business travel will not recover to pre-Covid-19 levels for another 5 years.

2.1 Industry and Sector Prospects

Developing the industry impact scenarios, Frost & Sullivan designed a model that assessed the various factors responsible for growth in the sectors and modelled that to produce growth scenarios post-Covid-19. The methodology is briefly described below.

2.1.1 Industry and Sector Growth Model Methodology

Future growth prospects for each sector were adjusted for the following:

- Past growth performance based on economic growth and demand.
- Future growth performance based on expected economic growth and demand.
- Adjustment factors based on growth fundamentals in the relevant sectors – this also relates to the policy and infrastructure support requirements.
- Adjustment factors relating to the impact from Covid-19 and the lockdowns.
- Adjustment factors relating to changes in preferences, technology and business models.

2.1.2 Direct Impact from Covid-19

Figure 6 depicts the direct growth impact of Covid-19 in 2020. The percentages depicted in the figure represent the decline or growth of the sector relative to 2019.

Figure 6: Direct Impact to Growth from Covid-19 in 2020

Source: Frost & Sullivan and StatsSA

As expected, the most negative impact was felt in the Tourism sector, with a decline of 58% in output to that of 2019. The hospitality industry was severely impacted, with many small businesses facing closure and larger groups suffering major losses. The knock-on effects of the loss of revenue in this sector will impact many businesses in the next few years due to increased debt commitments.

Closures in the manufacturing sector also contributed to significant negative numbers in the Automotive and Machinery industries. In the Automotive industry, not only have production numbers been impacted with the closure of plants, but also Automotive sales were significantly less than in the previous year. In 2020 domestic new vehicle sales plummeted by 29.1% and new vehicle exports declined by 29.8% from 2019. This was mostly due to the pressures on local middle-income households, decreased car rental market demand and lockdown measures in export markets.

Severe negative impacts were also felt in the Logistics sector, especially in ocean freight. Globally the disruption to supply chains and closures to factories resulted in a significant decline in freight bookings in Q1 of 2020. This situation improved moving into Q2, but the overall result was a decline of 4.1% in maritime freight volume as estimated by the United Nations Conference on Trade and Development (UNCTAD). On the other hand, the increase in e-commerce during lockdowns allowed a boom in the sector and last mile delivery. South Africa's largest online retailer, takealot.com increased its revenue by 28% in 2020. The entire South African e-commerce market is estimated to have boomed by 30% in 2020.

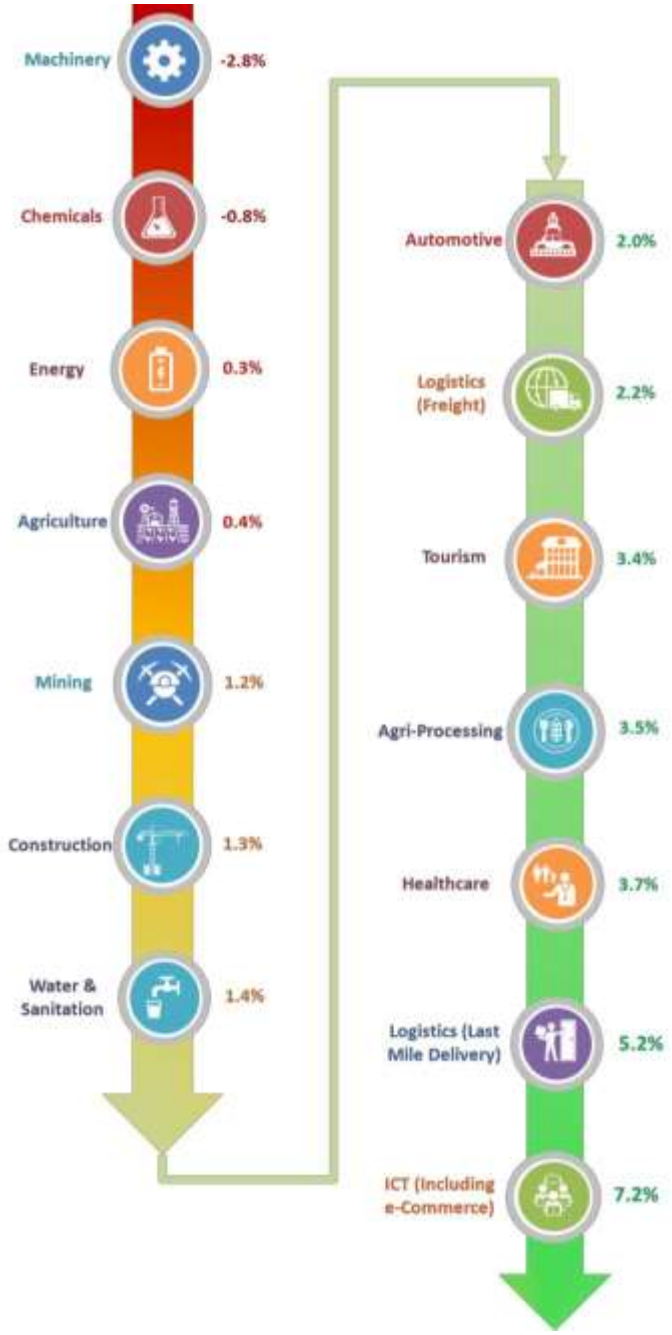
The ICT sector, offering infrastructure support to driving 'work-from-home' options and e-commerce also saw significant growth in broadband rollout during the 2020 period. Fibre-to-the-home rollout and 5G network installation was significant in 2020, with many providers and operators taking advantage of the release of spectrum by the Independent Communications Authority of South Africa (ICASA) in March 2020 to rollout 5G in major metro areas.

The growth in the agricultural sector during 2020 was not related to Covid-19, but rather positive climate conditions that allowed greater crop yields.

2.1.3 Sector Growth Outlook

Figure 7 depicts the growth outlook per sector in South Africa from 2021 to 2026.

Figure 7: Future Growth Outlook Per Sector – Expected Annual Growth Rate - South Africa (2021-2026)



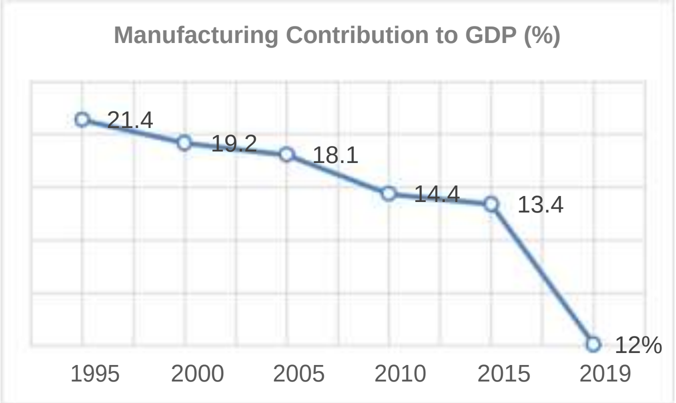
Source: Frost & Sullivan

Machinery and Chemicals

Prior to the lockdown in 2020, the machinery and chemicals sector in South Africa was under pressure. On average the machinery manufacturing segment posted negative growth, averaging (5%) YOY from 2015 to 2019. The chemical industry averaged (2%) YOY in the same period.

There is also a longer-term trend of manufacturing decline in South Africa which is depicted in Figure 8. The declining trend is expected to continue moving forward as economic fundamentals that support the manufacturing industry will remain under pressure. These include high input inflation from wages, transport and electricity costs, muted export and local demand, as well as stifled private investment.

Figure 8: South Africa's Manufacturing Contribution to GDP (%)



Source: StatsSA

Energy

The Energy sector has seen slow growth prior to 2020 with an annual average growth from 2015 to 2019 registering at (0.9%). There has been significant pressure on the energy sector in South Africa, with insufficient power and legislation limiting access of private power producers to the market. Renewable energy production has been slow with the limited private involvement. Moving forward there should be a significant uptick in the private sector with new renewable sources of energy being introduced to the grid and approximately R80 billion set aside for renewable energy infrastructure. These sources are expensive compared to the existing alternative, therefore growth in the sector is expected to remain subdued without a major boom at 2.3% per annum to 2026.

Agriculture and Mining

The agricultural sector has been under significant pressure in the past 5 years due to unfavourable climate conditions and drought. In 2020 these conditions turned positive and allowed greater crop yields. Agricultural growth in the next 5 years will remain positive but subdued at 0.4% per annum. It is difficult to predict agricultural sector growth based on demand as the demand is usually positive, but supply-side factors (such as climate) are the key unknown variables. The demand factors will remain positive with prices of crops seeing growth after the pandemic with trends in global markets.

Mining sector output should improve in 2021 and revenues will strengthen as a result of the global resurgence in commodity prices. The demand fundamentals for commodities continues to show improvement in export markets such as China. This will lead to growth for the mining sector in South Africa, estimated at 1.2% average annual growth in the next 5 years.

Construction

Declines in construction during 2020 were significant, registering a (20%) contraction. The sector has already seen a rebound from this during the final quarter of 2020. The growth fundamentals for the industry remain like that prior to 2020 where it registered an annual average (0.4%) decline from 2015 to 2019. GDP growth prospects are, however, more positive in the next 5 years and construction activity is expected to grow at an annual average of 1.3% from 2021 to 2026. The main drivers will be the increased need for infrastructure and utilities, the government's drive to improve infrastructure (using this to drive growth post Covid-19) and the resilience of demand in the urban residential market. Significant development of warehousing has been driving the construction industry in the latter half of 2020 and into 2021.

Automotive

The significant losses in the Automotive sector during 2020 has been followed by slow recovery into 2021, with January 2021 sales in passenger vehicles down 18% in comparison to January

2020. The prospects for the sector does remain brighter for the next 5 years as export markets recover. The local market may also show greater demand with low interest rates making finance easier. The National Association of Automobile Manufacturers of South Africa (NAAMSA) expects a 15% recovery in new vehicle sales volumes in 2021, vehicle exports should increase by 20% and production recovery by 18%. This will still put the totals below that of 2019, however, this should recover by 2023. The automotive industry is expected to post 2% average annual growth in the next 5 years.

Logistics

With the lower freight volumes in 2020 there has been recovery into 2021 with higher demand, especially from Asia. Freight rates remain on a historically high level, significantly increasing transportation costs. As manufacturing output increases the level of logistics revenues will also recover. It must be noted that logistics revenues are also driven by general trade and consumer expenditure. The level of logistics revenue is strongly correlated to that of GDP growth. The main reason for this is the relation to consumption expenditure that drives retail trade. The freight logistics sector will therefore show growth relative to GDP expansion in the next 5 years at an average of 2.2% per annum.

The last-mile delivery segment saw significant growth in 2020 and moving forward, demand fundamentals will allow for relatively higher growth to other sectors. Consumer preference changes moving retail trade to online platforms will be a significant growth driver to the last-mile delivery sector therefore allowing growth higher than that of GDP in the next 5 years. Considering the growth drivers and fundamentals, this sector is estimated to show growth of 5.2% on average, annually till 2026.

Healthcare

In 2020, the pandemic increased the demand for healthcare, however, the sector suffered losses due to the lack of revenue-generating practices. Areas such as elective surgeries, plastic surgery and medical tourism were severely impacted, and this reduced revenues for medical professionals and hospitals alike.

The decline in Covid-19 patients in hospitals and the easing of restrictions for surgeries and hospital stays, the revenues for this sector are expected to recover. Key growth fundamentals, consumer preferences, new business models and technology adoption will be significant drivers for the healthcare sector in the next 5 years.

The use of digital platforms and devices will be a major growth segment as this has allowed an increase in real-time monitoring, remote monitoring and access by medical insurance companies to the behaviour of patients. Increased collaboration between hospitals, healthcare providers and academia has resulted from behavioural changes brought about by the pandemic. The February 2021 budget speech has also made provision for promotion of collaboration in the healthcare sector between healthcare providers and academia to develop new technologies.

These drivers will contribute to the growth outlook for the healthcare sector in the next 5 years which is estimated to grow at an annual average growth rate of 3.7%.

ICT and e-Commerce

Although the e-commerce industry in South Africa only contributes to approximately 2% of total retail spend, this proportion is expected to grow. The restrictions on brick-and-mortar retailers during the pandemic has led to a significant preference shift in consumers who are now more willing to buy online. The convenience of online retail will also retain customers and bring new customers to these platforms.

Whether by choice or necessity, in the future, many more people will work from home as companies adopt new models and may even realise that they are making significant overhead cost savings with minimal impact to productivity. Not only has the crisis impacted businesses working from home, but there have been far-reaching impacts on demand from education, healthcare and government.

With increased broadband traffic on home networks, one of the major impacts has been on internet service providers (ISPs). This has fundamentally changed how, where and when the internet is used. Residential network traffic has skyrocketed and traffic originating from businesses and universities has slowed down. Overall, the traffic on the internet has gone up as many people are using streaming services longer during the day than previously as working habits have changed and many people are not working at all.

Turning to broader socio-economic considerations, it is estimated that just over 1.5 billion learners were stuck at home during the global lockdowns. In South Africa there are approximately 12 million learners in public schools and over 500,000 in independent schools, that were at home. It is important to note that many of the independent school learners had access to home schooling digital platforms, but this was not possible to implement under the public-school system due to the lack of connectivity or device access across the learner base.

e-Health also drove the need for broadband access, as a significant amount of healthcare provision was moved online with the use of technology to mitigate the severity or the Covid-19 outbreak.

Global lockdowns moved many businesses to use digital technology, relying on connectivity and managed to stay operational. Certain businesses were able to do this, while others were forced to close, due to the nature of the business and lack of technological solutions to the problem.

2 . The Road Ahead

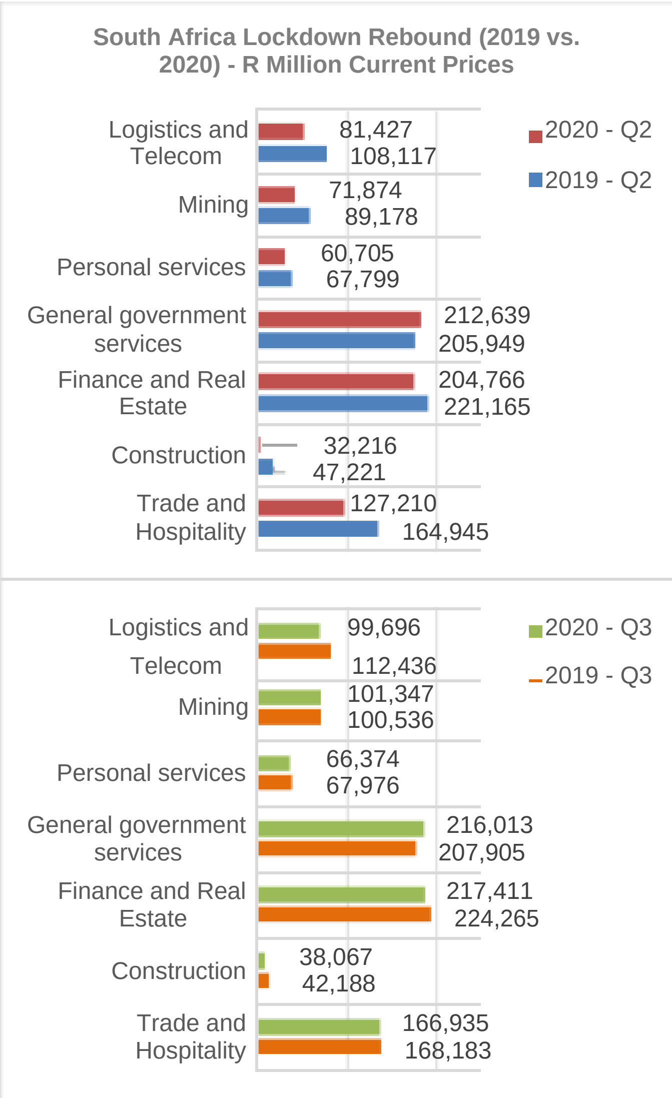
To increase connectivity, we saw a significant response to the crisis from government and the private sector to provide broadband access. In Kenya for example, high-altitude internet balloons beamed 4G to rural areas after the government fast-tracked regulatory approval. Globally, internet providers also increased speed and capacity at no cost to the user. Locally, access to spectrum was granted in March 2020.

Connectivity is an enabling technology that was needed to conduct business under the pandemic, but with consumer preference changes, increased demand will continue, as many businesses have adopted fundamental changes to work-from-home policies. The increased demand for fibre-to-the-home, 5G and broadband will drive the ICT sector in the next 5 years and Frost & Sullivan estimates an annual average growth of 7.2%.

3 Implications and Opportunities

Although the growth outlook for South Africa remains subdued in the next few years, there is still an opportunity for businesses to expand and post growth during this time.

Figure 9: Comparison of Economic Sector Performance (2019 vs. 2020) Current Prices

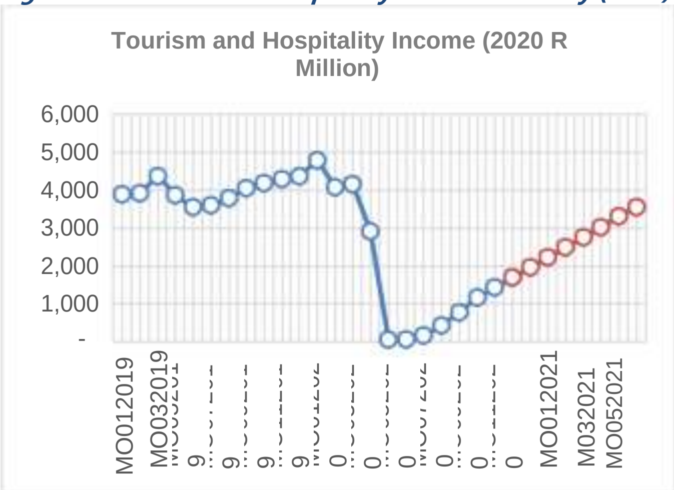


Source: StatsSA

SMMEs: Services, Hospitality and Trade

The first group showing great growth potential are small businesses in the services, hospitality and trade sectors. These businesses were hit by the brunt of the lockdown restrictions, but since these were lifted, many were able to post promising growth. Figure 9 shows the comparison between the second quarter performance (during hard lockdown) and during the third quarter when restrictions were somewhat eased. The rebound in personal services, trade and the hospitality industry are promising. The growth trend in Figure 10 illustrates that the rate of recovery has steadily picked up since June of 2020. Projections indicate that by June 2021 the industry should have recovered to levels before the 2020 lockdown in June of 2019.

Figure 10: Tourism and Hospitality Income Recovery (2020)



Source: StatsSA and Frost & Sullivan

Taking advantage of digital platforms will be crucial for small business moving forward. This will provide a platform to gain greater access to customers for their product or service. There is also an opportunity for support services to the SMME sector that will create new business opportunities. The lockdowns have created a shift in customer preferences that has drastically increased the need for e-commerce.

During the lockdown, many companies were forced to implement work-from-home strategies and have been successful at maintaining productivity levels for many functions of their business. This has led to companies adopting work-from-home models post-Covid and this trend is certainly going to continue as the new normal. With more people working from home, there is more opportunity to shop-from-home and for delivery of groceries and food. Much of this is a product of the convenience factor, but there is also a larger change in mindset that is also noticeable in the need for vehicle ownership. For many there is a shift in the need for personal transport and travel for their basic needs. During 2020 Uber Eats' revenue posted 124% growth over 2019 and this trend is expected to continue.

Small businesses have the opportunity to increase their reach to local and regional customers through such platforms, therefore catering to the needs of customers that no longer feel the need to commute during the week.

Construction

As previously noted, the construction sector should recover steadily, additionally there are also opportunities that have been created by the lockdowns. Large corporate spaces have remained empty during the lockdown periods with many work-from-home experiences being positive for companies. Global surveys indicate that firms are considering making the home-options permanent and we have already seen examples of this. Dropbox is transitioning to fully remote working with its existing office space to be allocated as studios where employees can elect to work in a shared space. Facebook is allowing 50% of its workforce to remain remote. Microsoft has allowed all their staff to work remotely for half the week and managers have the authority to offer full-time work from home options to staff. Salesforce is moving away from permanent office space to a model based on three options. Flexible, in the office 1-3 days a week, fully remote, and office-based for the few essential staff that cannot work from home. Lastly, as an example, Spotify announced that employees can choose to work in the office, remotely or in company-paid co-working spaces.

Companies have realised that monitoring productivity of employees is entirely possible remotely with new digital platforms and tools. This has drastically reduced the need for physical office space. There is an opportunity for property owners and facilities management groups to transform their traditional office spaces. Some of the options that have become popular are:

- Provide shared office platforms.
- Increase internal space to allow social distancing for desk space.
- Reconfigure the use of the office space.
- Reduce the footprint of corporate offices and move them to lower-cost areas.
- Providing flexible office use with no fixed desk allocations. Combining this with flexible working arrangements will reduce the number of employees per day and the office space needed.

New residential communities with integrated, shared remote working facilities will also become more popular, where residents can work remotely at home and utilise the infrastructure of the shared office facility.

Investment

There is no magic bullet for increasing private sector investment in South Africa. It involves fundamental principles of increasing investor confidence, improving our credit ratings and sustained commitment from government. Currently there is a significant drive from government to involve private sector investment into infrastructure through blended finance options to decrease risks to the private sector. There has been some progress on digital infrastructure and water purification projects, with further investment that will go into renewable energy. The Government has committed to expanding investment into road infrastructure by 27% from 2020/21 to 2023/24 and increase investment into water infrastructure by 5% during the same period.

The outlook for increased investment that will support growth remains positive if government remains committed to the needs of the private sector.

4 The Final Word

In summary, the road ahead for South Africa is not an easy one, but there is still significant opportunity for businesses to grow and even expand during this time.

Opportunities for growth lie in adaptation and implementation of new technologies or business models. With the rollout of the vaccines globally, there has been a significant increase in business confidence levels which is also expected at a local level and H2 2021 should see a noticeable change in business sentiment in South Africa as well.

If the Government stays the course with its commitment to promoting private sector investment, new opportunities will open for the economy as these positive benefits spilling over into the rest of the economy. Private sector value chains are functioning efficiently and are primed for an injection of activity. With sustained Government commitment, low interest rates and an effort to keep supply-driven inflation down, South African businesses will be well-placed to post consistent growth in the next few years.

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