

# Industry Challenges and Opportunities

## Analysis: Deliverable 3

Ferrous Metals Downstream Sector

August 2015



**the dti**

Department:  
Trade and Industry  
REPUBLIC OF SOUTH AFRICA



Industrial Development Corporation

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## Executive Summary

The South African downstream value adding steel industry is facing a number of serious challenges. These include rising operational expenses while global competition is putting downward pressure on selling prices. Therefore, manufacturers have to increasingly find ways of being innovative in the way they manage their businesses. Increases in labour costs, electricity and transportation are having detrimental impacts on margins, investment in new capacity and expanded job creation. Despite South Africa's rich mineral resources (especially in iron ore) South African manufacturers are benefiting only marginally from this resource. The issue of import parity pricing remains contentious in South Africa and is unlikely to change unless there is a shared vision on development, profits and industry expansion.

Traditional export markets are also changing. Markets in Europe and the USA are increasingly being serviced with products from Asia where there have been drastic quality improvements over the last 10 years. At the same time the ability to differentiate products in this market is extremely difficult as demand for steel products is mainly based on similarity in product design rather than unique design.

The downstream beneficiated steel industry is undeniably linked to the overall economy and in particular the expansion of industrial activity and infrastructure development. A significant hurdle to date has been the slow roll out of new projects in South Africa resulting in a lack of critical volume and hence reduced demand.

Most of the challenges facing the downstream steel beneficiated industry are also faced by most other manufacturing companies in South Africa. These include currency fluctuations, a mismatch of academic skills versus industry requirements, low tariff protection measures, substitute materials such as aluminium and PVC, the challenges of exporting into Africa and the relative distance to traditional international markets.

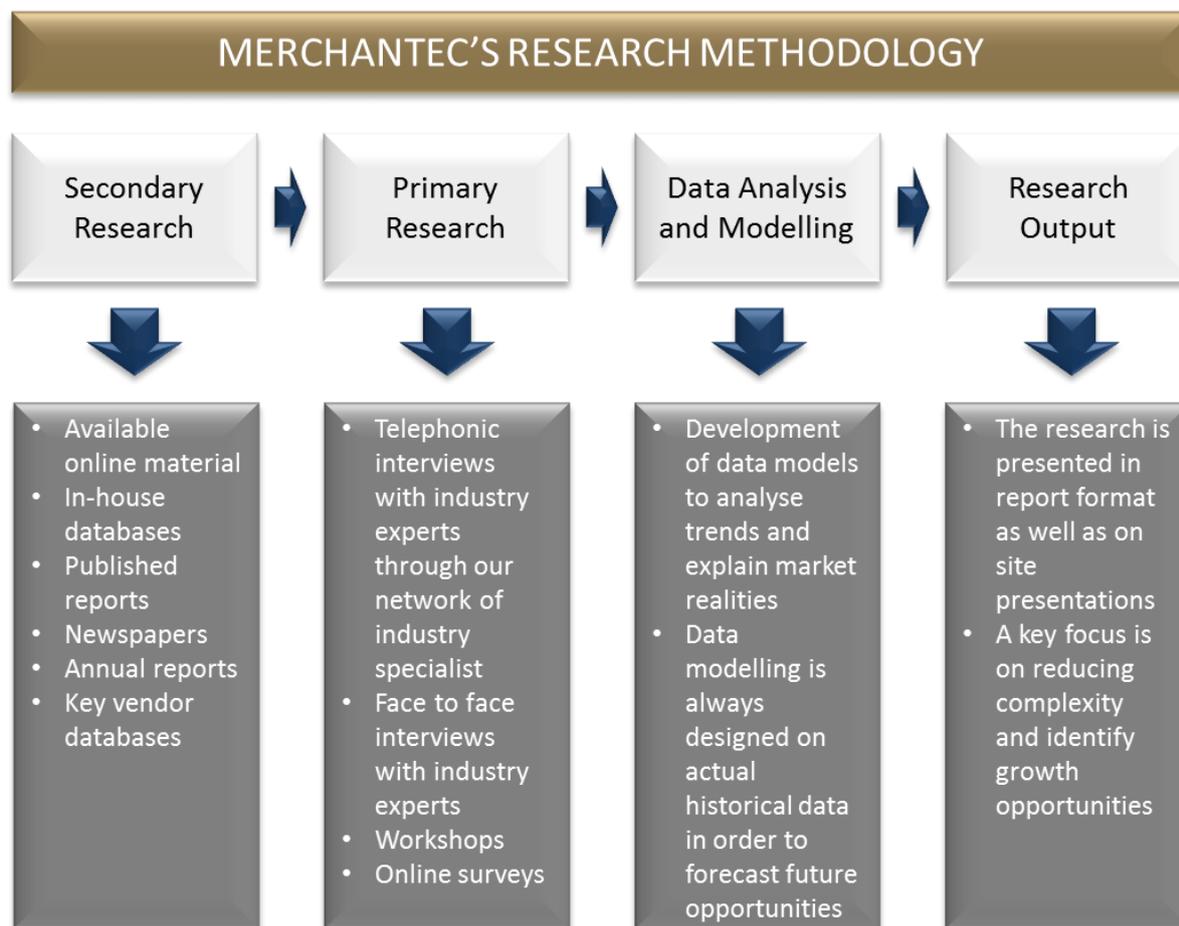
However, there are a number of opportunities developing as well. Government spending and product designation is a critical way of supporting local industry. The good work done by government on local content levels for project developers is also having a positive impact on the overall industry. Although export support measures are most likely too low there are incentives in place to help exporters bridge the geographic disadvantage gap. **The dti** also has a number of incentive schemes in place that are not fully utilised by industry.

The aim of this document is not to provide recommendations to the challenges or identify additional support measures. This document is aimed at describing the realities of business in South Africa and the outcomes of this document will feed into the final Recommendations Report that will feed into the IPAP strategy of government.

## Research Methodology

The following report is written based on information attained during a process of comprehensive industry research. The methods used to perform this research are discussed in detail below.

**Figure 1:** Research Methodology



### Secondary Research

Merchantec Capital used extensive secondary research to identify key stakeholders, quantify global markets and provide background to the research. A number of internal databases were also used for additional analysis.

### Primary Research

Merchantec made use of a number of techniques to perform detailed primary research into the steel industry, this allowed important first-hand information about each sub-sector to be gathered.

#### 1. Selection of sub-sectors

Merchantec contacted a number of industry experts as well as key association leaders to determine an appropriate breakdown of the sub-sectors. This was further confirmed in later interviews with industry experts as well as in responses to the supply side questionnaire. Additional to this secondary research, studies of previous research reports and SARS tariff codes performed which confirmed these findings.

The final selection of sub-sectors was as follows:

- Fabricated Structural Steel (which includes roofing and cladding, transmission pylons, and renewable energy structures)
- Wire Products (including cable products)
- Tube and Pipe Products
- Fasteners
- Pressure Vessels
- Speciality Steel Products
- Stainless Steel
- Hot Dip Galvanising
- Welding
- Automotive Components (not part of this analysis)
- Domestic Appliance Manufacturing (not part of this analysis)
- Forging (including valves) (not part of this analysis)
- Tooling Products (not part of this analysis)
- Rail Products (not part of this assignment)
- Drums and Packaging (not part of this assignment)

## 2. Challenges and Opportunities Discussion Guide

Merchantec developed 2 supply side discussion guides. The first was aimed at the industry associations to obtain insight into the overall industry, identify the major players and obtain insight into the challenges facing each sub sector. The second discussion guide was developed for individual companies in each sub-sector and covered information about the individual company as well as their perception of market conditions. Both questionnaires explored current incentives and the uptake thereof. More than 100 telephonic and face to face interviews were conducted across the associations, primary steel suppliers, large and small downstream manufacturers as well as industry specialists. The discussion guide was developed to facilitate discussion and not to be completed as a survey.

Since there are more than 3 000 companies represented under the engineering and metals industry the research is not aimed at providing statistical analysis of the industry. The research approach is based on the premise that the associations will be able to provide a holistic overview of each sub-sector while the largest companies in each sub-sector were targeted for company specific views.

## 3. Expert interviews

The main method of research for the report was in the form of highly detailed expert interviews with more than 100 experienced, senior individuals across each subsector. This included stakeholders at the main industry associations as well as discussions with the largest participants in each sub-sector as well as smaller companies trying to expand their market influence. These interviews were guided by responses to the discussion guide mentioned above. Throughout the report the findings of “industry experts” will be referenced as it is not appropriate to reveal individual sources in a report of this nature.

#### 4. Workshops

As part of the project Merchantec was requested to facilitate a number of key stakeholder workshops on behalf of the dti. The workshops are being completed as shown below.

**Table 1:** Workshop Schedule

#	Date	Focus Area
1.	29 Nov 13	Industry Associations
2.	26 Feb 14	Demand Participants
3.	15 May 14	State Owned Enterprises
4.	11 June 14	Trade Unions
5.	Still to be conducted	Government Departments
6.	Still to be conducted	Merchantec Feedback

Information collected during these workshops was continuously fed back into the project for deeper insight.

#### Research Output

The final deliverable will be a series of industry documents with insight into the supply, demand, trade analysis as well as growth opportunities and challenges analysis.

## Industry Challenges

A challenge for one industry is often an opportunity for another and hence it is important to understand from what perspective the challenge is viewed. The stakeholders in the downstream steel industry include manufacturers, end-users, labour and government. For each of these groups there are various challenges as listed below. Please note this list is not exhaustive. It serves as an example to show that each stakeholder has their own challenges and that it is therefore important to understand from which perspective the challenge is being looked at.

Government	Labour	End-users	Manufacturers
Expansion of economic activity	Industry transformation	Product quality	Unfair competition
Job creation	Wage levels	Volume requirements	Increasing manufacturing costs
BEE	Working conditions	Payment terms	Lack of localisation

The purpose of this report is to focus specifically on the challenges faced by the downstream value adding steel industry. In some cases the challenges facing the other stakeholders will be discussed in order to explain the challenges facing the downstream industry as the main focus of this report.

## Key Challenges in the Downstream Value Adding Steel Industry

The aim of this segment of the research project is to shed light on some of the key industry challenges and opportunities identified to date. This document is not aimed at providing deep insight into potential ways of solving these challenges as these will be discussed in the final report. In some cases reference will be made to suggested changes, but these will be explored in more detail in the last report.

The industry challenges discussed in this document pertain to all the selected value adding segments as identified in the Industry Supply Report. A summary of the challenges and the impact they have for each value adding segment is displayed below. The challenges are discussed in greater detail below.

The challenges identified in this report as well as their impact are shown below and was obtained through the industry expert interviews. Interesting to note is that most industries face the same challenges and that a collective effort is required to address some of these issues. The recommended actions will be discussed in detail in the final Recommendations Report.

Table 1: Summary of the Impact of Each Challenge on the Various Downstream Value Adding Steel Industry

CHALLENGE	IMPACT							
	Fabricated Structural Steel	Wire & Cables	Tube and Pipe	Fasteners	Pressure Vessels	Speciality Steel	Stainless Steel	Hot Dip Galvanising
Increased Imported Products	High	High	High	High	High	High	High	High
Cost of Doing Business in South Africa	High	High	High	High	High	High	High	High
Pricing of Steel	Medium	High	High	High	Low	High	High	Low
Tariff Levels for Value Added Products	Medium	High	High	High	Low	Low	High	Low
Raw Material Availability	High	Medium	Medium	Medium	High	High	Medium	Low
The China Issue	High	High	High	High	High	High	High	High
The Impact of the Competition Commission	Medium	High	High	High	Medium	Medium	High	Low
Delay in Local Projects	High	High	High	High	High	High	High	High
Currency Fluctuations	High	High	High	High	High	High	High	High
Interest Rate Differential	High	High	High	High	High	High	High	High
BBBEE	High	High	High	High	Medium	High	High	Medium
Skills	High	High	High	High	High	High	High	High
Export Challenges into Africa	High	High	High	High	High	High	High	High
Geographical Location (Distance to Markets)	High	High	High	High	High	High	High	High
Funding for Associations	High	High	High	High	High	High	High	High
Substitute Materials	Medium	Low	High	Medium	Low	Low	Low	Medium

Source: Merchantec

The information represented above was collected through primary research with the industry associations as well as a number of large and smaller companies in each of the industry segments. The information is entirely based on the perception of each industry segment.

### Increased Imported Products

A major concern raised across the value adding segments is the increased volume of products imported into South Africa which is putting pressure on local prices and leading to the closing of operations and ultimately the reduction of local manufacturing capacity.

The trend of increased imports is relevant across most of the included value adding segments. Imports increased by 5.6% in 2013 compared to 2012 and according to the various industry associations imports are expected to increase by between 5% and 10% on average in 2014.

Table 2: Imported Value Added Steel Products (2012 versus 2013)

HS heading	PRODUCT	2012 (Tons)	2013 (Tons)	% Change
7217	Drawn wire - carbon steel	35 206	29 918	-15.0%
7223	Drawn wire - stainless steel	7 097	7 348	3.5%
7229	Drawn wire - alloy steel	8 278	6 319	-23.7%
7301	Sheet piling	1 859	667	-64.2%
7301	Welded angles, shapes & sections	22	328	1408.1%
7302	Railway material	63 673	59 580	-6.4%
7303	Tubes & pipes - cast iron	13 486	19 687	46.0%
7304	Tubes & pipes - seamless	48 181	53 344	10.7%
7305	Tubes & pipes - welded large dia.	18 987	17 440	-8.1%
7306	Tubes & pipes - welded small dia.	47 462	87 403	84.2%
7307	Tubes & pipes - fittings	42 718	51 884	21.5%
7308	Structures, towers, scaffolding, bridges etc.	50 572	56 529	11.8%
7309	Tanks & containers >300L	4 596	4 101	-10.8%
7310	Tanks, drums & cans <300L	8 628	8 039	-6.8%
7311	High pressure containers	19 466	14 806	-23.9%
7312	Wire rope & cables	31 003	30 429	-1.9%
7313	Drawn wire - barbed wire	3 554	4 388	23.5%
7314	Cloth, grill, netting, expanded metal	7 734	8 147	5.3%
7315	Chains & parts	10 444	9 980	-4.4%
7316	Anchors & grapnels	539	645	19.6%
7317	Nails, tacks & staples	15 496	14 305	-7.7%
7318	Screws, bolts & nuts	57 470	59 303	3.2%
7319	Needles & pins	342	396	15.8%
7320	Springs	8 322	9 266	11.3%
7322	Air heaters & parts	278	322	15.9%
7323	Kitchen & household articles	24 181	22 446	-7.2%
7324	Sanitary ware	1 701	2 096	23.3%
7325	Cast iron products	39 704	38 205	-3.8%

7326	Articles of wire, forged products & other articles	58 595	47 367	-19.2%
<b>Total</b>		<b>629 595</b>	<b>664 690</b>	<b>5.6%</b>

Source: SAISI

From the table above it is clear that some categories of imports have actually decreased. The key drivers behind these decreases will be further explored in the Trade Analysis report.

### Cost of Doing Business in South Africa

A recurring theme was that suppliers are wedged between rising input costs and decreasing selling prices as a result of imported products. The result is that manufacturers' margins have come down and there have been a number of company liquidations. Two recent examples include Cosera and Duro who closed operations in 2013 and 2014 respectively. 4 key areas were mentioned in particular that are driving the current operational costs for companies:

#### 1. Electricity

The cost of electricity has increased sharply since 2009 as a result of years of cheap electricity prices that did not reflect the actual costs (especially savings for new infrastructure) of the national utility, Eskom. However, in 2007/8 as rolling blackouts and decreasing reserve margins plagued Eskom, it became evidently clear that South Africa urgently needed additional energy infrastructure.

Eskom invested heavily in ways to decrease demand including programmes for industrial, commercial, agricultural and residential energy end-users. These programmes were focussed on two elements namely 1) the reduction in demand through more efficient use of energy and 2) the reduction of demand by buying underutilised capacity from large energy end-users.

The first section focussed on replacing inefficient technologies with more energy efficient technologies. The specific products included the replacement of incandescent lights with compact fluorescent lighting (CFL), efficient plant design, finding and fixing leaks in compressor systems, driving demand for solar water heaters and heat pumps, implementing variable speed motors as well as remote geyser switches. The majority of these programmes have come to a standstill as a result of Eskom's MYPD 3 application of 16% per annum for 5 years where NERSA only allowed 8% increases. However, NERSA is at present reviewing Eskom's application for further support which will most likely result in above 8% increases for the utility.

The second demand reduction focus for Eskom was buying back underutilised capacity from key end-users. The result was that companies in the past applied for guaranteed supply on a particular line. However, if the company did not need the full capacity they could sell some of that capacity back to Eskom who in turn could use it to supply areas where there was a shortage. Although very effective in unlocking MW's for Eskom the result was decreased economic activity, partly as a result of the financial crisis but also as a result of decreases in demand as companies could make "easy money" by not being active.

The South African electricity industry is set up in the following manner:

Figure 1: The Electricity Supply Industry in South Africa



Source: Merchantec

Eskom supplies around 95% of South Africa's electricity to a variety of customers. The company owns the majority of thermal power plants in the country as well the transmission infrastructure. Customers include 146 large industrial customers consuming the bulk of Eskom's generated supply, a variety of remote customers mostly in the agricultural space, bulk energy buyers (municipalities) and lastly some urban customers. There is no clear reason why some urban customers purchase electricity directly from Eskom while other purchase it from municipalities, but Merchantec suspects it has to do with the development of towns and cities over time and that some rural areas become urban areas but that energy supply structures were not always changed.

Historically municipalities have used the sale of electricity to fund some of their other activities that are not cost reflective. The cost of electricity in municipal areas is determined by the cost of electricity from Eskom, the municipalities' infrastructure requirements (distribution maintenance) and also the profit margin. As a result, there is not uniformity in electricity prices across the country and there are vastly different prices charged to end-users depending on where they reside. At present NERSA do not regulate municipal electricity rates although they do provide guidelines for best practice. Municipalities that require above best practice increases can do so with only minor justification towards NERSA. The price of electricity to urban customers is significantly higher than that charged to large industrial end-users or bulk energy customers get from Eskom.

The majority of the downstream steel beneficiation industry falls within the municipal structures and purchases electricity from the municipalities. The result is that the cost of electricity has increased significantly over the last 7 years. The cost of this is not easily transferred to end-users since imported products are not under the same influence and profitability continues to erode. It is not only the steel industry that is suffering from this at present. Government has in the past tried to remove the electricity supply aspect away from the municipalities through the proposed Regional Electricity Distributors (RED) programme. However, the municipalities resisted losing electricity sales as this remains an important source of revenue for them.

Some very hard decisions will have to be made in order to protect the local manufacturing industry, but also balance the need for subsidised energy to the poor. The matter of electricity sales in South Africa through municipalities is a contentious issue and there are many stakeholders that could be impacted whichever decisions are taken.

Energy charges to consumers are a factor of three elements: 1) The energy charge (hourly charge), 2) the energy demand charge (monthly charge) and 3) Transmission network charge. Electricity is typically sold to municipalities at Megaflex rates. Eskom's charges vary greatly depending on the time of use (peak versus off peak pricing), seasonal pricing (winter periods is higher than summer periods) and also the distance from the generation source. The lowest Megaflex rate is 38.12c per kWh and the highest rate is 232.73c per kWh (Eskom tariff booklet 2014/15) taking all of the above considerations into account. Municipal rates typically vary from 85c per kWh (for less than 350 kWh's per month) to over R4 per kWh depending on time and quantity of electricity used. It is therefore clear that there is no single electricity price in South Africa. However, it is also clear that average municipal charges are higher than average Eskom charges (typically 35% to 200% higher) and that businesses could benefit from purchasing electricity directly from Eskom at cost reflective levels rather than from municipalities where it is cost reflective plus a significant margin.

## 2. Transportation

A general challenge all inland South African manufacturers face is the relatively high cost to ship their products to harbours. South Africa's rail infrastructure remains highly uncompetitive while road freight cost has also increased steeply over the last 5 years. Inland manufacturers often have to compete against companies in Asia and Europe that are located close to harbours and hence have a significant competitive advantage simply through manufacturing location.

One steel industry participant stated the following: "It can cost me as much to get my product from Pretoria to the harbour as what it costs me to get it from the harbour to Europe". Clearly transportation remains a significant hurdle in the sales process.

Inland companies indicated they prefer using road transportation to rail as it is only marginally more expensive but significantly more reliable. Merchantec obtained a number of quotes for the transportation of a 6m (24 tonne) container from Durban to Johannesburg. The cost by rail averaged R7 650 while road haul would amount to R9 500. It is therefore assumed that many of the manufacturers would make use of their own road transportation in order to optimise transportation costs.

It is beyond the scope of this research report to try and address the pressing issues around transportation in totality. The final recommendations report will however allude to potential benefits that can be unlocked within the transportation system without having to redevelop the entire system.

## 3. Labour

The South African government has followed an organised labour route, allowing labour to form trade unions to represent them. Often the negotiation for salary increases is done at a central level and in the steel industry the major trade unions are NUMSA and Solidarity while the employer organisation is SEIFSA.

Labour relations in South Africa remain a contentious area with very strong labour unions actively trying to improve the reality of workers while many employers feel they have lost the ability to create innovative work places.

One of the steel industry participants put it like this: “We have a good working relationship with our employees – but we also face difficulties. For instance we cannot incentivise or penalise our employees in terms of productivity (as this is negotiated at a central level). So what the employees do is work quite slowly during the week in order to work overtime (one and a half times the normal wage for Saturday work and double wages for Sunday). So whenever we get a large order in then we have to bargain on additional expenses over the weekend for work that should have been completed during the week. As a company owner I am not allowed to penalise employees for slow work. The only way we can get better productivity is by having bonus plans linked to productivity. But even then we find our employees bend the rules in order to work overtime”.

At the same time employers in South Africa have to be realistic about the labour relations situation in the country. It is clear from government’s perspective that the current system will not change. Collective bargaining and labour unions will remain the cornerstone of labour relations in South Africa. However, new ways of motivating staff (other than financial gain) need to be found in order to improve productivity. One such area should be continuous skills development where companies motivate employees to learn new skills in order to perform more difficult functions and thereby increasing their earning potential. This specific area will be addressed in more detail in the Recommendations Report.

According to the value added steel manufacturing industry it is important to note that it is not only factory staff where productivity is low, but also on the administration side. According to industry feedback the majority of countries whom they compete with are able to function effectively with much smaller administrative contingents and hence it is across companies that worker efficiency needs to increase.

South African labour needs to become more productive in order to compete with global competition. During the research process Merchantec prompted respondents to provide insight into the Chinese versus South African labour productivity comparison. According to industry participants the average output per employee per hour is more or less the same in China and South Africa. Cost per employee per month is also relatively similar. However, Chinese labourers work 6 days a week for 8 hours (excluding overtime). That is a total of 8 hours more per week than South African labour does. Also, Chinese employees have 11 days leave which includes 7 public holidays. South African labour has 15 days leave minimum plus around 12 public holidays. Also, team leaders and managers in China are more often than not qualified engineers able to make quick interventions and process improvements as opposed to South African floor management who are often artisans that have gained extensive experience and are promoted as a result of longevity. The productivity factor is therefore very much a part in how the system is set up compared to Chinese employees working harder per hour. The Chinese import threat is discussed in more detail below.

There is a need to conduct a research study on the relative productivity of South African manufacturing staff as compared to other BRICS countries in order to make a better judgement on the real relative productivity. The issue of productivity was mentioned many times with employers saying productivity is low while labour says productivity is on par with other developing countries and therefore a more objective analysis is required (which falls outside the mandate of this assignment).

#### 4. Pricing of Steel

The pricing of steel is a highly contentious issue in South Africa. Steel companies (and specifically the largest steel producer ArcelorMittal) charge downstream companies similar prices to what they would have paid if they had imported steel. This is termed import parity pricing. There has been an ongoing debate in South Africa as to the benefit downstream companies should get in South Africa based on the rich iron ore reserves in the country and the continued agreement between Kumba Iron Ore and ArcelorMittal for raw material at cost plus 3 percent. However, at the same time the financial results of the steel manufacturers in South Africa have not been particularly positive either over the last 5 years – mainly as a result of increasing global steel supply. As a result, there is huge debate as to the best way to transfer the benefit to local producers. ArcelorMittal and Highveld Everaz are the only two steel producers in South Africa using iron ore, the other producers use scrap metal (DRI input).

Companies where steel has a relatively high value to the final product (over 50% of the value) could benefit most from a more competitive steel price. Lower steel pricing will also make locally produced products more competitive and help to stem imports while also enabling more exports. However, there is only a small number of value adding segments where such reduced pricing will have a positive impact on local demand. In other words, end-users would not buy more steel products if prices of primary steel were reduced.

At the same time it is highly unlikely that the primary steel industry will change its current pricing strategies as the vast majority of primary steel manufacturing capacity is foreign owned and has been fiercely resisting interference on local steel pricing. It is also for this reason that foreign purchased primary steel products are deemed to be locally purchased for localisation targets. This challenge remains a significant hurdle to better industry co-operation, especially between primary steel producers and government. Solutions to primary steel pricing challenges falls outside the scope of this assignment but need further exploration in order to normalise the relationship between steel producers and government.

It should be mentioned here that ArcelorMittal is the most significant supporter of local manufacturing through its Value Added Export Rebates (R229 million in 2013), Strategic Rebates (R34 million in 2013) and COSM Levy (R66 million) in 2013. It is therefore clear that ArcelorMittal is already making a massive contribution to the downstream beneficiation industry – specifically for export purposes. And increased exports are exactly what are required in order to drive utilisation and capacity in South Africa. In addition to this ArcelorMittal contributed in excess of R5 million in 2013 to the industry associations and without this money most of the associations will become unsustainable.

#### 5. Other Costs

There are a number of other costs impacting the profitability of local manufacturers that are growing at a faster rate than some of South Africa's major competitor markets. These costs include transformation costs, social costs, urban tolling as well as soaring international marketing costs on the back of a depreciating rand.

### Tariff Levels for Value Added Products

South Africa has a relatively open tariff system and has been advocating limited tariff intervention as a trade mechanism. However, globally there have been accusations of unfair trade practices especially against Asian based steel companies. The majority of these complaints are against Chinese suppliers where government is actively involved as a manufacturer, exporter and rule maker. It is widely believed that Chinese steel suppliers have a competitive advantage as a result of extensive government support mechanisms. The support mechanisms include subsidies and tax breaks, especially for value added product manufacturers. The Chinese government has followed a strategy of export led growth creation and has been very successful at expanding manufacturing capability in China. However, there are serious questions about China's pricing strategy as it is widely believed that a large number of steel products are sold below actual costs. According to the South African steel industry this is done in order to drive job creation in China and to ensure the Chinese steel industry expands its global influence.

Dumping of products is a well-known strategy followed by companies seeking to gain a trade advantage. Dumping is the practice of supplying products below market value in order to eliminate competition. Once the competition has been eliminated prices are increased in a monopolistic market. Governments are therefore closely monitoring accusations of dumping in order to protect local businesses.

The downstream value adding sector has repeatedly stated that current tariff levels are too low and that upward adjustment (above 15%) will help to cancel industry support mechanisms employed by foreign countries.

Merchantec is of the opinion that it is the responsibility of the individual companies to apply for tariff increases from ITAC. However, Merchantec is also of the opinion that **the dti** should actively support the protection of the local industry by advocating tariff increases in the forums where they represent government. ITAC has indicated that they cannot apply blanket product applications for tariff increases (for example 15% on all wire products) as this would be considered as unfair trading practice. ITAC indicated they are very happy working with the industry associations but that any company or individual may bring a tariff increase or decrease application to the institution.

Care should be taken that tariffs are only applied to products under pressure from unfair imports or where nascent industries are being developed. Products that are not produced locally should not have any tariffs applied to them.

### Material Availability

A number of companies mentioned that they have to import steel products since the materials were either not available from the merchants or the mills in the right quantities or that the specific steel grade required was not available at that time. Companies indicated that they also import raw material and finished products as a result of better pricing from foreign suppliers. For instance, a local tooling company has discontinued manufacturing its low cost tooling range and is importing it now and selling it under its own name.

This challenge is not a major disruptor of local business but requires companies to plan well in advance as foreign ordered steel can take up to 4 months to arrive in South Africa.

## The China Issue

A continuous theme heard during the research process was that unfair trade practices in China were having a negative impact on local manufacturers. These practices are sometimes in contravention of World Trade Rules, but in some cases they are generally accepted and hence countries need to find a balance in the way they approach trade with China.

It is crucial to mention that most South African companies indicated that they are not seeking unfair government support in order to expand their exports. What they are looking for is a level playing field so that they can compete on normal business principles rather than being undermined by unfair practices.

According to WTO rules countries cannot develop country specific tariffs. Companies are however able to bring to the attention of their own government when they suspect unfair trade practices (such as dumping or unfair subsidies). It is therefore the role of companies to continuously bring to the attention of government where they find unfair trade practices.

The Chinese steel industry is in itself very complex and a large part of the industry is government owned. The result is that the products manufactured are often not priced as products from traditional capitalist factories. In many cases Chinese factories do not pay for the land they occupy, they do not pay for the machinery to manufacture and they get various subsidies in the form of subsidised material, electricity subsidies, transportation subsidies and export value added export subsidies as well as tax breaks (such as paying no VAT on value added export products). At the same time labour in China is on average more productive than in other countries based on their 6 day work week and limited private holidays. The number of relative hours spent at work is therefore much higher for most working Chinese when compared to other countries. Employees often live in the factory compounds, their children attend factory schools and hence the cost structures when comparing Chinese and South African wages are hard to measure like for like.

It is crucial for the Chinese government to ensure optimal employment creation and according to the research conducted it seems that the Chinese government is willing to subsidise a variety of products in order to gain market share. Value added steel products fall in this category as can be seen from the table below. In many cases the product is sold at a rate below the true value.

PWC in Australia has been doing ongoing research on unfair Chinese trade practices and has identified the following accusations of unfair trade practices against the Chinese Steel Industry.

Table 3: Alleged Unfair Trade Practices of Chinese Steel Suppliers into Australia

Program Number	Program Name	Program Type	Case 193 Program Number	Case 177 Program Number
1	Hot rolled coil provided by government at less than adequate remuneration	Remuneration	1	1
2	Steel slab provided by government at less than adequate remuneration	Remuneration	NA	N/A
3	Coking coal provided by government at less than adequate remuneration	Remuneration	2	N/A
4	Coke provided by government at less than adequate remuneration	Remuneration	3	N/A
5	Preferential Tax Policies for Enterprises with Foreign Investment Established in the Coastal Economic Open Areas and Economic and Technological Development Zones	Income Tax	4	1

6	Preferential Tax Policies for Foreign Invested Enterprises– Reduced Tax Rate for Productive Foreign Invested Enterprises scheduled to operate for a period of not less than 10 years	Income Tax	5	10
7	Preferential Tax Policies for Enterprises with Foreign Investment Established in Special Economic Zones (excluding Shanghai Pudong area)	Income Tax	6	11
8	Preferential Tax Policies for Enterprises with Foreign Investment Established in Pudong area of Shanghai	Income Tax	7	12
9	Preferential Tax Policies in the Western Regions	Income Tax	8	13
10	Land Use Tax Deduction	Income Tax	9	29
11	Preferential Tax Policies for High and New Technology Enterprises	Income Tax	10	35
12	Tariff and value-added tax (VAT) Exemptions on Imported Materials and Equipments	Tariff & VAT	11	14
13	One-time Awards to Enterprises Whose Products Qualify for ‘Well- Known Trademarks of China’ and ‘Famous Brands of China’	Grant	14	2
14	Matching Funds for International Market Development for Small and Medium Enterprises Grant	Grant	13	5
15	Superstar Enterprise Grant	Grant	14	6
16	Research & Development (R&D) Assistance Grant	Grant	15	7
17	Patent Award of Guangdong Province	Grant	16	8
18	Innovative Experimental Enterprise Grant	Grant	17	15
19	Special Support Fund for Non State-Owned Enterprises	Grant	18	16
20	Venture Investment Fund of Hi-Tech Industry	Grant	19	17
21	Grants for Encouraging the Establishment of Headquarters and Regional Headquarters with Foreign Investment.	Grant	20	18
22	Grant for key enterprises in equipment manufacturing industry of Zhongshan	Grant	12	19
23	Water Conservancy Fund Deduction	Grant	22	21
24	Wuxing District Freight Assistance	Grant	23	22
25	Huzhou City Public Listing Grant	Grant	24	23
26	Huzhou City Quality Award	Grant	25	27
27	Huzhou Industry Enterprise Transformation & Upgrade Development Fund	Grant	26	28
28	Wuxing District Public List Grant	Grant	27	30
29	Anti-dumping Respondent Assistance	Grant	28	31
30	Technology Project Assistance	Grant	29	32
<b>New potential subsidies investigated only in hot rolled plate steel</b>				
Program Number	Program Name (New)	Program Type	Provider	Date of Grant
31	Technique transformation grant for rolling machine	Grant	Jinan Development and Reform Commission	Nov 2009

32	Grant for Industrial enterprise energy management centre construction demonstration project Year 2009	Grant	Ministry of Finance	Dec 2009
33	Key industry revitalization infrastructure spending in budget Year 2010	Grant	Shandong Provincial Department of Finance	Dec 2009
34	Provincial emerging industry and key industry development special fund	Grant	Shandong Provincial Department of Finance and Shandong Economic and Information Committee	Nov 2010
35	Environmental protection fund	Grant	Jinan Municipal Bureau of Finance and Jinan Municipal Environmental Protection Bureau	Dec 2011
36	400 sintering desulfuration transformation fund	Grant	Jinan Municipal Economic and Information Committee and Jinan Municipal Bureau of Finance	Dec 2011
37	Intellectual property licensing	Grant	Intellectual Property Office of Shandong Province	Jun 2012
38	Financial resources construction special fund	Grant	Jinan Finance Bureau	Dec 2012
39	Reducing pollution discharging and Environment improvement assessment award	Grant	Jinan Municipal Finance Bureau	Dec 2012
40	Comprehensive utilization of resources - VAT refund upon collection	Tariff and VAT	Shandong provincial economic and information commission	Dec 2012
41	Grant of elimination of outdated capacity (350 blast furnace)	Grant	Shandong Province Finance Bureau	May 2012
42	Grant from Technology Bureau (development and application of coke oven gas waste heat efficiency reuse technology)	Grant	Jinan Licheng District Finance Bureau	Jun 2012

Source: SEIFSA

From the list it is clear that the Chinese government supports its steel industry through a large number of incentive and subsidy schemes to the detriment of steel manufacturers in other countries. The support mechanisms used for exports to Australia are also widely used for exports to South Africa with similar consequences. It is therefore clear that Chinese manufacturers are not more cost competitive than South African suppliers based on efficiency or technological superiority but as a result of government support mechanisms.

A commonly mentioned support mechanism for the downstream value added steel industry is the wavering of sales taxes for Chinese companies to the value of 15% for value added export products. This tax reduction is widely viewed as an enabler for value added product exports from China and gives Chinese exporters a significant competitive advantage.

Although this report is not aimed at providing recommendations as yet it is crucial that South African government explores the China issue further as the continued viability of large parts of the South African manufacturing industry will be impacted unless the playing fields are more levelled.

### The Impact of the Competition Commission

The impact of the Competition Commission on the downstream value added steel industry has been significant. The Commission became particularly active towards the late 2000's and had a number of impacts on the downstream steel industry.

The first impact is that the associations have stopped the formal collection of industry statistics in order to avoid potential collusive behaviour. Although the immediate result has been that collusion and cartel activity in the industry has indeed reduced, the industry has also stopped communicating effectively with one another to collectively respond to industry challenges such as addressing imports and collectively seeking export opportunities too large to be completed by a single South African supplier.

Merchantec is of the opinion that the Industry Associations should be allowed to help co-ordinate the industries better, but at the same time prevent collusive behaviour. A collective response is required by the value adding steel industry and unfortunately trust levels between companies are low and decreasing. The result is that companies have become paranoid with information sharing – even to third party institutions. As a result, it is taking longer and has become more complicated to apply for tariff increases from ITAC.

The aim of this report is not to provide solutions to the challenges facing the industry as this will be done in the final report. However, it is crucial for the industry to design a forum conducive for information sharing without collusion. It will therefore have to include senior representation from government, the associations and the steel industry leaders. More details on a proposed forum will be provided in the final report containing specific recommendations.

### Delay in Local Projects

The expected pipeline of projects in South Africa is significant. It includes investment in energy, rail and related infrastructure. However, a major challenge to suppliers has been the delay in these projects. Projects such as the Medupi Power station were scheduled to have been completed by 2013. Kusile power station should have been well advanced by now. Similarly, the delay in the roll out of the Strategic Infrastructure Projects (SIP's) have all resulted in delayed orders. Likewise investments into the mining industry have greatly reduced while general industrial investment has also slowed down.

The volume of investment in South Africa is at present reducing - both local investment as well as FDI. Many international companies no longer view South Africa as the gateway into the continent

but prefer to go directly to countries with high economic growth including Mozambique, Zambia, Nigeria, Ghana and Kenya.

If the investment cycle was pushed forward and government infrastructure projects were fast tracked then there would be a significant push for steel products across the value adding segments. There is a large probability that many of the large infrastructure projects will require technical support from international engineering companies and this could in turn lead to counter investment and additional job creation (as is commonly negotiated with large infrastructure projects).

The potential benefits to the steel industry in particular but the economy as a whole offered by the SIP's is significant and hence all efforts should be used in order to drive the progression of these projects. The mechanisms required to speed up the SIP projects are beyond the scope of this project but notice should be made of the importance of these projects.

Although the private sector confidence is particularly low at present there is a feeling amongst business leaders in South Africa that with a small number of changes some large investments can be unlocked. Again, these changes are beyond the scope of this assignment but revolve around policy certainty, effectively addressing corruption and proper spending of provincial budgets.

Similarly, the mining industry is not at present spending significantly in new expansion projects. However, should the price of key commodities rise and remain high there is all indication that mining houses would invest in new capacity. The main challenge in the meantime is for companies to find alternative destinations for their products while the local market is in a slow investment cycle.

### Currency Fluctuations

It is often argued that South African manufacturers benefit from a weak Rand while they struggle to export when the Rand increases in value. However, most manufacturers indicated that the volatility in the Rand makes long-term planning nearly impossible and that the cost of using financial instruments to counter currency volatility is high. Manufacturers also indicated that a weak Rand only has short-term benefits as currency depreciation typically leads to inflationary pressure resulting in faster than anticipated operational expenditure. The long-term impact of a weak currency as well as large currency fluctuations is detrimental to local manufacturers. Manufacturers indicated that a stronger, but more stable currency would in fact enable them to do better long term planning, cost management and help to bring stability to their income.

Unfortunately currency value control is particularly difficult since the majority of currency trade is done outside of South Africa and is mostly done for the purposes of buying and selling shares and therefore the trade in South African Rand is very high, but this does not translate into actual economic growth or investment.

Solving this issue is beyond the scope of this assignment, but notice should be taken that currency fluctuation is negative to the manufacturing industry in general in South Africa.

### Interest Rate Differential

Manufacturers in South Africa find it hard to expand their operations through debt funding. South Africa's interest rates are substantially higher than the developed markets of Europe and the USA

where interest rates are presently at historical lows. At the time of writing the interest rate from the European Central Bank was at 0.15% whereas the repo rate in South Africa at the same time was 5.75%.

Manufactures indicated that they typically try and source cheaper funding wherever they can, but on average the given rates are still much higher than their foreign competitors. Preferential loans from IDC or other state investment corporations are typically a route companies will go in order to reduce their financing costs, but these loans are relatively difficult to obtain.

Most companies in South Africa try to leverage their debt so that they have manageable repayments. Companies typically make use of both short-term debt (mostly for operational expenditure and working capital requirements) as well long-term debt for capital investment and expansion.

According to the industry the current margins companies make is often below the cost of capital from finance institutions making it unattractive to use debt for plant expansion, new investment or even facilitating transformation in the industry since there are at present better investment opportunities for PDI's.

In some cases in South Africa cost-efficient bridge financing is available from development institutions. The final report where industry recommendations are provided will recommend potential bridge financing solutions that industry could make use of.

## BBBEE

The downstream value adding steel industry ownership has on average not yet become broadly representative of the South African society. Many of the large steel companies are family owned which makes mechanisms for these companies to sell equity stakes in their businesses complicated. As a result, many of these companies struggle to access incentive packages from government.

BBBEE is a complex business reality in South Africa. It is highly unlikely that the current system will change any time soon and new ways of dealing with the negative impact of these requirements should be looked at. The complexity of such a review is beyond the scope of this assignment, but the dti needs to take notice of the concern from industry regarding government support access in cases where the companies have poor BBBEE ratings yet create large scale employment.

Merchantec is of the opinion that more needs to be done to transform the industry, but that this needs to be done in a manner to stimulate job creation and local consumption. More emphasis will be placed on this issue in the Project Recommendations Document.

## Skills

A recurring theme during the research process was that companies on average mentioned that there is no shortage of academically technically skilled employees in the marketplace. The problem continuously mentioned was that the majority of training institutions provide skills development that is either of too low a level, or develop skills that are not required in the South African environment. The result is that a large numbers of students graduate with technical and artisanal qualifications, but that they are not absorbed into the workplace despite vacancies. It is particularly in the field of welding that there is a significant gap between what is required by companies versus what is being taught by FET colleges and training institutions.

There was a general comment from the Associations that not enough was being done by both training institutions as well as industry to ensure that the skills taught at an academic level are indeed what is required in a commercial environment.

Some training institutions have however been singled out as delivering better results. This includes the technical training provided by Eskom as well as the some of the training programmes provided by Transnet.

The majority of large companies said that they have relatively small in-house training and mentoring programmes or that they would like to have training programmes but that the cost of training and mentoring is prohibiting them from doing so.

There is a general agreement that there are too few engineers available in South Africa. Estimates from industry varied from 20% to 100% more required engineers across the civil, mechanical, electrical, chemical and industrial engineering fields. According to the industry the average skill levels of engineers graduating from university was of an acceptable level and that engineers were often recruited to work for companies even before they have completed their final qualifications.

### Export Challenges into Africa

Various manufacturing companies mentioned that they fear doing business into Africa as a result of all the typical challenges companies face in doing business in the country. Particular mention was made of payment terms, challenges with logistics infrastructure, corruption, challenges at border posts, physical security risk as well as high tariff barriers in some countries.

However, companies that have gained some experience in exports into Africa have indicated that they believe trading into Africa is the most prominent opportunity for South African companies and that there are increasing opportunities that can be explored. Furthermore, South African companies are held in high regard across most of Sub Saharan Africa regarding product quality, honouring of warranties and after sales service.

There is a need from industry to learn from companies that have been successful in doing repeat business in Africa. This includes information on the steps needed to develop relationships, key risks that need to be managed and co-operation opportunities for companies. Merchantec will explore the potential for an African Services Desk at **the dti** in more detail in the Project Recommendations report.

### Geographical Location (Distance to Markets)

South Africa has traditionally been far from its main trading partners. However, the rise of new industrial powers such as Turkey, India, Vietnam and other countries means that South Africa is now at a distinct disadvantage to service these markets. In addition, many companies in Europe and the US prefer increasingly smaller orders but with smaller delivery intervals making economies of scale difficult.

South African business will have to look more closely at the opportunities into the African region and this opportunity will be explored in more detail in the Trade Analysis document.

### Funding for Associations

The associations play an important role in co-ordination, some data collection and training of specific employees who can fulfil specific needs in the industry. The associations are heavily dependent on the funding paid by members, **the dti** (in some cases) and ArcelorMittal. Without this funding the associations will most definitely not be able to play the important role of being the mouth piece of the industry, lobbying government where appropriate and assisting with artisanal training.

It is in particular the funding supplied by ArcelorMittal that assists a large number of the downstream value adding associations to be able to grow in importance and deliver real value to the overall industry. ArcelorMittal has contributed in excess of R5 million in association support over the last 2 years and is playing a pivotal role in understanding the downstream industry requirements and supporting companies where it deems strategically important.

The associations in turn will have to play a more prominent role in driving the interests of the overall industry, but they can only do this effectively if they have efficient forums to raise their concerns and propose changes in policy and legislation that will drive industry growth. The issue of a downstream steel industry forum will be explored further in the Recommendations Report.

### Substitute Materials

Replacement materials are increasingly a problem. Aluminium can replace steel in a variety of applications – especially in the automotive, roofing and packaging markets. The relative advantage is of course decreased weight with relatively similar strength and durability. So in some applications vehicle manufacturers would gladly replace steel with aluminium. The relative price differential between steel and aluminium has decreased over the last 10 years making it increasingly attractive to pay a small additional cost for aluminium while gaining greatly in weight benefit. The current price differential is around 20% and although this does make a substantial difference when purchased in large quantities there would be consumers willing to pay more for a metal of less weight yet durable enough to support the key application thereof.

Other replacement materials are in the water utility space where some steel pipes (smaller bore in particular) are increasingly being replaced by plastic alternatives, such as PVC pipes. These products often seal better (less water loss) and have a decreased lifetime cost, according to water utilities interviewed.

Within the large drum packaging industry there were no immediate alternatives for steel, although some of the smaller packagers preferred plastics over steel as it is easier to handle and cheaper to produce. In the food and beverage industry there has been a marked move away from steel cans to aluminium in many cases and this trend is expected to continue.

### Innovation, R&D and Technology Improvement

The majority of downstream value adding companies have not invested in new technology over the last 5 years as a result of a variety of reasons. The reasons include a negative market outlook and no incentive to invest, a preference to use labour instead of mechanisation and the high cost of new equipment. However, as a result, South African producers are increasingly facing competitors with highly sophisticated machinery that is more efficient than the local companies. As a result of margin pressure the amount of R&D being done within industries is relatively low and hence fewer new products are developed locally that could give local manufacturers a competitive advantage. More needs to be done to create an environment where companies are encouraged to invest in R&D and

innovation. Recommendations regarding innovation will be presented in the final recommendations assignment.

### Obstacles of doing business in BRICS

South Africa's inclusion into the BRICS formation has been cheered as a vote of confidence in Africa's most sophisticated market and was meant to open new trade corridors for South African business. However, it has proven not to be the case and although South Africa has benefited greatly in brand, South African business has not seen the benefits of this formation. In fact South African business has struggled greatly to access the markets in Brazil and China in particular. The China issue was discussed in more detail. In Brazil government and industry are working together to make it extremely difficult for South African exporters to access their markets. Excessive red tape and various attempts to disrupt trade have resulted in lost opportunities. Some companies indicated that they were able to identify new business opportunities in Brazil, but that their cargo was held for such a long time at the harbour that the new client resorted to finding an alternative supplier.

As one respondent put it: "South Africa is part of this formation on paper only. We do not benefit any more than any other country in gaining access to the large internal markets of our partner countries. There is no real business benefit for our industries at present."

## Opportunity Analysis

### DTI Incentives

The dti has a number of incentives and support mechanisms in place that could benefit the downstream value adding steel industry.

Specific incentives that could be used to drive development in the industry include:

Table 4: Key DTI Incentives Currently in Place for Downstream Value Adding Steel Manufacturers

Incentive	Short Description
12L	The 12I Tax Incentive is designed to support Greenfield investments (i.e. new industrial projects that utilise only new and unused manufacturing assets), as well as Brownfield investments (i.e. expansions or upgrades of existing industrial projects). The new incentive offers support for both capital investment and training.
Automotive Investment Scheme	The Automotive Investment Scheme (AIS) is an incentive designed to grow and develop the automotive sector through investment in new and/ or replacement models and components that will increase plant production volumes, sustain employment and/ or strengthen the automotive value chain.
Black Business Supplier Development Scheme	The Black Business Supplier Development Programme (BBSDP) is a cost-sharing grant offered to black-owned small enterprises to assist them to improve their competitiveness and sustainability to become part of the mainstream economy and create employment.
Critical Infrastructure Programme (CIP)	A cash grant to a maximum of 30% capped at R30 million of the development cost of qualifying infrastructure.
Capital Projects Feasibility Programme (CPFP)	The Capital Projects Feasibility Programme (CPFP) is a cost-sharing grant that contributes to the cost of feasibility studies likely to lead to projects that will increase local exports and stimulate the market for South African capital goods and services.
Employment Creation Fund (ECF) (Currently on Hold)	The ECF supports projects and programmes that have a positive impact on employment creation, skills development and capacity building, developing the 'green economy,' developing the agriculture and agro-processing value-chain, technology diffusion and commercialisation, public employment creation, rural development and the business environment.
Export Marketing & Investment Assistance Scheme (EMIA)	The Export Marketing and Investment Assistance (EMIA) scheme develops export markets for South African products and services and to recruit new foreign direct investment into the country.
SMME Development Financial Assistance (Incentives)	In continuing to strengthen economic development through broadening participation in the economy, the ISP aims to ensure that small, micro and medium enterprises (SMMEs) graduate into the mainstream economy through the support provided by the incubators. The ISP is one of the support measures to encourage partnerships in which big business assists SMMEs with skills transfer, enterprise development, supplier development and marketing opportunities.
The Manufacturing Competitiveness Enhancement Programme (MCEP)	The Manufacturing Competitiveness Enhancement Programme (MCEP) which is one of the key action programmes of the Industrial Policy Action Plan (IPAP) 2012/13 – 2014/15 will provide enhanced manufacturing support aimed at encouraging manufacturers to upgrade their production

		facilities in a manner that sustains employment and maximises value-addition in the short to medium term.
Sector Assistance (SSAS)	Specific Scheme	The Sector Specific Assistance Scheme (SSAS) is a reimbursable 80:20 cost-sharing grant offering financial support to export councils, joint action groups and industry associations.
Support for Innovation (SPII)	Programme for Industrial	The Support Programme for Industrial Innovation (SPII) is designed to promote technology development in South Africa's industry, through the provision of financial assistance for the development of innovative products and/or processes. SPII is focussed specifically on the development phase, which begins at the conclusion of basic research and ends at the point when a pre-production prototype has been produced.

Source: **The dti**

Value adding steel industry companies are in general unaware of most of the incentives available. When Merchantec prompted companies on specific incentives more than 75% of these companies were unaware of the incentives or mentioned that the red tape required to access these incentives was excessive. It is therefore clear that much education is required in the steel industry for companies to make optimal use of available incentives.

In the Recommendations Report more attention will be provided on how downstream steel companies can be educated on available incentives.

### Trade and Investment South Africa (TISA)

TISA is a dti initiative with the aim of being a one stop shop for investors into South Africa and also to assist South African companies to expand their exports. According to TISA the demand for goods and services from South Africa has been on the increase, but that global demand has been flat for the last few years. As a result the department has spent a significant portion of their budget (around 30%) on trade missions in order to uncover opportunities for local suppliers.

According to TISA the main barriers preventing further exports are:

1. Non-tariff barriers
2. Language barriers
3. Non-traditional markets, South African products not known
4. Ability to supply quantities as required by markets such as China

TISA further provides around R110 million in export credit insurance available to exporters. This helps exporters in creating certainty that they will be paid and hence increase the attractiveness of identifying export opportunities.

TISA is responsible for the effective management and administration of the Department's Foreign Offices based abroad. The dti has 27 Foreign Economic Representatives and 48 Marketing Officers covering a footprint of 37 countries. In countries where TISA does not have Foreign Economic Representatives (FER's), TISA works closely with DIRCO (Department of International Relations and Co-operation). TISA spend around 30% of their budget annually on maintaining these offices (R120 million).

TISA spends around R30 million on export development support while nearly R50 million is spent on marketing South African products in foreign countries.

Feedback from the downstream industry is that these promotion and marketing campaigns are great for creating awareness around South African products, but this does not necessarily result in new

business or export opportunities. Companies in the downstream industry indicated that they still have to invest in business development capacity in these countries to ensure a continuous stream of exports and that this is costly and also daunting since Africa is a very large continent with 54 autonomous countries. According to industry the focus of TISA is too high level and that there is a need for more granular information on projects happening in Africa.

### Bilateral Trade Agreements

South Africa is signatory to a number of trade agreements including being part of the BRICS formation. It was previously mentioned that the current arrangement does not really benefit South African business. However, this formation could potentially be a strong opportunity for export led growth. South African value added steel manufacturers expressed their hope that government could potentially push its trading partners to focus on delivering products in the steel industry that is complimentary rather than competitive in nature. According to the industry they believe there is sufficient local competition to keep prices in check while reducing foreign competition from subsidised producers. According to the industry there are a large number of value added products that are not manufactured locally and hence could be imported from the other BRICS countries. A deal such as this will obviate the necessity of having to go through the painful and expensive exercise of applying for import tariffs or dumping duties.

### COSM and Export Support Mechanisms

The impact of COSM will be discussed in more detail in the Trade Analysis document. However, at present it is the only support mechanism for exporters and is aimed to assist exporters in reducing the cost of transportation to distant markets. The fund is supported by all ferrous metal smelters in South Africa and is paid to export companies that export their products via sea transportation through SAISI.

The fund paid out just over R62 million in 2013 to over 120 exporting companies. This excludes Africa overland exporters.

A second important category of support for the downstream beneficiation industry in South Africa comes from the steel mills. Not all steel mills provide these support mechanisms but there are two that contribute a significant level of support to local manufacturers. ArcelorMittal (ferrous product) and Columbus Stainless provide project and manufacturing specific pricing for manufacturers that help drive local demand.

ArcelorMittal in particular has contributed significantly to the downstream value adding steel industry by contributing over R1.5 billion over the last 5 years. The contributions are as follow:

Table 5: ArcelorMittal's Monetary Contribution to the South African Steel Industry

Initiative	2009	2010	2011	2012	2013	Comments
Value Added Export Rebates	189	258	293	237	229	ArcelorMittal specific additional Value Added Export initiative
Strategic Rebates	22	1	2	26	34	Projects in process to drive local sales
COSM Levy	36	46	55	28	66	National value added export rebate administered by SAISI
Total	247	305	350	291	329	Total contribution to South African downstream manufacturing

Source: ArcelorMittal

## Designation

Designation in the valves industry is expected to have a significantly positive impact on local valve manufacturers. Similarly, this practice could be used for more steel value added products especially for government infrastructure projects. Manufacturers indicated that more should be done to create homogenous standards for products in South Africa across key end-users such as water infrastructure, “road furniture”, and other national infrastructure.

Specific products that could be designated will be identified and described in more detail in the Recommendations Report.

## Local Content Levels

Government (mainly through **the dti**) has been very aggressive in driving localisation requirements for foreign investors doing business with South Africa. An example that was often mentioned was the positive impact the Renewable Energy programme run by the Department of Energy was having on local manufacturers. Future projects where government has a say in procurement will likely continue to demand local content and development and should be further encouraged.

Aggressive local content targets should be set as has been done in the automotive industry where up to 60% of locally manufactured vehicle content is locally sourced. Recommendations around local content targets for the steel industry will be done in the Recommendations Report.

**The dti** has been very active in pushing local and provincial government to set higher local content targets and should be commended for their efforts in driving local manufacturing. The knock down benefit of local manufacturing is far larger than just the price paid for goods and equipment sourced for local projects.

More work around proudly buying South African products should be encouraged as a regular theme to local industry and commerce. More details on a potential approach for such a campaign will be supplied in the Recommendations Report.

## Trade Finance

One of the largest challenges facing the development of infrastructure (and Africa in particular) is the availability of funding. At present, a number of government owned as well as private institutions are developing finance lines to help facilitate the required investment. Examples of such institutions include the recent formation of the BRICKS Development Bank aimed at facilitating infrastructure development in the leading developing countries. Other opportunities include institutions that provide bridge finance for export opportunities (cash flow), as well as trade insurance companies that will investigate the feasibility of a specific export opportunity and then guarantee payment and hence improve the financial feasibility of manufacturing companies.

## Relative Ease with Which Companies Can Gear Up

Although companies are relatively underutilised at present, the positive implication is that most companies can quickly ramp up production and hence there is no need for significant investment in production capacity and machinery to increase manufacturing capability.

Most companies could easily implement an additional shift which would result in decreased production costs (as fixed costs are already absorbed in current manufacturing activity). Steel value

added companies indicated they would be able to ramp up production within a few weeks with the only real challenge finding suitable qualified staff to man additional shifts.

Some companies have indicated that they are hesitant to expand the number of shifts as theft typically increases as more shifts are implemented. However, by implementing proper security measures and employing the right staff will greatly help to limit losses as a result of theft.

### African Markets Beyond SADC

The downstream value adding steel industry has done well to develop business relationships into SADC and from the trade analysis it is clear that the region is the most important export region. However, South African companies have not yet fully explored opportunities outside the SADC region and more needs to be done to identify long term offset markets where South Africa could benefit from its position on the continent. Specific recommendations on how to create more awareness and opportunities for South African companies will be discussed in the Recommendations Report.

## Conclusions

The South African downstream value added steel industry is facing a number of challenges with the majority of these not being steel specific industry challenges but rather general manufacturing challenges in South Africa.

Throughout the value adding segments, companies mentioned the threat of increasing imports as a key challenge. In particular the increase in imports from Asia is on the increase and further research is required to understand the exact nature and legality of the support mechanisms provided to Chinese steel producing and value adding companies.

At the same time, Merchantec gathered information on the rising cost of doing business in South Africa as a manufacturing entity. Increasing electricity and labour costs are hindering manufacturing output in a period where value adding companies struggle to pass on costs to consumers. Inland customers are particularly hard hit with transportation costs and an inefficient rail system. A very contentious issue is that of steel pricing in South Africa. The relative advantage of rich iron ore minerals in South Africa is not passed on to value adding companies, but similarly the primary steel industry is not making significant margins. More will have to be done in order to solve the primary steel pricing scenario.

South Africa has favoured an open trading strategy of limited tariffs with the rest of the world since sanctions were lifted on the country. This has in turn made South African companies leaner and more efficient. However, more protection is required against imports from countries where manufacturers receive significant government support. A review of current steel tariffs should therefore be undertaken.

Local manufacturers confirmed that they often imported primary steel products as they may not be able to get the quantity or quality of product that they require. The challenge is not so much in sourcing steel as it is the lead time to transport to South Africa (in excess of 3 months).

A deep concern in the industry is the slow pace at which government infrastructure and new private investment is being rolled out. Companies interviewed indicated they feel optimistic about the potential projects planned under the government's infrastructure programme but that these projects were not being rolled out fast enough.

Financial challenges facing the industry include significant currency fluctuations as well as the high cost of capital in South Africa as compared with most developed countries. Companies indicated they had little incentive to expand operations if new opportunities arise since profit margins were already under pressure.

BBBEE also remains a contentious business issue with the manufacturing industry not transforming as fast as government would like while many of the privately owned companies are not wanting to sell equity stakes in their family owned businesses.

South Africa has spent a significant amount of resources on skills development and the positive impact has been that many artisans have been trained over the last 5 years. However, there is a mismatch of skills between what companies really need versus what the training industry is providing. Better communication channels as well as more on the job training are required to fix this problem.

South Africa is geographically far from the majority of its major markets in Europe and the USA. South African market share is also increasingly being eroded by manufacturers from Asia. Fortunately Africa as a market is increasingly important to South African manufacturers. However, African business is often viewed as high risk and new ways of doing business is often required. More needs to be done to empower South African businesses to do business in Africa.

The industry associations play an important role in facilitating communication in the downstream industry, they address communal problems and lobby government when needed. Unfortunately the majority of associations in South Africa are under pressure financially as their contributing members are themselves facing financial insecurity. The value these associations add is significant and more needs to be done in order to finance their activities.

Lastly, there are a number of substitute materials currently eroding demand for steel products.

At the same time, there are growth and support opportunities that are not yet fully exploited. The first are the manufacturing incentives in place from the dti. Few companies are aware of the incentives and general feedback was that these incentives are hard to access and that red tape prevented companies from accessing them. More awareness of the process and benefit of these incentives should be done.

The support offered to export companies through the COSM fund helps to decrease the costs of export. The current support levels are relatively low and more should be done to support export companies.

A very important opportunity is that of government procurement and the potential for designation. More information around specific product designation will be supplied in the final recommendations report.

Lastly, although downstream steel manufacturing capability is underutilised it does mean that companies can ramp up production quickly and hence little additional investment is required to drive expansion.