Over the last 60 years, South African cement demand has gone through a number of cycles, most recently characterised by a very strong and prolonged growth phase between 2000 and 2007.

During this period, local cement producers were highly profitable and returned a significant amount of cash to shareholders. However, since the 2007 market peak, volumes have declined sharply and producers’ margins have come under pressure.
The elevated profit margins at the peak of the market attracted investment to expand the industry’s production capacity. Due to the increased competition in the industry, it seems unlikely that cement companies will soon return to the levels of profitability that were achieved during the previous up-cycle.

Against this backdrop of a mature and over-supplied local market, our clients are not invested in the sector. However, cement companies have historically provided good returns to investors and we are closely following PPC’s expansion into attractive markets elsewhere in Africa.

Supply
The local industry is controlled by four main players: PPC, Afrisam, Lafarge and NPC-Cimpor. Cement industries tend to be delineated into geographic areas as cement is expensive to transport. Transport accounts for roughly a third of the cost and, in most circumstances, it is not economical to transport cement more than 250km from the milling plant. This is particularly pronounced in South Africa as almost all cement is transported by road, which constrains the economic distribution radius more than rail does. Cement can, however, be transported relatively efficiently by sea. Imports, mainly into KwaZulu Natal, now account for about 6% of the local market.

PPC has the largest footprint and supplies the inland market, the Western Cape and the Eastern Cape. AfriSam and Lafarge only supply the inland market and NPC-Cimpor focuses on KwaZulu Natal and Mozambique (see map). These four producers operated as part of a legal cartel until it was disbanded around 1995 and competition between them has remained relatively low since. Competition now seems to be intensifying in the face of weaker market demand and these producers have not been able to pass through all of the input cost increases that they have experienced over the last few years. This has resulted in margin pressure.

Local cement plants sell cement in South Africa and in neighbouring countries. Production capacity (excluding mothballed plants) is roughly 16.5 million tons per year, although the interpretation of capacity can vary. By comparison, the regional market used about 15.5 million tons of cement at its peak in 2007.

Demand
Cement is the key ingredient in concrete, an essential component in the construction of most buildings and structures. Cement demand is driven by economic and population growth, and infrastructure investment is a key determinant of demand growth.

Residential building is the most cement intensive type of construction and, for the cost of building, uses a

**New entrant**
Sephaku Cement is the first new competitor in the inland market since 1934 and is due to start production by early 2014. With the construction of its cement plant near Lichtenburg and a grinding facility in Delmas, it is expected to add 2.6 million tons of capacity with new and more efficient equipment. This will add a significant share of low-cost capacity to the inland market and is likely to result in increased competition. Apart from gaining market share, the additional capacity is bound to lead to lower retail cement price growth. Sephaku is already exerting pressure on existing companies to optimise their capacity to compete with its new equipment.

Cement plants and grinding facilities

[Map of cement plants and grinding facilities in South Africa]

Source: PPC
Cement in South Africa

A disproportionately large amount of cement. The government’s social housing projects should therefore support cement demand as about seven tons of cement is required to build a small 80m² RDP house. Although important, non-residential building and civil construction is typically less cement intensive as a greater share of other building material is used.

2000 to 2007 and beyond

As shown in the graph, demand grew substantially between 2000 and 2007, accompanied by robust pricing and record levels of profitability for cement producers. This was supported by buoyant private sector building activity and investment in infrastructure across South Africa.

The market has contracted materially in recent years and annual demand is now 19% below the peak reached in 2007. There has been a steep decline in demand from construction activity, which has been partially offset by strong demand from retail consumers. This consumer demand has been boosted by, among other factors, the growth in social grants and unsecured lending.

Although government infrastructure development plans and a recovery in private building activity will drive growth in the cement market, it is likely to be a few years before the previous peak demand is reached. It is important to bear in mind that industry capacity will be significantly higher than in 2007 when demand peaks again, which will result in an improved market balance.

Price

Historically, the industry has successfully passed through price increases, even during times of weak demand. Pricing was previously controlled, first by government regulation and later by a legal cement cartel. Although coordinated pricing is now illegal, the industry remains concentrated with divided markets due to the location of existing plants. Prices are therefore relatively elevated by global standards.

The graph on the next page shows the pricing discipline still exercised almost two decades after the disbandment of the cartel. Recent initiatives by the Competition Commission and the imminent entry of Sephaku suggest that the industry will enjoy less pricing power going forward.

**Regional cement sales**

Regional market includes South Africa, Botswana, Swaziland, Lesotho and Namibia

Source: I-Net, C&CI, PPC, Kagiso Asset Management research
Africa
Due to the mature South African market, PPC is looking for growth opportunities elsewhere in Africa. Sub-Saharan Africa has an enormous need for infrastructure development and scores very well on a number of metrics as an attractive place to invest in cement manufacturing capacity. Strong demand growth is driven by the current low per capita consumption, high GDP growth rates and rapidly urbanising populations. In addition, cement prices are often very high, driven by supply deficits and the logistical challenge of importing cement. These positive factors are obviously accompanied by a number of risks involved in investing in Africa.

Besides existing operations in Botswana and Zimbabwe, PPC has recently invested in two significant new projects in Africa: Cimerwa in Rwanda and Habesha Cement in Ethiopia. In Rwanda, the company has commissioned the construction of a new cement plant. PPC is also in the final stages of evaluating investments in new plants in the DRC and northern Zimbabwe. All the new plants will be built by a Chinese engineering contractor, Sinoma, which has quickly established a reputation for building high quality cement plants in Africa at low cost.

Sinoma also takes on most of the risks in the construction phase, which dramatically simplifies PPC’s investment in these less developed countries. The plants will take about two years to build and will start to contribute meaningfully to PPC from 2016 onwards.

In summary
Looking ahead, growth in cement demand will be balanced by the increased capacity from existing players and the entry of Sephaku. It is therefore unlikely that cement companies’ profitability will return to previous peak levels in the next growth cycle. We will, however, be watching PPC’s African expansion efforts with interest.  

Producer pricing power

Source: I-Net, SBG Securities, Stats SA, Kagiso Asset Management research