

South African retail and consumer products outlook 2012-2016



October 2012 South African edition

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This report was written in cooperation with the Economist Intelligence Unit's industry and management research division. The economic and industry forecasts included are those of the Economist Intelligence Unit.



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Foreword

We are pleased to present the 2012 edition of our South African retail and consumer products outlook thought leadership series, covering the forecast period of 2012-2016. Each section of the publication sets out key trends, challenges and opportunities as well as outlining future prospects for the forecast period.

Challenging business environment

As we contemplate future prospects, it is equally important to reflect on the events of the past few years and the context they provide. The global financial crisis of 2008 and the recession that followed brought with it pervasive uncertainty, which has been exacerbated more recently by the Eurozone crisis and economic slowdown in Asia.

Such global events have certainly been felt in South Africa, with GDP shrinking by 1.3% in 2009, and the sluggish recovery experienced since 2010 continues to restrict growth potential across a range of industries and sectors, including retail and consumer products.

With slow GDP growth, high unemployment and structural shortcomings in the economy persisting, overall growth for the forecast period is expected to be modest, if not fragile. In particular, retail and consumer products companies must contend with limited volume growth, increasing costs and falling prices.

Competition driving efficiency

The entry of Walmart into the South African market is expected to further intensify competition, placing added pressure on already thin average profit margins. As competition increases, companies are being driven to introduce more efficient supply chains and advanced technology to reduce the cost of doing business and enhance the customer experience.

Cost inflation brings similar pressures and we expect retail and consumer goods companies will make significant progress in slicing out costs along their supply chains and operations to achieve volume growth above their fixed-cost bases. This will be no mean feat given that electricity prices are continuing to increase materially, along with wages and both the costs of fuel and retail occupancy.

Consumer power

Increased competition translates into more power and choice for consumers. In this era of the Internet and social media, consumers are also becoming more vocal as they can compare products, prices and customer experiences online in real time. While companies have nowhere to hide, the fact that consumers are now more active in voting with their wallets can be seen in the pressure being placed on companies to demonstrate a commitment to sustainability, fair business practice, appropriate food labelling and employment equity, to mention a few recent instances. Companies that fail to stand up to customers' scrutiny will feel the effects in lost sales.

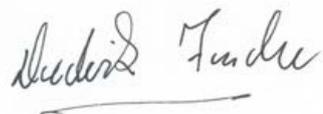
Pursuing growth

Despite retail and consumer products companies' almost single-minded focus on operational efficiency, there is also a mood of cautious optimism as they continue to seek growth opportunities in new areas, both in South Africa and across Africa. Opportunities identified include attracting informal trade at the lower end of the market into the formal retail sector and capitalising on the opportunities presented by the country's steadily expanding black middle class. In contrast, online retailing will remain a niche proposition for the medium term, although we expect to see growth accelerate as Internet access reaches critical mass.

Given local constraints and despite the considerable challenges, all major retail and consumer products companies have started to either expand into the rest of Africa or increase the presence they already have there, some more aggressively than others. Over the years, many of the most successful companies in South Africa have developed their business models to compete and be successful in the tough African market. Today, we see they most often find themselves better prepared and more competitive when expanding into other African economies, where the realities of supply chain difficulties, poor infrastructure and unfamiliar cultural, legal and trading environments can be daunting.

In conclusion, we express our thanks to the Economist Intelligence Unit and our sincere gratitude to all the executives and analysts who set aside time in their busy schedules to share many of the insights contained in this publication.

We trust this report will provide you with some useful perspectives in recognising and addressing present challenges as well as in realising the numerous opportunities that the market presents.



Diederik Fouche
Consumer and Industrial
Products Leader



John Wilkinson
Retail & Consumer Leader

October 2012
PwC Southern Africa

What retail and consumer goods companies should consider

- Long-term success will depend on a continued focus on the consumer, efficient supply chains and a low cost of doing business. This will be particularly important for those companies looking to expand their footprint in Africa.
- Companies that differentiate their products or formats and provide a compelling reason for customers to buy from them will continue to survive. Those that don't will face an onslaught from competitors.
- The ability of companies to identify, react to and take advantage of changing consumer behaviour will determine their level of success.
- In difficult times like these, companies need to critically re-examine their cost structures, operational effectiveness and efficiency.

Acknowledgements

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- Mel Urdang, Director: retail and leasing, Liberty Properties
- Nick Dennis, CEO, Lodestone Brands
- Pieter Erasmus, CEO, Pepkor
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- Wayne McCauley, Director: sales and distribution, SABMiller





Executive summary

Long written off by corporate investors, the perception of Africa has been buoyed by a strong decade. Democracy has spread, while a more competitive landscape for private companies has emerged in many places. The continent's collective GDP is expected to swell by US\$1tr by 2020, up from US\$1.6tr in 2010¹. The Economist Intelligence Unit forecasts real GDP growth of 4.9% from 2012-16, well above average world growth. Crucially, an emerging middle class, with modest, but rapidly increasing disposable income, accounts for a growing proportion of this uptick. This is now generating substantial consumer demand for retailers and consumer goods companies.

Leading the charge in this turnaround is South Africa, the continent's most sophisticated economy. It is already the biggest retail market in sub-Saharan Africa, and the 20th largest in the world, with a wide array of shopping malls and retail developments, as well as a sizable food and non-food manufacturing sector². While average GDP growth rates are modest, per capita incomes are far higher than elsewhere on the continent. Furthermore, local consumers are highly aspirational and brand conscious, making for a thriving and competitive retail and consumer goods market, as a visit to any of the country's many large shopping malls will attest.

This report considers South Africa's outlook for both retailers and consumer goods firms, providing growth estimates for the 2012-16 forecast period. It reviews the major opportunities, key pressures faced and some of the growth strategies being deployed. It also touches on the impact of further entrants into the market, following the high-profile 2011 acquisition of Massmart by Walmart, the world's largest retailer.

The main findings of the report:

- **Total retail sales will continue to expand steadily from 2012-16, driven in particular by the continued emergence of a black middle class.**

Both food and non-food sales will rack up steady, if unspectacular, growth. Measured by volume, sales will climb by an average of 2.9%, after recovering from a low in 2012. By value, sales will expand at an average of 7.85% in nominal terms. In 2011, the country's aggregate retail sales surpassed a trillion rand for the first time in history, and are likely to hit R1.46tr by 2016. The most mouth-watering prospect for retailers and consumer goods firms is the country's steadily expanding black middle class. By 2016, some 11 million households are expected to have annual incomes of about R89 500 (or US\$10 000¹) – a level that gives them discretionary spending for a far wider range of consumer goods, as in other emerging markets. Although figures are hard to verify, some experts believe the country is already home to some 71 000 dollar millionaires.

- **Unemployment will remain the country's largest drag on growth, entrenching high rates of income inequality. This has been further exacerbated since the 2009 downturn and will remain a key policy challenge, not least amidst sharp income inequality.**

South Africa is considered by many to have one of the highest rates of income inequality in the world. As such, its emerging middle class is matched by a vast number of people on the poverty line. Many are supported by a basic government social welfare scheme, but the scale of unemployment – which has climbed officially to 24.9% since the 2009 economic downturn, but is informally considered far higher – is the country's most significant drag on retail growth.

- **Although overall growth will be moderate, sales growth will be strong at both the low-end and high-end, reflecting South Africa's income spread.**

Although food sales, which accounted for 54% of all sales in 2011, are forecast to expand relatively slowly, there is more exciting demand at the top and bottom ends of the income spectrum. At the low end, the most basic fast-moving consumer goods, such as soaps and cleaners, are buoyed by the large-scale social grants provided by the Government, expanding by an average of just over 17% over the forecast period. At the high-end, goods such as household audio and video products are both expected to grow at around 18%, not least as the middle class continues to grow and increase its aspirational spending. As one anecdotal example of this wealth disparity, South Africa was ranked as the world's fifth-largest export market for Scotch whisky in 2011, a drink locally recognised as a status symbol.

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- **Although South Africa's retail market has bounced back from recession, growth prospects remain fragile, with considerable downside risks.**

The country may have joined the league of the 'BRICS' in name, but growth rates here remain highly uncertain. GDP is expected to expand by 2.8% in real terms in 2012, down from 3.1% last year. This is far below the rate required to make a significant impact on unemployment rates, and more on a par with far more mature economies. In part this is shaped by the weak global economy and the Eurozone crisis. However, local issues constrain growth too, such as uncertainty over policies related to labour flexibility, along with a growing legislative burden, such as more onerous product labelling requirements and other requirements introduced in the newly-promulgated Consumer Protection Act. Furthermore, the competitiveness of the local consumer goods manufacturing sector is being challenged by lower cost international rivals.

- **For local retailers and consumer goods firms, the rest of Africa is widely viewed as an opportunity for expansion.**

Every major retailer and consumer goods company has started to expand into the rest of Africa, along with ongoing efforts at home to expand retail space. The charge is being led by the domestic food retail giant Shoprite, which already has stores in 17 countries. Nevertheless, most brands are treating the Africa aspect of their growth cautiously, given the significant risks that remain. As such, most are embracing a strategy of steady organic expansion. For retailers in particular, many are operating in tandem with property developers, opening up in parallel with new mall developments and shopping complexes.

The rest of Africa is widely viewed as an opportunity for expansion.

- **Despite the headline Massmart acquisition, few retailers expect a rush of mergers and acquisitions (M&A).**

The South African retail scene is dominated by a small number of major retail and consumer goods companies, many of which could make appealing takeover targets. Nevertheless, given the challenges of Walmart's acquisition, which attracted close scrutiny from the Competition Commission, along with strong local competition, few experts are forecasting a boom in M&A from foreign entrants. In part, this is because few major international food retailers appear to be moving quickly to enter the African market, while fashion brands and other retailers appear likely to expand organically, rather than via acquisition. However, given the limited availability of free retail space, such growth will necessarily happen gradually.

- **Operational efficiency will be a core focus for retailers in the medium term.**

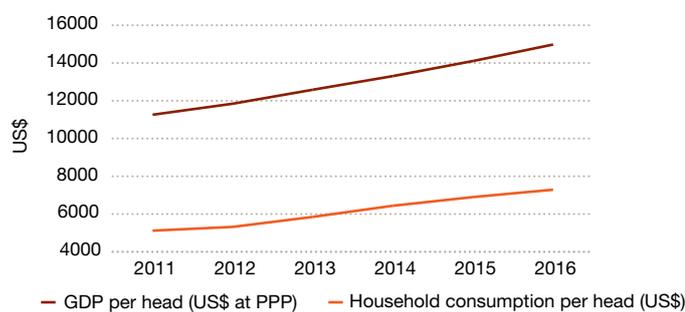
A range of pressures – including worries over currency volatility and price inflation, concerns over the global economy, and increased competitive pressures from the entry of Walmart – are driving local retailers to invest heavily in operational efficiency. For many, the headline investments are being made in their supply chains, such as centralised distribution, as well as in more advanced IT systems, in the pursuit of greater efficiency.

- **Online retailing remains a niche proposition for the medium term, although growth is now starting to accelerate.**

Growth in Internet access, which has long been a major constraint in South Africa, is now speeding up as the market gets more competitive. Nevertheless, only higher-end retailers are giving e-commerce much attention, with most focus on non-food goods. Costly online access aside, the local postal system is also a constraint on growth, given concerns over its efficiency. A rising trend is online price comparison, booking and purchasing followed by in-store collection.

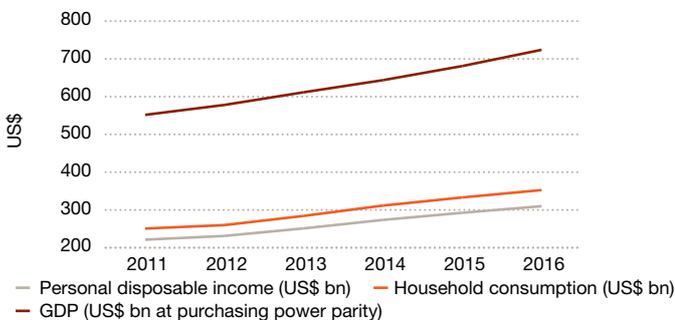
Introduction

GDP per head vs household consumption per head



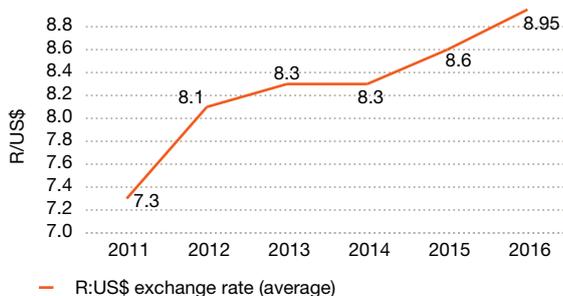
Source: Economist Intelligence Unit

Personal disposable income, household consumption and GDP



Source: Economist Intelligence Unit

R:US\$ exchange rate



Source: Economist Intelligence Unit

Barring a short, sharp recession in 2009, South Africa has so far avoided the worst of the global economic downturn. However, as both global and domestic conditions weaken, real gross domestic product (GDP) growth is expected to slow to 2.8% in 2012, from 3.1% last year. Among leading retail and consumer goods executives interviewed for this report, this downward pressure is being keenly felt.

For outside observers, this gloomy mood may come as a surprise. The country successfully hosted the 2010 FIFA World Cup, with a consequent boost in tourism and profile. And despite being home to a sophisticated banking sector, there has been no local banking crisis. The country has made much of joining its (far larger) emerging market peers in the BRICS club, along with Brazil, Russia, India and China.

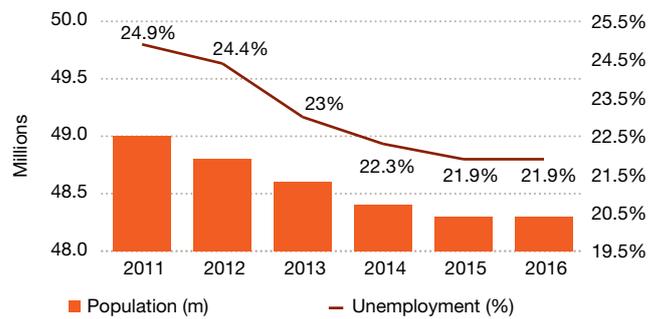
Indeed, South Africa is following in the footsteps of many other emerging markets by developing an increasingly large band of middle-class consumers. For retail and consumer goods companies in particular, these consumers are highly aspirational – and have plenty of opportunities to deploy their disposable incomes, with local cities well stocked with modern malls. These cater to a local consumer culture that places a premium on high-end consumer goods, from fashion labels through to luxury car marques.

For first time visitors, the degree of sophistication and spending power among many of the country's consumer class can come as a surprise. But it also quickly becomes apparent that there are clear downside risks. The rand, South Africa's currency, is highly volatile, which makes forecasting for import-dependent local retailers and consumer goods companies difficult. Local inflation is also unstable, with steep price increases for fuel and electricity currently being sorely felt.

Most obvious, though, is the unemployment rate. This acts as a huge drag on both growth and consumer spending. Unemployment deteriorated to 24.9% in 2011, from a low of 22.9% in 2008. Informal estimates put this far higher, while youth unemployment is especially problematic. In the first quarter of 2012, the rate made its biggest quarterly jump in three years, to 25.2%. A broader figure that includes discouraged job seekers puts the jobless rate at 33.8%, the second worst on record. This is most evident in rural areas, or within the townships that lie on the periphery of the country's main urban centres. Here, the retail sector more closely parallels those in other poor economies: a far higher proportion of informal retail outlets, and spending focused on subsistence food and goods.

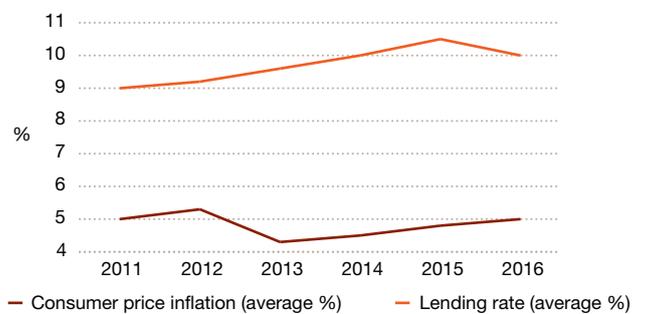
These areas highlight a key facet of South Africa's consumer market: its income inequality, which is among the highest in the world. The top 10% of the country's earners take away 101 times the earnings of the bottom 10% of the population³. The country's Gini coefficient, a measure of income inequality, is among the top three in most world rankings⁴. And although South Africa has a potential labour market of about 31 million, just 13 million have jobs and only about 5 million earn enough to pay taxes⁵.

Population and unemployment



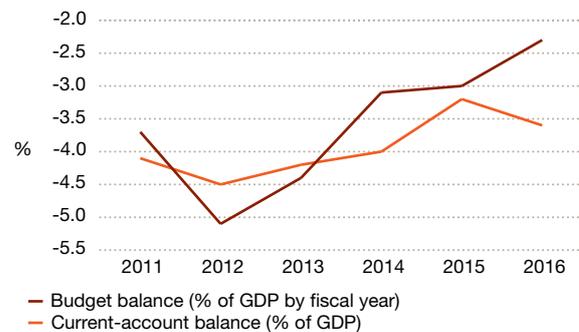
Source: Economist Intelligence Unit

CPI vs lending rate



Source: Economist Intelligence Unit

Budget balance vs current-account balance



Source: Economist Intelligence Unit

Eyeing the rest of Africa

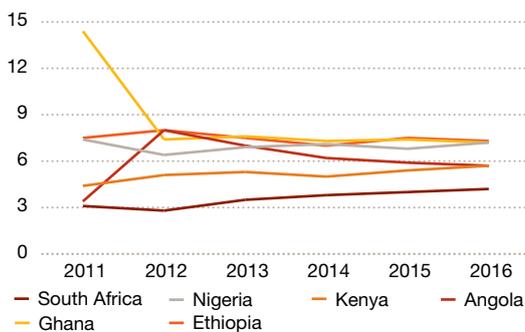
Despite these challenges, global retail and consumer goods companies are eyeing South Africa's burgeoning middle class. The biggest news was Walmart's R16.5bn 2011 acquisition of 51% of Massmart, which operates local retail brands such as Game, Makro, Builders Warehouse and Cambridge Food. Despite stiff opposition from unions and sections of Government, notably in the Department of Economic Development⁶, both of whom feared widespread layoffs, South Africa's Competition Commission approved the deal⁷. The American retailer will initially focus on the South African market, but plans to use Massmart's presence in 12 African countries as a stepping-stone into the continent.

It is almost certainly not alone in such aspirations. Experts estimate that there are now around 50 million middle-class households across Africa, measured as those with incomes of at least US\$20 000 – about the same as India⁸. This can be easily seen through increasing investments in retail infrastructure, with many large Western-style shopping centres opening up. Ghana opened its approximately R250m Accra Mall in 2009, its first. Kenya's Nairobi already has a thriving retail scene. In December 2011, the over R700m Ikeja City Mall opened in Lagos, Nigeria⁹. The Angolan capital, Luanda, has embarked on a multi-billion rand, 15-year redevelopment of its seafront, which will bring offices, hotels and retail outlets.

South Africa's retailers have been among the quickest to snap up such opportunities. The anchor tenants of many of these new malls are typically well-known names from the southern tip of Africa, such as Shoprite, Woolworths, Mr Price, Truworths, Pick 'n Pay and Game, along with food chains such as Spur. Shoprite is among the most ambitious of these, but nearly all the major South African brands have plans to find new growth up north.

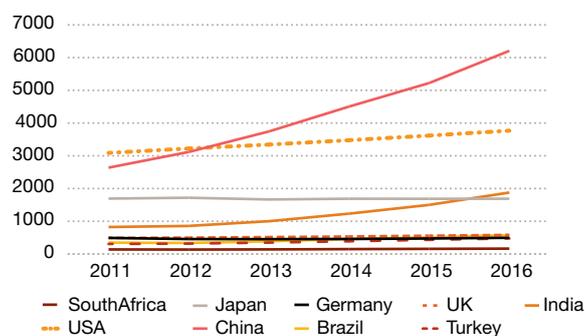
For consumer goods companies, much of this is already old news. Giants such as Unilever, Nestlé and Coca-Cola have traded across Africa for decades, while SABMiller has used its strength across African markets to become a major global competitor and the world's second-largest brewer. Other consumer goods companies and retailers are now adding Africa to their growth plans. For many, the most obvious starting point is South Africa.

Real GDP growth rates, select African economies (% change per annum)



Source: Economist Intelligence Unit

Retail sales, international comparison (US\$ bn)



Sources: Planet Retail, Economist Intelligence Unit



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Section 1
Retail

Outlook

Key findings

- After a strong recovery since the 2009 recession, South Africa's retail market is slowing significantly in 2012, with forecast growth in sales volumes of just 0.7%.
- Immediate pressures aside, both food and non-food retail sales are expected to grow steadily through 2012-2016. Sales by value will grow by an average of 7.85% in nominal terms.
- Walmart's entry is expected to further intensify competition, putting added pressure on already thin average profit margins.
- From a growth perspective, major retailers are focusing on expansion into new areas, converting informal trade into formal retail, growth into the rest of Africa, diversifying into new service lines and boosting operating efficiencies.
- Although now expanding more rapidly, e-commerce remains a niche part of the retail mix.

The outlook for South Africa's retailers

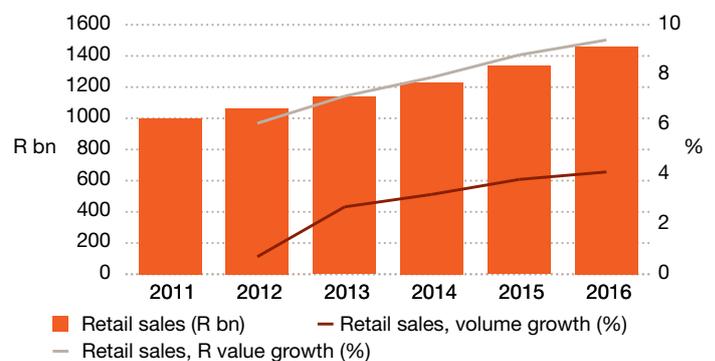
Compared with the rest of Africa, South Africa's retail market is already a juggernaut. In 2011, retail sales surpassed a trillion rand for the first time in history. By 2016, this is expected to swell to R1.46tr. Much of this market is dominated by about a dozen large holding companies, which collectively own the majority of the country's biggest brands. The biggest of these – Shoprite, Pick 'n Pay, Spar and Massmart – account for about 80% of local retail sales, with various sub-brands targeting different consumer segments of the market. Until the entry of Walmart, all of these companies were locally owned.

But following a major growth spurt in 2010 – predominantly through sales of higher-value goods, rather than a major rise in volume – the retail outlook has dimmed. Volume growth for 2012 is expected to be just 0.7%, down from 3.9% in 2011. And as pressures on consumers' wallets rise, retail sales by value are expected to slow this year, after growth of over 9% in 2011. 'The economic outlook going forward is expected to be in line with the previous year, moderate to unspectacular growth, let's call it that,' explains Justin Crowhurst, head of strategy, planning and performance at Woolworths, an upmarket food and fashion retailer. 'We're expecting a low 3% GDP growth.'

As some of the executives interviewed for this report note, this can be witnessed through consumers 'trading down' as they become more price conscious. 'You are seeing this trading down right through the system, which is a worrying sign, because it shows consumers are under strain,' notes Syd Vianello, a retail analyst at Nedbank Capital, a local investment bank. In part, this is being driven by rising living costs, notably a significant jump in electricity prices as part of the country's response to its electricity supply lagging demand. 'Many retailers are definitely seeing more of a price consciousness within the market,' says Mel Urdang, director for retail at Liberty Properties, owner of major retail sites in South Africa such as its flagship Sandton City shopping centre.

This strain is expected to filter through to food sales in general, which accounted for 54% of retail sales in 2011. Here, sales are forecast to edge up to R576.7bn in 2012, from R542.3bn in 2011. Sales will accelerate again from 2013, rising to R787.6bn by 2016. Non-food sales will also slow this year, with R485.8bn expected in 2012, up from R459.6bn in 2011. But growth is expected to pick up again in 2013, before expanding steadily to R787.6bn by 2016. At an aggregate level, retail sales volumes are forecast to expand by 3.45% over the period 2013-2016. 'We're coming out of a period with huge tailwinds for the consumer, including low interest rates, very low food inflation and stable overall inflation, a strong rand, and very good wage growth. Now it feels like there are more headwinds to come,' says Antoinette Coetzee, an analyst with RMB Morgan Stanley, an investment bank.

Retail sales at a glance



Sources: Planet Retail, Economist Intelligence Unit

Growth drivers

Any new growth will be largely driven by the number of black consumers rising into middle- and upper-income groups, with a consequent expansion in their disposable income. By 2016, some 11 million households are expected to have an annual income above R89 500 (or US\$10 000). At the upper end of the income scale, some forecasters believe the country is already home to about 71 000 dollar millionaires¹⁰. Their spending power is further bolstered by widely available consumer credit, both from retail banks and retail chains – although some fear this is now slowing. ‘There has been a massive boost in unsecured lending, which also facilitated more spending at the bottom end, but that is coming to an end,’ argues Renier Swanepoel, an analyst with UBS, an investment bank.

Nevertheless, striking income disparities have prompted local retailers to focus closely on how they position their brands against specific income bands. These are typically defined locally by the Living Standards Measure market segmentation model, or LSM. The LSM divides the population into 10 LSM groups – 10 (highest) to 1 (lowest) – according to their living standards using criteria such as degree of urbanisation and ownership of cars and other major appliances¹¹.

For those on the upper end of the scale, there is a clear aspirational drive to increase spending, especially for status purchases such as of high-end motorcars and premium alcohols. To give one example, South Africa was the world’s fifth largest export market for Scotch whisky in 2011¹². And there is continued migration from lower LSM scores through to higher ones, with immediate knock-on benefits for retailers. ‘The food retailers benefit first, because as you go through LSM migration, consumers tend to move from an informal retail environment to a formal one,’ says Ms Coetzee.

For the large, lower-end pool of consumers, two key government initiatives – large-scale infrastructure investments across the country and wide-ranging social grants – are in turn helping to prop up demand. Both of these initiatives are significant. Social grant payouts reached nearly R100bn in 2011, much of which is dispensed via retail outlets across the country, especially in rural areas, which acts as a boost to local retailers¹³. Meanwhile, the Government is looking for ways to fund up to R3.2tr in infrastructure investments over a nine-year period, as announced by the President in February 2012¹⁴. ‘If all these things come to fruition and there are no nasty shocks in the system, this should translate into very substantial growth in consumer spending,’ notes Mr Vianello.

Downside pressures

However, as executives are quick to note, all growth forecasts for the country face considerable downside risks. These largely relate to the significant uncertainties within the Eurozone, which may also affect the country’s ability to raise financing for its infrastructure investment plans. There are also more recent doubts about economic growth in Asia and its consequent impact on the world economy. Any such uncertainty typically dampens local demand, with consumers curtailing unnecessary expenditure.

There are also local risks, such as policy uncertainties over labour broking and temporary workers, which are considered crucial to flexibly adapting staffing levels in line with demand peaks. The Government is under pressure from trade unions to clamp down on labour broking, which could have clear consequences on the cost base of many retailers.

Striking income disparities have prompted local retailers to focus closely on how they position their brands towards specific income bands.

This issue is one of a number of cost pressures facing retailers at the moment. Electricity prices are increasing materially, along with ongoing wage increases; fuel costs remain persistently high; and retail occupancy costs are being pushed upwards. To keep pace, retailers have relied on increasing top-line sales, but this strategy has now come unstuck for some, as both volume and value growth has stalled. This raises tough decisions: 'Margins are too dependent on how retailers keep sales growing, and if that means you've got to be more promotional then you've got a clear risk to the gross margin. This is the big conundrum in retail at the moment,' explains RMB Morgan Stanley's Ms Coetzee.

A further pressure is a persistent skills shortage, especially among middle management. There is a shortage of strong graduates emerging from local tertiary education, while most retailers have had to develop significant in-house training capacity in order to continue developing skills.

Growth strategies

The changing dynamics of the local retail environment clearly shape firms' growth strategies. Despite the Walmart deal, few anticipate a significant wave of M&A in the sector. This is partly thanks to the relatively high degree of consolidation within the formal retail sector. But it is also because any further consolidation in the sector will come under close scrutiny from the Competition Commission. 'The competition laws have become tougher and tougher, which is going to make it extremely difficult for any significant acquisition to take place,' notes Nedbank Capital's Mr Vianello. Instead, retailers – especially within the food and general goods sector – are focused on a three-prong growth strategy: ongoing organic growth; an expansion into Africa and a drive for greater efficiencies to control costs.

Organic expansion

Organic expansion is the most obvious: both opening new stores and squeezing more sales out of existing ones. Woolworths, for example, is investing heavily in space expansion, including a 3 200m² concept food store, its largest, at Nicolway Bryanston, a R500m retail development in Johannesburg's northern suburbs¹⁵. Despite such high-profile openings, there are clear limitations to growth, given the relative maturity of the market.

An important, and related, part of this organic expansion is the ongoing formalisation of the country's significant informal trade, which ranges from street vendors and spaza shops (informal convenience stores), through to family-owned retail outlets. It is difficult to precisely estimate the size of this market, but RMB Morgan Stanley gives an estimate for the informal food market of about 35%. For food retailers, this expansion is thus typically into lower-end segments of the market.

Shoprite, the country's biggest grocery retailer by market share, notes that its further growth in South Africa is contingent on an improvement in the unemployment rate and conversion of the informal trade sector (see *Q&A with James Wellwood 'Whitey' Basson, MD and CEO of Shoprite Holdings page 22*). Others see similar opportunity at this lower end of the market. In 2011, Massmart, for example, launched Foodco – the name of its low-cost private label food brand, and also the brand for its supermarket within a store concept, which it is now rolling out within its Game store brand¹⁶.

In focus: Food and beverages

South African consumers allocate just over one-quarter of their household expenditure to food and beverages (and tobacco), touching on 27% in 2012. This translated into some R491.28bn in 2011, which is expected to expand by 2.6% in 2012, making it a crucial retail segment. The market leader today is Shoprite, which controls three major retail brands targeting different income levels across the market. Following on its heels are Pick 'n Pay, Spar and Massmart.

Collectively, these four companies dominate the mass-market grocery sector. At the high-end, however, Woolworths is the dominant food retailer. Overall, about eight in ten retailers in South Africa sell food, spanning supermarkets, hypermarkets, discount stores, convenience stores, independent grocers and food specialists. To secure future growth, they are steadily encroaching into the turf of the country's large informal food trade, which ranges from street hawkers through to informal spaza shops located in townships and informal settlements.

By contrast, for non-food retailers, organic expansion often moves in line with related property infrastructure development. New shopping malls continue to open across the country, such as the 2009 opening of the R1.5bn Hemingways Mall in the Eastern Cape¹⁷, although the country is already well stocked with malls. Many new mall openings have come within historically disadvantaged areas, such as the four new malls that opened in Soweto between 2005 and 2008. To add to these, TBG, a property developer, is currently converting the Soweto Power Station into a 65 000m² retail and entertainment hub, which it hopes to open in late 2012¹⁸.

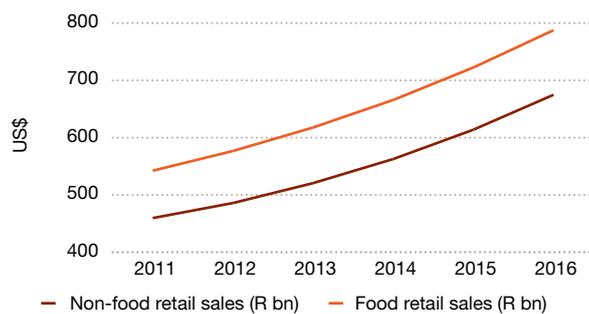
But for some, there is already a concern that some target areas may be oversupplied. As such, certain areas may feel a shakeout if market pressures deepen. This may not be wholly negative. Liberty Properties' Mr Urdang argues, for example, that a recession period acts as a useful 'reality check' for firms: 'What the cycles tend to do is weed out the marginal opportunities. So while there are not as many cranes on the horizon as five years ago, the situation is healthy as it allows for a cooling off and consolidation.'

Given this context, a related area of organic growth is expected to come from increased diversification, as retailers use their existing reach to provide a wider range of services to consumers. Shoprite has steadily expanded its offerings, for example into ticketing and financial services. The same is apparent at Pick 'n Pay, which offers a range of banking and other services, including travel bookings. This is consistent with steps taken by international retailers, such as the UK's Tesco or Walmart in the US, which have steadily extended their range of offerings, from telecoms through to financial services.

Heading North

Given such local constraints, most retailers are eyeing growth in the rest of Africa. Shoprite has taken the lead on this, having opened up stores across 17 African countries, ranging from Ghana through to the Democratic Republic of Congo. Mr Price recently opened its first store in Ghana, while Pepkor is in the midst of a R100m expansion into Nigeria, with plans to open 50 outlets¹⁹. Woolworths already has operations in Botswana, Kenya, Ghana, Mozambique, Nigeria, Tanzania, Zambia and Uganda, with a mix of corporate and franchise stores.

Food and non-food sales



Sources: Planet Retail, Economist Intelligence Unit

Nevertheless, there are considerable challenges to such expansion, as many are quick to warn. One clear issue relates to the supply chain, given the paucity of infrastructure in many areas. Furthermore, red tape and high tariffs are also significant obstacles that make stockholding calculations difficult. From a cost perspective, indirect taxes are a pressure point, not least when imported goods transit through countries. Furthermore, there are sharp limitations in the availability and quality of data in local markets, from market basics such as available disposable incomes in specific regions or communities, through to operational specifics, such as trade tariffs, tax rates and labour rules. As with many other emerging markets, there are also varying degrees of local corruption to navigate.

A related question for retailers – many of whom have diverging views on the best way forward – is choosing the degree of control they wish to exercise in their northerly expansion, and thus the degree of risk they're exposed to. For lower risk, franchising or licensing is popular, but also brings lower returns and limited control. On the flip side, a greenfield operation provides 'high risk, but also high reward,' as UBS's Mr Swanepoel puts it.

This retail expansion is also a clear opportunity for property developers. Nevertheless, as Liberty Properties' Mr Urdang notes, the nature of growth in much of the rest of Africa lends itself to smaller, concentrated expansion. 'Does the continent's growth mean the time is ripe for the biggest shopping experience in the world to be placed in Africa? The answer is no. But does it mean that any country in a growth phase, which needs 30, 40, 100 smaller centres that cater to huge local populations are more appropriate? The answer is yes,' he says.

A drive for efficiency

A final element of retailers' growth strategies relates to the bottom line, with a major efficiency drive likely across many brands. Much of the investment is focused on improving supply chains, while also working out how to generate more revenue per square metre of existing retail space. 'Due to the cost pressures being faced, sales growth will be far closer to cost growth for many retailers. This brings it down to how efficiently you can run your business, so owning stores and owning the supply chain are going to become increasingly important,' says RMB Morgan Stanley's Ms Coetzee. At Woolworths, for example, there is a close focus on improving profitability, in part through buying back former franchises to improve control of in-store operations and merchandising, among other things.

For many, a major area of investment is in centralised distribution facilities. In the food sector, Shoprite has already invested heavily in this, including in a major centre in Centurion, which includes a 114 000m² main building that the company claims is the biggest distribution centre under one roof on the continent²⁵. Most others are making similar efforts. At Pick 'n Pay, the company is also investing in new distribution capacity in Cape Town and Durban, as well as a second distribution centre in Johannesburg, to keep pace with key rivals. Massmart is tapping Walmart's distribution expertise as part of its expansion of its distribution centres. Fashion and apparel retailers are also investing heavily: Truworths, Foschini and Mr Price, for example, are all investing in distribution capacity.

For all these firms, an important driver for these investments is improved logistics and stock control to ensure that customers can consistently find what they need in stores. However, another key consideration is a desire to improve trading margins. Mr Swanepoel argues that greater investment into centralised distribution hubs is part of a wider effort to bolster trading margins. Shoprite, for example, which now considers its centralised distribution a part of its competitive advantage²⁶, recorded a 5.51% trading margin in its 2010/11 period²⁷. Although not solely due to this factor, Pick 'n Pay, which is still working to develop its centralised distribution capacity, recorded a trading margin of just 2.3% in its most recent operating period, ending in February 2012²⁸.

In focus: Fashion and apparel

South Africa's fashion retail scene is currently dominated by home-grown brands. Biggest among these is Edcon, which operates 10 retail brands, including Edgars, Boardmans, Red Square and CNA, which collectively generated about R27.3bn in its 2011/12 fiscal year²⁰. It operates nearly 1 200 stores in South Africa, Botswana, Namibia, Swaziland and Lesotho²¹. Alongside Edcon are a number of other major retailers that compete across a range of market segments, including Woolworths, Mr Price Group, Truworths, Pep, and the Foschini Group.

The biggest news of recent years has been the arrival of a number of international brands. In March 2012, US retailer Gap opened its first store in the country, in Sandton, with several more planned over the course of the year²². It will focus on the domestic market for several years, working in partnership with Stuttafords department stores, with whom it has a wholesale relationship²³, before expanding further into the rest of Africa. The retailer's entry came on the heels of a late 2011 arrival of Spanish retailer Zara, also in Sandton, with a further store opening during 2012 in Durban's Gateway shopping centre²⁴ and Cape Town's V&A Waterfront.

Zara in particular will challenge local retailers to up their game with its 'fast fashion' approach, which introduces new styles on a continuous basis. This will pressurise some local rivals that typically stock up for entire seasons in advance. Nevertheless, the growth of international rivals will likely be constrained to some degree by the availability of retail space in the country.



A second major area of investment is in technology. Significant investments are being made in better systems, from more sophisticated supply chain management systems through to retail analytics tools. Pick 'n Pay, for example, has invested R500m in an SAP enterprise resource planning system²⁹. Such investments help provide detailed management insights, such as the precise sell-off rates of certain stock items, to help maintain optimum stockholding. 'Doing things like this, and better managing your stock and working capital, can improve your margins, so we're seeing huge investments in technology right across the board,' says Nedbank Capital's Mr Vianello. At Woolworths, for example, the use of analytics has helped the company 'refine its proposition' in terms of products, services and formats, notes the company's Mr Crowhurst.

A related aim of many technology investments is to increase the degree of automation in order to cut reliance on labour in certain parts of the business. 'More and more companies will invest more in capital goods, and then slowly over time reduce the labour force,' argues UBS's Mr Swanepoel. The introduction of more foreign rivals, especially in the 'fast fashion' sector, will also force local retailers to consider how they can use technology to increase the sophistication of their operations and stock management. However, unlike their peers in many other more developed countries, few retailers are yet investing significantly in online commerce (see later).

Another area of investment, which technology also helps to enable, is in customer loyalty programmes. Pick 'n Pay launched its Smart Shopper loyalty card programme, which gathered 5m active users in its first year³⁰. Woolworths operates its Difference card, which launched in 2005, while other non-food retail schemes, such as the Clicks ClubCard, are already long established in the market³¹. In many international markets, such schemes have helped retailers more precisely target deals and offerings to their consumers – in anything from merchandising layout through to the timeliness of offerings – based on a deeper knowledge of their spending patterns.

Corporate sustainability: another lens for efficiency

In other developed markets, leading retailers are reacting to increased pressure to improve their impact on the environment and society as part of a greater awareness and consideration of sustainability, or corporate social responsibility (CSR), concerns. But while a significant minority of consumers there are potentially swayed by such schemes, only a far minority of South African consumers today are shifting their buying decisions as a result of this.

So far, only those retailers appealing to the higher-end of the market, such as Woolworths and Pick 'n Pay, have implemented any meaningful initiatives in this area. For some, this is largely focused on corporate philanthropy, allocating ad-hoc donations to specific communities or causes. For the rest, there is essentially no consumer pressure today to change, with most buying decisions focusing on price sensitivity alone.

Nevertheless, in the environmental domain, a different driver is shaping action: the steep and ongoing rise in electricity costs. While this may not be explicitly bundled under the umbrella of sustainability, cost and supply concerns are driving retailers to improve energy efficiency within stores and distribution centres. The real impetus came in 2008, as rolling blackouts forced businesses to respond to a sharp threat to their business. 'A lot of retailers that ran refrigeration found very clever ways to reduce their electricity usage, which in turn was good for their margins,' says Ms Coetzee.

There have been wide-ranging responses, from investments in solar power capacity through to tweaks to refrigeration to repurpose the surplus heat generated. 'We're now using 20% less kilowatt hours within our stores than we were four years ago. It has a very real strategic impact on our cost, because of the way electricity prices have gone up. We've likely avoided about R220m in electricity costs since 2008 as a result,' says Gareth Ackerman, executive chairman of Pick 'n Pay. A related aspect has been efforts to reduce water consumption, in part by capturing and reusing grey water, especially within distribution centres, although water pricing signals are not yet shaping responses in the same way as electricity.

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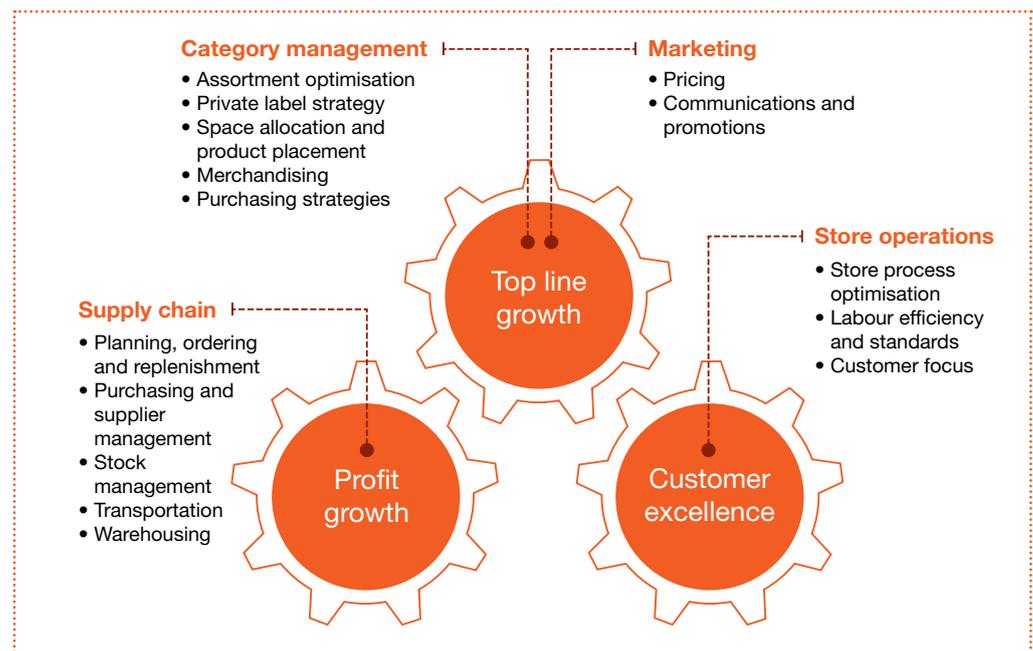
Fighting the margin pressure in retail*

Retailer margins are under intense pressure in the current economic environment. First, decreasing disposable income leads to lower consumer spending, with direct impact on the bottom line. Second, shrinking margins in the FMCG industry make negotiations with suppliers of branded goods increasingly difficult. Last but not least, maturity in many markets leads to the introduction of new formats (including increasing numbers of convenience stores) and more discount retailers, generating fierce competition.

In order to address these challenges, retailers must proactively balance between top-line performance, profitability and customer excellence. We have identified several key areas that have a strong impact on operational and financial performance: category management, marketing, procurement and supply chain and store operations.

Retailers can use several levers to further improve their positioning

Operational efficiency will be a core focus for retailers in the medium term.



Our experience shows that, in many cases, **category management** is handled by buyers. But burdened with many operational tasks, they have limited time to dedicate to the more strategic aspects of category management. Also, in some cases, space allocation and planograms do not balance sufficiently between revenue and profit potential, while private labels do not follow a rigorous strategy. Hence, improvements in end-to-end category management can lead to important benefits in terms of sales growth and overall profitability improvements.

Marketing provides a complex set of tools that help to create value for customers, strengthen the brand, improve customer retention and maximise revenue potential. In many cases, pricing strategies are reactive rather than proactive and are insufficiently differentiated based on the strategic, competitive position of the retailer. With pricing being one of the most powerful levers for increasing operational profit, proactive demand-side pricing can significantly boost financial performance.

Procurement and supply chain encompasses the planning and managing of all activities, from sourcing to planning, ordering and replenishment, as well as the related logistics, including stock management, transportation and warehousing operations.

In some cases, we observe that supplier negotiations are more operational than strategic, as the complexity of the analysis required in order to build a fact-based negotiation is high and time consuming; therefore results are often suboptimal. Moreover, forecasting and planning are complex tasks, especially in an unstable economic environment, leading to excessive inventory, write-offs and shrinkage in certain categories and unmanaged out-of-stock occurrences in other categories.

Customer service levels that are misaligned with the importance of the category and turnover lead to additional complexity. Therefore, rigorous application of strategic procurement techniques can increase profitability by several percentage points, while optimising the supply chain can improve the balance between costs and customer satisfaction.

Store operations levers address areas related to daily retail processes and procedures in the network. Few retailers use demand forecasts for planning their store operations and staffing needs. Leveraging rigorous labour standards and flexible manning through advanced analytical techniques can generate important cost reductions, in parallel with improvements in customer satisfaction.

*Retail & consumer hot topics, PwC, October 2011. Accessed at <http://www.pwc.com/r&c>

Q&A with James Wellwood ‘Whitey’ Basson, MD and CEO of Shoprite

Holdings

Shoprite is South Africa’s largest grocery retailer, in terms of overall market share. As of 2010, it held about 34% of the overall market. It is also rapidly expanding its footprint out of South Africa, including the aim of establishing a major presence in Nigeria.

What is your overall outlook for the South African retail sector over the next 3-5 years?

The retail sector’s competitiveness is intensifying immensely with additional players entering the food segment competing for local food expenditure. Economic growth should remain positive but more muted. This is a result of unemployment rates and the inescapable impact of international factors such as the Eurozone crisis. Suitable growth opportunities in formal food retail still exist though, since an estimated 30% of the country’s food expenditure still goes through informal outlets. Formalised retail’s rapid increase in footprint is quickly capturing this spend.

What is the primary growth strategy that your business is relying on within South Africa?

Our growth strategy has been acquisitive in nature in the past, but organic expansion is now our primary growth driver. We have three core supermarket brands each with a unique positioning in the market. The brands start with Usave, a limited assortment hard discounter, which is capturing share from informal traders, independent retailers and previously under-served areas (LSMs 2-5). Shoprite is the group’s principal brand and is positioned on low price leadership targeting the price-conscious mass middle market (LSMs 4-7). It is capitalising on the rising middle class as well as increased government spending on social grants. Finally, our Checkers brand has been repositioned and caters to more upmarket consumers, with market share being won from competitors in the LSM 8-10 segments.

A further key growth driver is the addition of complementary business services. This includes the development of pharmacies, liquor outlets, event ticketing services and basic financial services.

How about growth in the rest of Africa?

Considering that the local market is approaching relative maturity, growth here will be closely linked to the ability to create sustainable employment for the masses of unemployed youth. The opportunity represented by the oil-rich West African countries that previously lacked strong formal retail representation is important to our business in the next 10 years. This will be a significant driver of sales and profitability growth.

What are the main barriers to further investment in the sector?

The sluggish pace of property development in Africa and the lack of suitable anchor tenant sites can create significant hurdles to any expansion plans. In South Africa, the over regulation of consumer goods is creating unnecessary inefficiencies and costs. Examples are new foodstuffs labelling requirements, which make it difficult for even developed economies to export their products into the country. Furthermore, the Consumer Protection Act makes the South African consumer one of the most protected in the world.

In Africa the bureaucracy of intra-African trade is a major challenge. Tedious trade agreements and administration-heavy import/export requirements make cross-border trade a lengthy and complicated process. The inefficiency of various customs agencies and government departments make product distribution lead times untenably drawn out and inefficient, which has a negative impact on product availability and costs.

How has the Walmart acquisition changed attitudes towards investment in your sector?

Despite the level of foreign investor interest in the SA retail sector having risen prior to the acquisition, there has been a marked increase in foreign investment interest since the announcement. Combined with South Africa’s inclusion in the BRICS group of countries, many investors are now fascinated by the African growth story and this can be seen in both the increase of foreign shareholding – as well as the elevated price/earnings ratios – of South African retail companies.

A slow shift online

In many developed markets, one of the most disruptive forces for retailers has been the aggressive growth of online retailers, in both food and non-food businesses. But in South Africa, the e-commerce market remains relatively niche, and is largely focused on the non-food market.

For all retailers, there are several clear barriers to development. The first is the low penetration and high cost of broadband Internet. However, an increasingly competitive service provider market, along with more compelling mobile and smartphone-based access options, is finally starting to more rapidly expand the number of online users. During 2011, the number of online users expanded by 25%, to reach 8.5 million, or about 17% of the market³². There is potential for this to top 10 million by the end of 2012 if this growth rate is sustained. Furthermore, this group of online users correlates very closely with the medium- to high-income sector of the population, which appears to have a strong pent-up demand for online services. A survey by MasterCard found that about 58% of local active Internet users now shop online, up from 53% in 2010³³. Furthermore, the arrival of PayPal, an online payments system, in 2010 has helped to encourage growth within the e-commerce market.

Two food retailers, Pick 'n Pay and Woolworths, have launched limited home-shopping websites, aimed at the higher end of the market. 'Online is an important part of our business, but it's small and not yet a highly profitable part. So it's a challenge, but it's a part of business and a great added offering for our customers,' says Mr Ackerman. And for more upmarket brands that target affluent consumers, this clearly is even more important. At Woolworths, for example, Mr Crowhurst sees the Internet as crucial for its longer-term future: 'We've really got to invest in our systems to make sure we are able to interact with our customers through whatever channel they decide to use,' he says. Woolworths says online sales are increasing by 'more than 20% every year' in both volume and value. Even if this is currently a tiny fraction of overall sales, the company sees the value in developing its proposition, as cross-channel consumers typically spend more.

After online access, another constraint is a postal system that is widely perceived as inefficient and poorly run. A low point came in 2008, when US online retailer Amazon.com blacklisted the South African Post Office over concerns about theft³⁴. More recently, a 2012 newspaper editorial from *Business Day* described the organisation as being in 'disarray'³⁵, following a three-month strike by temporary workers and the resignation of key top executives³⁶. As such, concerns over the service require most retailers to rely on private courier services for deliveries, especially time-sensitive ones, which in turn adds significant costs. This is especially complicated in the food market, given the need for refrigerated deliveries, which demands that users are at home when deliveries are made. 'Food only works if you can get your delivery window spot on, because of the fresh and perishable component. Frozen goods need to go straight into the deep freeze,' explains Ms Coetzee.

'Online is an important part of our business, but it's small and not yet a highly profitable part. So it's a challenge, but it's a part of business and a great added offering for our customers.'

– Gareth Ackerman.

As such, the majority of e-commerce is focused in the non-food market, with players such as Kalahari.com and Exclusive Books focusing on products such as books, music and DVDs. One clear threat to these businesses is from the rapid rise in popularity of e-book and tablet devices, which is removing delivery constraints and costs. In the fashion and apparel trade, there are some limited moves to enter this market. One recent entrant is Mr Price, a value-focused fashion retailer, which launched its e-commerce platform in mid-2012³⁷. In a related trend, e-commerce may also drive an increasing number of consumers to shop online, but collect in store, so that they can be sure their key goods are available before travelling to the mall.

South Africa's online access in numbers

8.5 million Number of users with Internet access, end 2011

6.8 million Number of users with Internet access, end 2010

25% Growth rate, 2010-11

2.48 million Number of users with mobile phone-based access only

7.9 million Number of users regularly going online via phone

Source: World Wide Worx

Q&A with Gareth Ackerman, executive chairman of Pick n' Pay Stores

Gareth Ackerman is the executive chairman and a director of Pick 'n Pay, South Africa's second-largest grocery retailer, accounting for about 19% of the market in 2010.

What is your view of the outlook for retailers in the medium term, and what are some of the major forces shaping your business?

We keep an open mind as to what happens in the marketplace. Much of our sales are guided by the inflation rate, so if inflation moves up it's generally good for us, as people get more money to spend and they can spend it in our retail businesses. We are also very dependent on what happens to global commodities, particularly soft commodities (commodities typically grown, such as sugar or wheat), which are dollar-denominated and therefore driven by the rand-dollar exchange rate. So, to some degree, we experience inflation or deflation depending what happens in the global economy and how this feeds into soft commodity prices.

What kind of impact do you think the entry of Walmart will have on the local competitive environment?

South Africa is part of the global world. We can't hide away and say nobody is ever going to come here. So we have to be the most efficient and effective we possibly can be. One positive is that South Africa has always been an extremely competitive retail environment. If you look at the net margins in the supermarket industry, they are historically on the low side. The entry of international players into this market has been long anticipated, so local retailers have geared up for it. We are, however, concerned about overtrading and over-storing. We are seeing huge numbers of stores in new areas, and if there is a big downward tick in the economy, that will be felt.

What growth strategy are you relying on?

The biggest part of our growth is likely to be organic – making our existing stores more effective and productive and increasing trading densities. As we become more sophisticated with our centralised distribution and supply chain, we are going to have more space available within our stores. So it's a question of how we use that existing space to increase sales. The second area is a rollout of Pick 'n Pay Express stores within (BP petrol station) forecourts. We've got nine at the moment, but plan to rollout another 120 over the next couple of years. The third area is across Africa. We've already got 96 stores outside South Africa. We've just spent about R100m buying another 24% of TM Supermarkets in Zimbabwe, to take our ownership there to 49%.

What are the key challenges or operational areas of the business you are focusing on at the moment?

Getting our supply chain right. Then getting our IT working properly, to make sure our category management is working properly. These are all being driven to make sure we get better service at store level and make sure we're more often in stock. One of the real issues worrying us at the moment is the number of stock shortages that we're facing among suppliers. There's been a lot of market growth, but there hasn't been enough investment in plants to keep up with demand. There are issues regarding moving products from one country to the next, as well as compliance with SABS (South African Bureau of Standards) specifications. But the real point is that we don't have enough stock, and there is not enough coming from our suppliers.

What do you see as the key policy issues at the moment?

The main issue is around contract labour. This is a big issue for us because we need very flexible labour. Where we find that we're short of people, and we can't get our normal staff to work, then we need to bring (temporary) workforces in. Sometimes people don't want to work till seven o'clock at night, but we need people in our stores then, so we need to find people to be able to do that at fairly short notice and that's why we need some form of labour broking. I don't believe that our business should be totally run on this basis, but we do need flexibility. Of course, retailers need to pay people properly and it needs to be properly regulated.





Section 2

Consumer goods

Outlook

Key findings

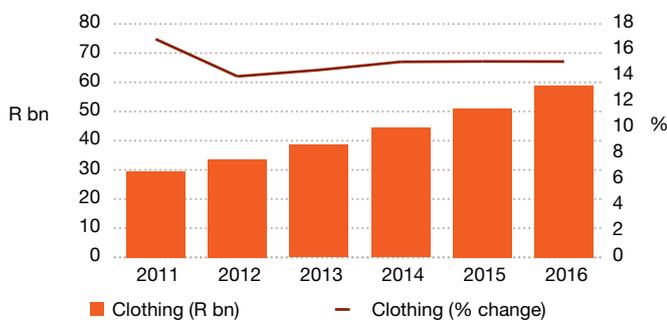
- Demand for food, beverages (and tobacco) was an estimated R491.5bn in South Africa in 2011. This is expected to grow by an average of 11.5%, in nominal terms, over the 2012-16 forecast period, reaching a total value of R847bn in 2016.
- But demand for other consumer goods is likely to grow more rapidly: clothing will expand by nearly 15% per annum over the same period, while electrical appliances and houseware will grow at about 16%.
- Although domestic consumer goods companies are competitive in the food and beverages market, especially the latter, local companies are struggling to compete in non-food consumer goods.
- The relative cost of South Africa's labour force, as well as a shortage of middle-management skills, are key issues hampering further development within the sector.

Consumer demand forecasts in this chapter are based on the EIU's demand-side calculations for household spending, based on available income to allocate to retail spending. By contrast, total retail sales in the prior chapter are based on supply-side calculations, based on reported sales by formal retailers and estimates for informal retail. Given the need for statistical estimates to overcome data limitations, and the use of differing methodologies for supply and demand-side forecasting, there are some variances between the forecasts in the two chapters.

The outlook for South Africa's consumer goods sector

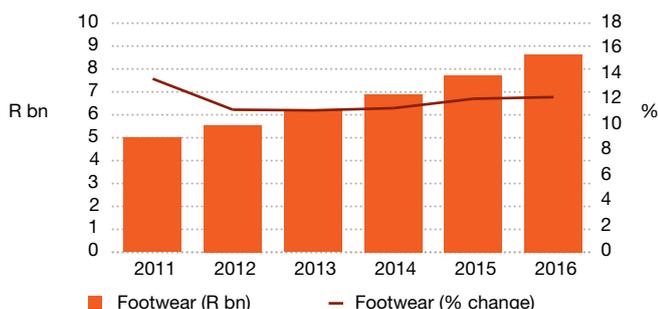
South Africa's expanding middle class is an appealing prospect for providers of both durable and non-durable goods. Across many product categories, growth over the 2012-16 forecast period is expected to be relatively robust. Clothing, for example, which was already a R29.57bn market in 2011, is forecast to expand by 14.7% over the period. This is about the same growth rate expected for household furniture, a R27.35bn market in 2011.

Market demand for apparel



Source: Economist Intelligence Unit

Market demand for footwear

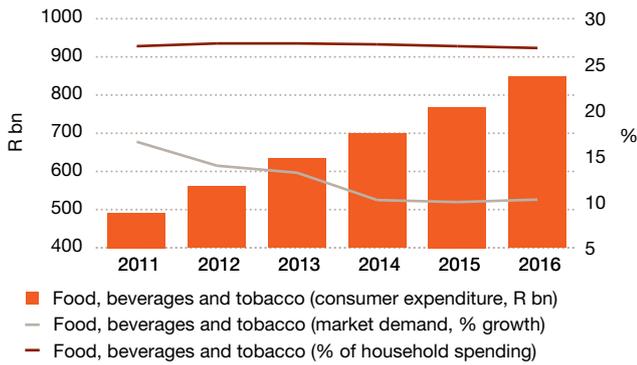


Source: Economist Intelligence Unit

In focus: Apparel and footwear

South Africa's apparel industry is relatively developed and is one of the country's top-ten sources of employment, but faces material threats to its future survival. First, despite some locally sourced materials, the sector is heavily reliant on imported materials. Second, the textile industry has been hard hit by Chinese imports in particular, which now have about 70% of the market (about 90% of the apparel sold in the country is now imported⁴²). Third, the US-initiated African Growth and Opportunity Act, which cuts tariffs on imports from select African countries, including South Africa, faces an uncertain outlook for South Africa beyond 2015, given uncertainties about the political transition in this year's US presidential election⁴³. If this is not renewed, it could further jeopardise the apparel sector's growth prospects. In response to these issues, the sector concluded a landmark deal with the Southern African Clothing and Textile Workers Union (SACTWU) in late 2011, to offer 30% lower wages to new employees, as part of a bid to create more jobs⁴⁴. However, less than a year later, the deal has been in peril, with SACTWU threatening strike action over wage disputes⁴⁵. Amidst such disputes, a significant proportion of production continues to shift to neighbouring countries Swaziland and Lesotho, where wage costs are considerably lower and unions are less entrenched.

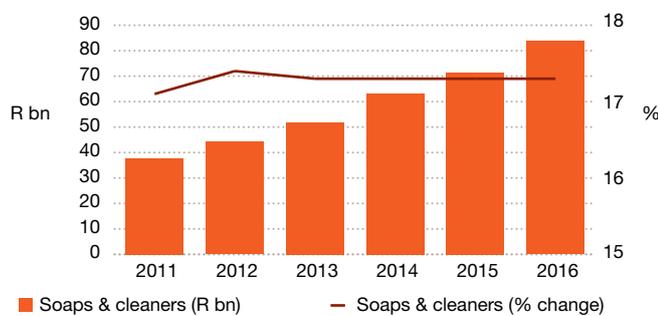
Food, beverages and tobacco consumption



Source: Economist Intelligence Unit

Many categories stand to gain as low-income subsistence consumers start to have greater disposable incomes. To some extent, non-durable goods, such as food, beverages and tobacco, should benefit more, as many consumers are likely to first trade-up to more formal retail products in these categories. But growth here is closely correlated with the overall economy, expanding by an average of 3.5% in real terms. To some extent, this reflects the fact that the food and beverage market is already quite mature. Consumption across an array of basic food goods – meat, fruit, vegetables and milk – is already robust, and will continue to expand steadily.

Market demand for household soaps and cleaners

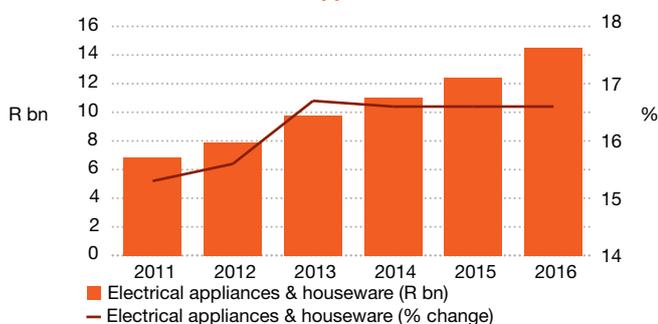


Source: Economist Intelligence Unit

From a growth perspective, the biggest growth lies at opposite extremes of the market. At one end are the most basic wares, such as soaps and cleaners, which are forecast to expand at about 17% from 2012-16. For these FMCG segments, local suppliers for cosmetics, pharmaceuticals and toiletries are already well established, including brands such as Adcock Ingram and Avroy Shlain. Meanwhile, at the other end of the spectrum, aspirational categories of consumer goods are also likely to experience high growth rates. Household audio and video equipment, for example, is forecast to expand by 18% over the forecast period. Sales of household goods will also be strong, as many households acquire basic goods for the first time – from kettles and toasters, through to washing machines and other white goods. Here, though, there is relatively little domestic supply of goods, with the majority being imported.

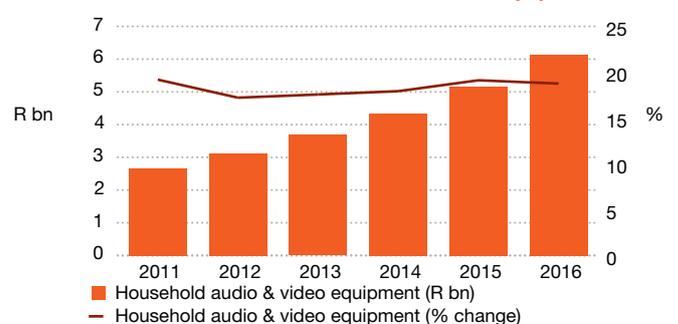
Sales continue to be boosted by the Government’s ongoing efforts to provide electricity and water to a far higher proportion of the country’s households. This is part of an ongoing service delivery and public housing scheme, which aims to convert informal settlements into formal housing. Between 1994 and mid-2010, over 3m homes were built, sheltering an estimated 13m people³⁸. This initiative, which faces a backlog estimated at 2.1m more homes, will continue to provide a significant base for future expansion³⁹.

Market demand for electrical appliances and houseware



Source: Economist Intelligence Unit

Market demand for household audio and video equipment

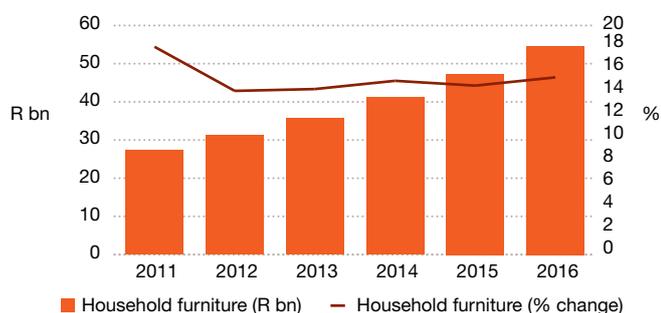


Source: Economist Intelligence Unit

To tap this, domestic consumer goods firms are pursuing several growth strategies. At the top of the agenda, given various cost pressures, there is a strong focus on increasing operational efficiencies and improving channels to market. A number of companies are also seeking to expand production capacity, either through mergers and acquisitions or else organically. Pioneer Foods, which owns a range of consumer food brands such as Sasko, Bokomo and Ceres, has invested significantly in its capacity over the past five years. ‘We’ve invested substantially, to provide the capacity for growth, in breakfast cereals, pasta, rice, milling, baking, nearly all the categories we compete in. [This has happened] from 1997, when we merged our Sasko and Bokomo milling operations and founded Pioneer Foods,’ says André Hanekom, the company’s managing director. Having done this, the firm is now planning to focus largely on efficiency improvements, in part through investments in more advanced IT systems.

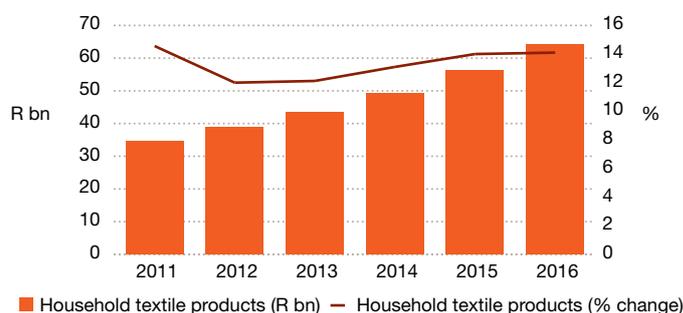
Many local consumer goods companies have also sought to expand capacity by acquiring existing operations in other African markets, in order to then invest to develop and upgrade their technology (see *Q&A with Nick Dennis, CEO of Lodestone Brands page 34*). However, this is especially notable for domestic brands buying capacity in other African markets, as they seek to establish a stronger foothold in new markets. Beyond this, there is a growing focus on brand development, especially relating to more carefully positioning consumer brands to appeal to distinct segments of the evolving consumer landscape. Related to this, more challenging market conditions will likely see an increase in demand for private label goods, as has been witnessed within other markets, such as the UK. Lodestone Brands, a recent entrant to the South African consumer goods market, is one example of a firm pursuing this category.

Market demand for household furniture



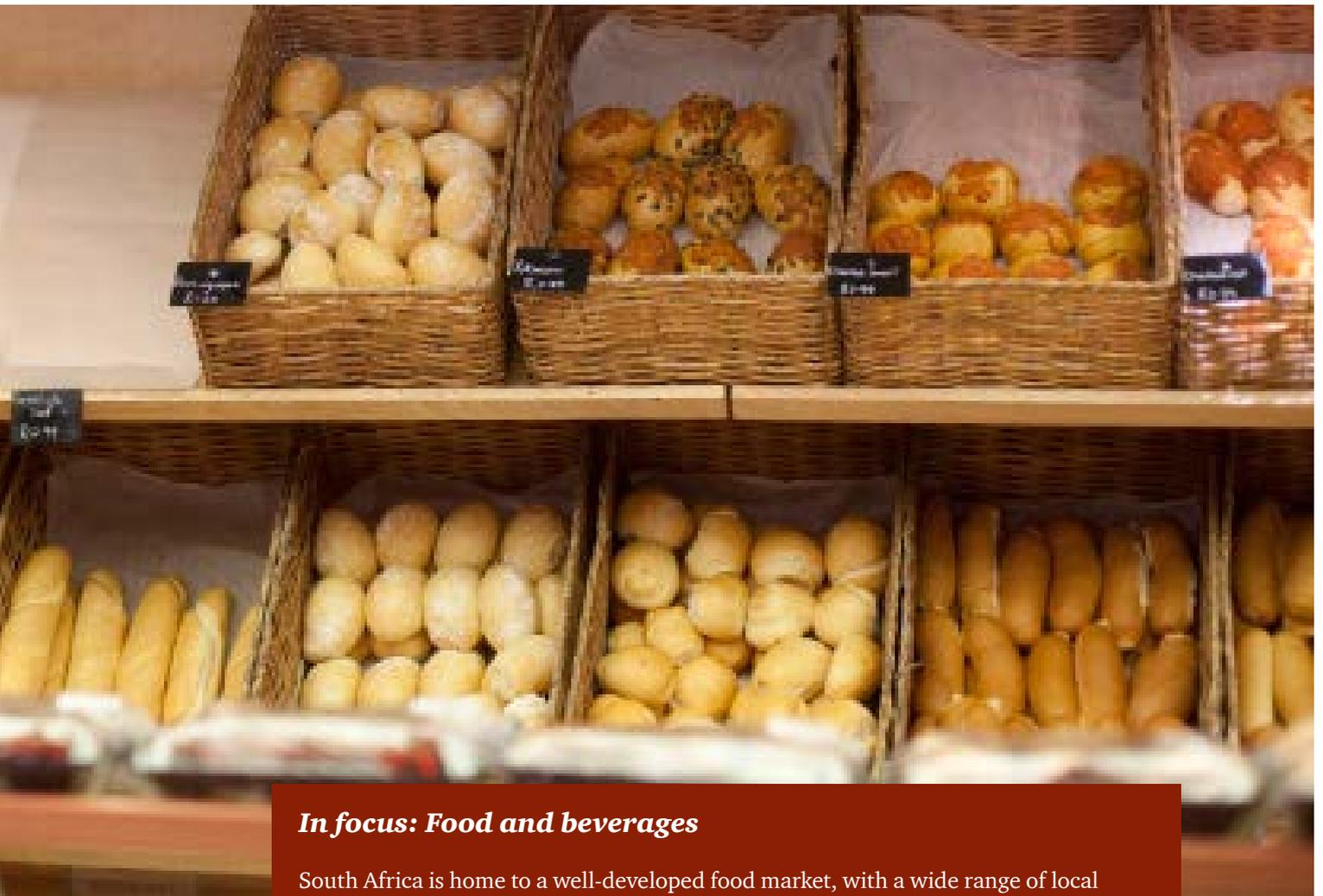
Source: Economist Intelligence Unit

Market demand for household textile products



Source: Economist Intelligence Unit

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In focus: Food and beverages

South Africa is home to a well-developed food market, with a wide range of local competitors, such as Tiger Brands, Pioneer Foods and Foodcorp, all of which have diverse food operations. But a number of international brands also compete heavily in the market, including giants Nestlé and Unilever. These rivals all compete for a share of supermarket shelves, which are the most important distribution channels for food, accounting for 55% of sales. From a trend perspective, food retailers are paying increased attention to ready-meals and other prepared foods. Demand for such products still lags that of developed markets, but busier urban lifestyles are boosting demand. Growing consumer awareness of health issues, given the country's alarming proportion of overweight consumers, is also driving demand for low-fat goods and other health foods. Some studies estimate that 61% of the country's adults are either overweight or obese⁴⁰.

The country's beverage sector is more highly localised. Brewing giant SABMiller controls about 90% of the total beer market, and 72% of the overall alcohol market⁴¹. Given that alcohol is the biggest-selling consumer good after food, with beer accounting for about 50% of the total sold, this gives it a considerable local position. The local beer market recently passed 29 hectolitres in size for the first time. In wine, the local market is protected by a 25% import duty, helping it to be dominated by local suppliers, while wine is a significant export product too. Growth in both beer and wine is expected to come mainly from black higher-income groups. In the soft-drinks sector, Coca-Cola is the dominant player in the market, providing a stiff challenge to any local rivals.

Barriers to growth

For consumer goods companies, as with retailers, the primary constraint to further development is the country's pressing unemployment problem. Similarly, although South Africa has a reasonable manufacturing base, especially within food and beverages, it is less competitive in other areas, especially consumer durables. In white goods, apparel and electrical goods, for example, the country is heavily dependent on imports⁴⁶.

Indeed, local manufacturers are struggling to maintain competitiveness against international rivals, in part due to relatively high local wages, labour unrest and inflexible labour policies. During 2011, average wages rose at about twice the rate of inflation, which has hampered manufacturers' competitiveness⁴⁷. In the textiles sector, for example, thousands of jobs have relocated to Lesotho, where wages are less than one-third. In the first half of 2011 alone, some 52 clothing factories closed in South Africa, according to South Africa's National Bargaining Council for the Clothing Manufacturing Industry⁴⁸. Despite the existing pressures, unionised workers in South Africa have a reputation for regularly taking strike action to demand wage increases.

Not only are labour costs a barrier to growth, but a shortage of skills is also an issue. 'Skills are likely to prove an inhibiting factor for some years to come,' notes Wayne McCauley, sales and distribution director for SAB (Pty) Ltd. To respond to this, the brewer has an ongoing internal initiative to develop skills and capabilities internally, as does Pioneer Foods. However, few local producers have the scale to be able to invest in such initiatives, making the skills gap a crucial challenge that can hinder growth. This gap is not only a challenge for firms internally, but also when they seek to partner with others, where decisions can be constrained by skills limitations in potential suitors.

Not only are labour costs a barrier to growth, but a shortage of skills is also an issue.

Unlike other major sectors in South Africa, such as mining or construction, the skills challenge is especially problematic for the manufacturing sector, which is the largest employer of specialist skills and artisans. The sector's companies continue to invest in technology and machinery, which helps reduce overall employment demand on the one hand, but further exacerbates the need for more specialised skills. The skills gap is a widely recognised national priority.

A further significant challenge for local consumer goods manufacturers is currency volatility. To a fairly large degree, much of this lies outside of the control of the country, which has been buffeted by pressures in the global economy, and which have an especially strong effect on emerging markets such as South Africa. The country's currency is closely linked with prospects for global growth, so many of its gains and declines occur independently of the underlying outlook for the domestic market. Currency fluctuations make life especially hard for manufacturers needing a lengthy lead-time to order their raw materials from abroad, which limits their ability to pass any consequent price increases onto consumers. 'Pricing is really tough to pass through, not least as consumers are already under strain,' explains Pioneer Foods' Mr Hanekom.



In particular, research by Barclays Capital suggests that the rand has been the global currency most closely correlated with world raw-material prices⁴⁹. This has raised concerns in some quarters over the risk of Dutch disease, whereby an overreliance on natural resource exports strengthens the currency and in turn erodes the competitiveness of the manufacturing sector⁵⁰. Various Government ministers, including the Minister of Trade and Industry, Rob Davies⁵¹, and the Director-General of the Department of Trade Industry, Lionel October⁵², have suggested that the currency is overvalued.

Many local manufacturers also complain about insufficient government backing to support local consumer goods manufacturing. This includes efforts to prevent the cut-price dumping of goods from other markets, along with tariffs to protect fledgling local industries. There are isolated actions. For example, authorities recently added tariffs of between 6% and 63% on imports of Brazilian chicken, which are the subject of a current dumping investigation⁵³. Nevertheless, the issue highlights the challenge that local manufacturers face in competing on price. Furthermore, such tariffs also serve to depress local demand, by keeping real prices higher. Already, South Africa remains at the lower end of the Economist Intelligence Unit's affordability ranking for most food and beverage products, despite significant local production capacity⁵⁴.

However, concerns over dumping also need to be reflected in light of local anti-competitive behaviour within the food sector. The Competition Commission, for example, has flagged the food and agro-processing sector as a review priority, where it notes high levels of corporate concentration within segments such as the trading, storage and processing of wheat and maize, and the milling and baking of bread⁵⁵.

A final challenge for local consumer goods firms is increased regulation. Some examples include increasingly tough rules on product labelling and food safety, both of which raise costs. 'You have to handle this properly, but this adds to your overheads, it requires lots more time on reporting, and particular care and attention overall,' notes Mr Hanekom. Overall, although there is plenty of future potential within South Africa's consumer good sectors, the pressures continue to mount.

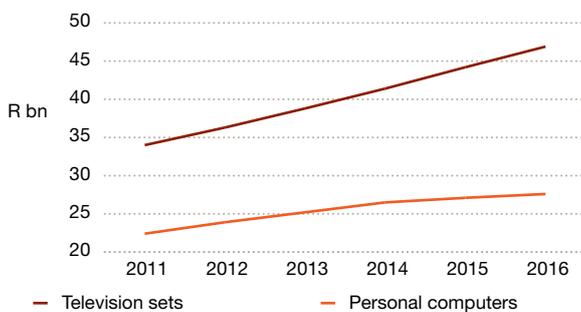
In focus: Luxury goods

South Africa is better established as a source of demand for luxury goods, rather than being a major supplier. Given the strength of its mining sector, it is a major global source of precious metals and gems, including platinum, gold and diamonds. It is also a key supplier of ostrich leather globally. However, local luxury goods production is more limited to niche specialist sectors, especially within leather goods and jewellery. But given highly status-conscious local consumers, international luxury goods brands have long eyed the local market – and many shopping malls feature high-end aspirational brands. Worldwide, emerging markets now account for some 30% of global luxury goods sales, of which South Africa is becoming an increasing focus, not least as major brands seek new growth outside of more stagnant developed markets⁵⁶.

In focus: Consumer durables

South Africa has relatively limited local production of many consumer durables, barring within the automobile sector. In the white goods and electronics sector, the majority of brands are foreign. For white goods, LG and Samsung are especially predominant, whereas HP, IBM and Dell are all leaders in the personal computer sector. However, the automobile sector is a major one, with both strong demand and supply. Volkswagen, Ford, General Motors, Mercedes-Benz, BMW, Toyota and Tata have all established manufacturing capacity within the country, partly for export purposes, but also to service local demand. The Government has various initiatives to support the sector, although no local brands have yet broken into the market. Overall, about 570 000 cars were sold in South Africa during 2011, a 15.6% increase over 2010⁵⁷.

Television sets and personal computers
(estimated number in use per 100 people)



Source: Economist Intelligence Unit, ITU; Pyramid Research

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Q&A with Nick Dennis, CEO, Lodestone Brands

Lodestone Brands is a new entrant into the South African fast-moving consumer goods market. Its CEO, Nick Dennis, was previously the CEO of Tiger Brands, one of South Africa's largest consumer goods firms.

You're most well known for your role as CEO at Tiger Brands, but can you tell us a little more about your new venture?

After retiring from Tiger, I started Lodestone Brands with three other partners. We've put our own money into the venture, but our prime financial backer is Standard Chartered Bank. It is a group of four companies and our dream is to build a serious FMCG business across Africa in a range of sectors, such as groceries, confectionary, beverages, personal care, home care and baby. We've acquired two companies in confectionary, one in beverages, and one in disposable diapers. In each of these categories we do the manufacturing, the distribution and the marketing. In some instances, in addition to our own brands, we supply private label goods for some of the big retailers.

What market segments do you target?

The diaper and beverage business is overwhelmingly LSM 4-6, so it's fairly low disposable income in terms of our target market. Our Mister Sweet business, which is one of the two confectionary companies, is aimed at LSM 9-10. The other confectionary company, Candy Tops, is LSM 4-6, and is largely into the wholesale trade, but is also now moving into formal retail.

How are you investing to support your growth strategy?

Our lifeblood is making acquisitions, to take the organisation to the next level. Within the business, it's about investing in capital projects. These may be about expansion in terms of growth, because we are reaching capacity on certain lines or in innovation because we have developed new projects that require innovation and new capital. So it's a combination of investing in acquisitions here in South Africa, and also the rest of the continent.

What is your view of the local retail market, as a consumer goods manufacturer?

The retail market is very sophisticated and competitive. Sometimes, I think it's overtraded, in terms of the way we see new shopping centres popping up all over. If it is not overtraded, it could get that way. But it's run by really professional people and they exert significant influence. For most manufacturers, there are probably four organisations that could represent up to 40-50% of your business. So if you have brands that need the retail space, these retailers exert significant influence.

How bullish are you about growth?

I think that it has slowed down. The consumer in South Africa is under serious pressure. This might be a function of a wave of petrol price increases, electricity increases, and I think a lot is going to depend on what happens to the rand in the short term. A big brake on growth is going to be unemployment. This is a big challenge and if anything is going to hamper growth, it is this. Of course, this is a huge challenge elsewhere in Africa too: in Angola or Nigeria or East Africa and Mozambique.

What are some of your key barriers to growth?

The challenge we have in South Africa is the weakness of our middle management here versus what you would get in North America or Europe. You've got insufficient people coming out of universities and technikons, and while they're qualified, they're not experienced. Nothing can replace the grey hair, and there is no shortcut for parachuting people into top jobs when they actually haven't been in the trenches.

Should government be doing more to support local manufacturing?

I think as a fledgling economy, if we don't have that support for the manufacturing sectors, then this has clear implications for local jobs. And if you lose your manufacturing base, and if the currency goes downhill, then you are in trouble, because you can't import goods because you can't pay for them. Nigeria's economy with its 160m people is able to pull this off thanks to their oil exports. But they need to use that oil lifeline to build a manufacturing base, because one day when the oil runs out, if you don't have a manufacturing base and your currency goes, you've got a problem.

Q&A with Wayne McCauley, sales and distribution director, SAB (Pty) Ltd

SAB is the South African arm of SABMiller, the world's second-largest brewing company, with brands including Castle, Grolsch, Peroni and Miller, among others.

What is your view of the outlook for the South African consumer goods sector over the coming 3-5 years?

We've seen the beer market in South Africa break through the elusive 29 million hectolitre barrier for the first time in history. We're going through an exciting period, with increased innovation, exposure and competitiveness – and consumers are responding well to this. Our growth outlook is for an average of about 1-4%. South Africa's growth is increasingly dependent on consumer spending. This is slowing and we expect it to continue to slow while global uncertainty persists.

To what extent has a greater push on branding supported your growth?

We put a lot of money into our brands, and we've significantly increased our spending on marketing and branding. A brand rejuvenation exercise has added considerable value. We've re-looked at our portfolio and our brand positioning and become a lot more precise in how our brands fit into particular target markets. Once you're clear on the role of your brands in your overall portfolio, it makes it easier to invest and the marketing dollars that you put behind your brands become more effective.

What are the main industry trends you see in your area of market?

We're seeing the consolidation of what we call the modern trade, and we also hope that the large informal, on-premise outlets will become increasingly formalised through licensing. In comparison to other emerging markets, the proportion of South Africa's outlets licensed to sell liquor remains low. Also, affordability will become much more important as consumers feel the increasing pressure on their income. This is also affected by the volatile rand and consumer price inflation, which are expected to put pressure on the cost and affordability of our products.

Is most of the consumer growth for your business concentrated within cities, as it seems to be for many other consumer goods firms?

Actually what we find is that growth in the rural areas is higher than in the urban settings. This is probably more the effect of government grants than anything else. But there's also the fact that the inflationary basket is actually higher for the urban consumer than it is for others. Things like electricity price increases are really affecting Johannesburg consumers more than the guys in rural areas. So, funnily enough, one would expect growth to be bigger in major urban areas, but that's not necessarily always the case.

How much of a challenge is a shortage of skills to your overall growth and how are you responding to this?

Slowing economic growth has somewhat eased the demand on skilled resources, but this will be an inhibiting factor for some years to come. We are focusing on capability development, with training done through what we call 'action learning'. We are putting considerable effort into up-skilling our people. For example, we're working to improve what we call professional account management. This is a methodology of driving your sales peoples' capabilities, to develop everything from pre-call planning and set-up, right through to creating win-win propositions for retailers, concluding the call and measuring the result. We are developing similar skills across our sales team and brand team, as well as our technical and brewery teams.

What are the other key concerns for your business?

The beer market continues to be highly competitive and we are facing several headwinds including a significant unexpected increase in excise, rising raw material costs and regulatory risks. The latter includes licensing and the formalisation of the informal market. We are big proponents of bringing unlicensed outlets into formal sector to ensure it can be regulated, but this licensing is unfortunately going very slowly.

Conclusion

The past decade has seen a remarkable turnaround in the fortunes of the African market, which has been host to many of the world's fastest growing markets. This has piqued the interest of the world's retailers and consumer goods companies, as they search for new growth. But on the continent, there remains a significant gulf between South Africa's highly developed and competitive retail market, and far less developed economies north of its borders. This has made the country an inevitable destination of interest for foreign rivals. In turn, this is forcing local retailers to sharpen their performance, although many of them are rightly confident of their ability to stand up to the test.

At a macro level, though, the country has little to be complacent about. Its economy faces significant downside risks to its future growth rate. This is partly due to its close links to the global economy, but also from its local policies. Policymakers have so far had few answers to its persistently high unemployment rate, which is the single largest drag on potential consumer demand. Due to this, the maturity of the local market, and growth elsewhere in Africa, international players will increasingly compete with South Africa's retailers for a stake in countries such as Nigeria, Kenya and Ghana. A new scramble for Africa is already underway. South Africa's players hold a considerable home-side advantage today, given their awareness of the difficulties of doing business in Africa, but they will need to work hard to maintain this position in the future.

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