

The Construction Industry as a Vehicle for Contractor Development and Transformation

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Background

Investment in infrastructure underpins the economic growth of any country and provides opportunities for enterprise development, employment creation and poverty alleviation. The public sector (general government and parastatals) is a major contributor to infrastructure development, accounting for around R150-billion in civil engineering projects and R25-billion in residential and non-residential building works annually.

Given the magnitude of Government's infrastructure budget, it is natural that it looks to the construction industry to mirror the country's demographic map and preferential public procurement is one of its tools which have been effectively used to increase the percentage of black-owned contracting enterprises.

Based on the cidb's grading system of one to nine (Grade 1 representing largely job seekers that are eligible to undertake government quotations up to a value of R200 000, and Grade 9 covering the largest and often publicly-owned enterprises with annual sales in the billions), approximately 8 300 enterprises (approximately 76% of which are black-owned) are currently registered with the organisation in Grades 2 and above in general building (GB) and civil engineering (CE). These enterprises provide employment opportunities for around 1 000 000 people. When materials manufacturing, retailing and transportation are added to the mix, the economic impact is almost twice that attributable to contractors.

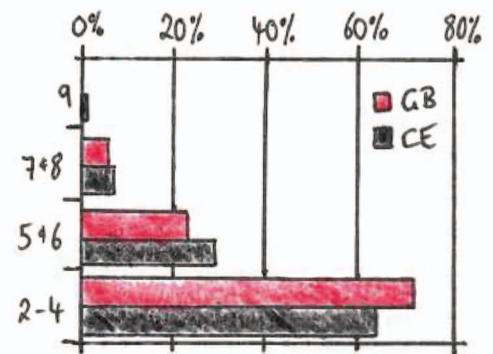
The supply profile of the contracting industry is largely a market response to demand but is influenced through policy and regulatory mechanisms such as preferential procurement and the BBBEE charters. The industry is characterised by a few large (Grade 7 to 9) companies with substantive financial and technical resources, and thanks to low barriers to entry, a host of smaller enterprises (Grades 1 to 6), many of which face financial, managerial and technical constraints.

Government Spending Profile

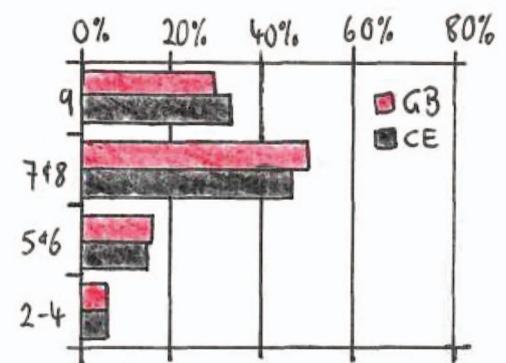
Over 80% of the value of public sector infrastructure spending occurs on projects of R13-million and larger (Grade 7 and larger), and approximately 30% of this amount is spent on projects of R130-million and larger (Grade 9). These high-value projects are typically large-scale and cannot be sub-divided or awarded piecemeal. They also require a high level of financial resources, management skills and technical capabilities – all typical characteristics of Grade 7 to 9 contractors. Conversely, around 20% of the value of public sector infrastructure spending occurs on projects of less than R13-million (Grade 6 and smaller), and only 6% goes to projects of less than R4-million (Grade 4 and smaller).

Although Grades 7 to 9 comprise only 7% of the total number of contractor registrations in Grades 2 and above, it is estimated that they account for around 75% of public sector contracts in rand terms. However, this does not mean that the remaining 93% of contractors only benefit from 25% of public contracts, as between 50% to 80% of the work awarded to large contractors is usually sub-contracted to smaller enterprises¹.

1. While sub-contracting (or co-contracting as it is increasingly being referred to) is an indispensable part of the industry, sub-contracting however introduces inappropriate management dynamics which the cidb is currently looking into.

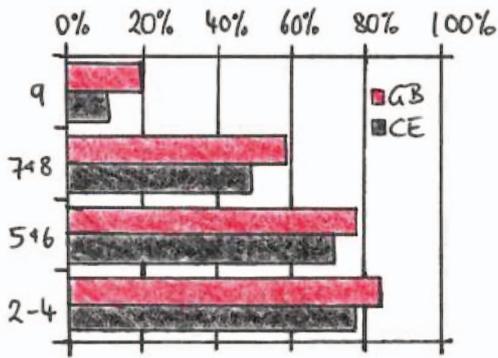


Distribution (%) of cidb registered contractors by contractor Grade (GB and CE; 2011 Q1)



Distribution (%) of public sector spend by contract Grade (GB and CE)

Progress in Black Ownership

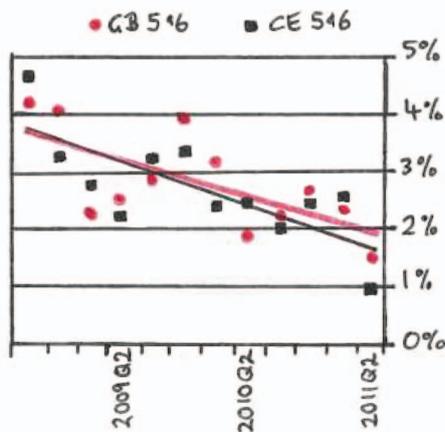


Distribution (%) of black-owned cidb registered contractors by contractor Grade (GB and CE; 2011Q1)

The current status of black ownership in the general building and civil engineering sectors reflects that considerable progress has been made in increasing the number of black-owned contracting businesses in the lower grades within the GB and CE sectors (Black ownership is defined here as equity ownership of 50% or greater).

These advances have been most pronounced among Grades 2 to 6, where 75% of all cidb registered contractors are black-owned. Black ownership figures for Grades 2 to 4 are around 80% in the GB and CE sector. The figures for Grades 5 & 6 are around 75% and for Grades 7 & 8 around 55% (CE). There are a total of 28 Grade 9 GB and 45 CE registrations, of which 21% and 13% respectively are black-owned. However, many of the Grade 9 contractors are publicly-owned which makes it difficult to determine ownership profiles.

Infrastructure Investment – A Driver of Contractor Development



Percentage of contractor upgrades from Grades 5 & 6 per quarter (GB and CE)

Environmental and market factors have a fundamental impact on the sustainability and growth of any enterprise, and in a recent cidb survey of registered contractors, the majority said that an increase in spending by Government and the private sector on infrastructure is the most significant opportunity for growth at the inception of their businesses.

As public procurement is the bread and butter of most cidb-registered companies, there is a direct correlation between public-sector infrastructure spending and the rate at which new black-owned companies are created and grow. However, since public contract awards started to decrease in around 2008, there has been a concomitant decrease in the number of contractor upgrades in general, and in the upgrading of black-owned contractors in particular.

Public procurement is therefore critical to the ongoing growth and transformation of the construction industry.

Procurement Driven Transformation

Government is committed to the objective that the ownership profile of contractors must reflect the demographics of the country, and government procurement is a key mechanism to achieve this. However, there is much debate as to the most appropriate mechanisms to achieve this.

One view that has been put forward is the belief that the grading pyramid can be inverted, namely that most Grade 1 to 6 enterprises can be elevated to Grade 9. The cidb maintains that this is not a realistic objective nor is it economically feasible. Not everyone can become a big player and nor should they. There is a need for Grade 1 to 6 enterprises in the economic mix. Moreover, there is simply not enough work to sustain or even come close to such an objective. Based as they are on the country's GNP, the funds available for infrastructure and other construction work is finite.

Another method that has been advocated is that of flattening the pyramid by awarding public procurement contracts which would normally be allocated to Grade 7 to 9 companies to their Grade 1 to 6 counterparts.

However, in the first instance most Grade 1 to 6 companies do not have the financial, managerial and technical ability to handle the complexity of extremely large contracts. Secondly, by awarding these contracts to Grade 1 to 6 enterprises, black-owned Grade 7 to 9 enterprises would then not be sustainable and would close down. Alternatively, they would unbundle and downsize into the lower grades to secure the work.

Thirdly, as more than half the Grade 7 and 8 companies are black-owned, inverting the pyramid would jeopardise many of those black-owned companies (companies with considerable technical expertise and experience) best placed to advance to Grade 9 status.

South Africa is no different to the rest of the world where the greatest number of operators are to be found at the base of the pyramid, and as the pyramid rises, the number of enterprises decreases steadily. This is a reflection of economic reality. However, each level within the pyramid has a vital role to play and each offers a service for which the market is willing to pay. Trying to alter this natural order of market forces by inverting the pyramid is liable to do far more harm than good.

But, this does not mean that nothing can be done, and in its inform practice notes 1 and 10, the cidb advocates various procurement models, including the bundling and unbundling of contracts to support socio-economic and developmental outcomes^{2,3}.

More recently, the cidb has also developed a discussion document which could make enterprise development of black-owned contractors mandatory on qualifying government contracts⁴.

Government is committed to using its procurement to support transformation of the construction industry.

Contractor Growth Mechanisms

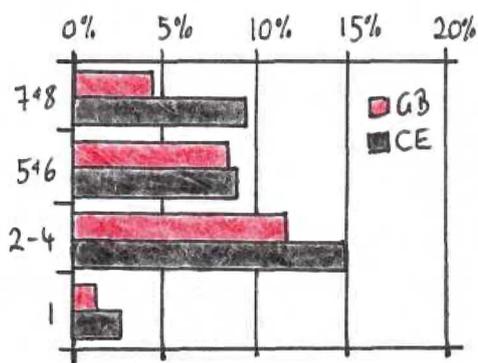
The cidb register of contractors provides a wealth of information on contractor development and growth.

Two of the factors which determine the cidb's contractor-grading process are financial capacity and the size of the largest contract undertaken during the past five years. Upgrading to a higher grading level therefore requires greater financial capacity and an increase in the size of projects successfully completed – both of which cannot be achieved without access to work opportunities.

2. cidb (2006). Scaling Up Delivery and Accelerating Empowerment, cidb inform practice note # 1, Construction Industry Development Board, August 2006.

3. cidb (2008). Attaining Social and Economic Deliverables, cidb inform practice note # 10, Construction Industry Development Board, February 2008.

4. cidb (2011). Requirements for Indirect Targeting for Enterprise Development (Draft). Construction Industry Development Board, 2011.



Profile (%) of contractor upgrades per year of cidb registered contractors by contractor Grade (GB and CE; 2011Q1)

An analysis of the rate of contractor upgrading shows that approximately 1 000 or 10% of building and civil engineering contractor registrations in Grades 2 to 8 upgrade by at least one grade per year. The highest rate of upgrades occurs in Grades 2 to 4. Around 1 400 Grade 1 contractors upgrade by at least one grade per year, or around 2%.

Although roughly 10% of contractors upgrade by one or more grades annually, only 2% have been improved by three or more grades since cidb registration. This equates to around 67 GB or CE contractors upgrading by three or more grades since 2006.

The pace of upgrades demonstrates that enterprises take time to grow and develop their financial resources, management skills, and technical capabilities. Other factors such as construction experience, as well as process maturity (business and construction processes) are also relevant. As organisations grow, their processes have to be continually adapted. It should be stressed, however, that all construction companies can mature over time – even if they remain at the same grade.

Organic Growth

Besides mergers and acquisitions, one of the methods of increasing black-ownership within Grades 7 to 9 is to grow Grade 2 to 6 companies into these higher grades through internal (organic) growth. In order to verify to what extent this process is feasible the cidb commissioned some research which followed the fortunes of 12 of the most successful contractors that had upgraded four or more grades over a five-year period, beginning in 2006 and culminating in 2010.

Nine of these contractors were black-owned. The key objective was to monitor the organic growth paths of these companies and to observe the factors which led to their expansion. Growth achieved through mergers and acquisitions did not apply. It was found that, on average, they upgraded once every 10 to 12 months or at a rate of three grades every three years.

Of the 12, seven contractors were elevated from Grade 4 to Grade 7, four attained Grade 8 status and one company reached Grade 9.

Although Government policies are important to advancing the growth of black-owned contracting businesses there are several other factors which also influence the growth of these companies.

These include:

- good individual and collective experience;
- attracting and retaining the right people and maintaining a strong workforce;
- the maintenance of high standards;
- investment in fixed assets; and
- working closely with the supply chain.

Some of the key lessons from the cidb survey can be summarised as follows:

- Construction companies require time to grow – successful enterprises only achieve sustained growth at an average rate of three grades every three years.
- Although Government policies play a crucial role in promoting the growth of contractors, they do not guarantee success. Enterprises have to use their organisational strengths to be effective and efficient.
- Successful companies have tended to be formed by leaders who have acquired good individual and collective experience in the construction industry. Strong teams have the requisite experience and education to develop faster.
- Successful companies focus on developing a strong financial base, delivering quality, building a strong track record and investing in fixed assets.
- They focus on developing and maintaining a strong workforce and working closely with their supply chain.
- Geographic spread and product diversification are necessary growth spurs.
- Delegation is important so that senior management can concentrate on a strong strategic focus. They must manage the managers and have a clear idea of what has to be done, when and by whom.

Conclusion

While it is acknowledged that black-owned contracting companies in the general building and civil engineering sectors do not yet reflect the country's demographic map, considerable progress has been made in the lower grades and Government can be justifiably proud of this achievement. Further progress is within our grasp and will take place thanks to preferential procurement and BBEEE policies, and through Government interventions such as the National Contractor Development Programme⁵, the cidb Best Practice Project Assessment Scheme, and others.

However, the transformation process can and should be accelerated through an increase in public and private sector spending.

What won't work is interfering with the natural economic laws of supply and demand. Rather, the emphasis should be placed on a continuation of existing policies but with an increase in and a steady flow of public procurement infrastructural contracts.

Acknowledgements

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The cidb would also like to acknowledge the support from the contributors of the construction industry that were interviewed during this research – and who provide role models for other participants in the industry.

5. DPW & cidb (2011). NCDP Summary Framework. Construction Industry Development Board, September 2011.

