

Win-Win Relationships via Embedded Services:

Materials Suppliers and MSEs in South Africa's Construction Sector

Armin Sethna
Ntinga LINK Program
World Education, SA

October 2005



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Implementation Grant Program BDS Learning Network

Case Study #5

Win-Win Relationships via Embedded Services: Materials Suppliers and MSEs in South Africa's Construction Sector

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IGP-BDS Learning Network

The United States Agency for Development's (USAID) Microenterprise Development Division has been funding programs in microfinance and business development services (BDS) through the Implementation Grant Program (IGP) since 1995. As of 30th September 2004, over 90 grants have been approved for a total life-of-project funding greater than 100 million dollars. The current IGP-BDS grantees are an impressive group of organizations and projects that: cover almost every geographic region, consist of numerous value chains, use various approaches, and contain enormous potential to make a positive impact. These programs present an important learning opportunity on how to improve the design, implementation, and impact of BDS programs.

The USAID Microenterprise Development Division, in an effort to establish a participatory learning process, initiated a learning network for the IGP-BDS grantees. The SEEP Network, a non-profit organization in Washington, DC, is the secretariat for the IGP-BDS Learning Network. The SEEP Network provides resources for the IGP-BDS grantees to conduct technical exchanges, hold virtual discussions, organize an annual meeting, and learn about different approaches and tools that are being used in the various IGP-BDS grant programs. In addition, The SEEP Network generates opportunities for: peer exchanges, collaborative case studies, and conference participation for IGP-BDS Learning Network participants.

The goal of the IGP-BDS Learning Network is to be an excellent technical resource for the participants of the IGP-BDS Learning Network, furthering their program and organization objectives. Through the IGP-BDS Learning Network, lessons on sound practices will be captured and disseminated to the wider microenterprise development industry.

The IGP-BDS Learning Network was officially launched during a meeting organized by The SEEP Network

and held in New Delhi, India in December 2003. This Learning Network identified the following three learning themes, which frame the common challenges of the IGP-BDS Learning Network participants, and are aligned with the market development goals of the IGP-BDS grants.

1. How to effectively manage the market facilitation role and tasks across a range of market settings and market problems.
2. How to build win/win business relationships between MSEs and other key market players.
3. How to effectively stimulate demand for business services.

Each IGP-BDS grant operates on a performance basis, tracking progress against targets established at the outset of the grant. The semi annual reports also provide qualitative narratives that link programmatic performance to the overarching IGP-BDS Learning Network's agenda. The agenda aims to understand how to harness the power of increased MSE participation in growing markets to achieve positive and lasting development outcomes.

Six IGP-BDS Learning Network case studies have resulted from the first two learning themes. These cases were written against a set of guidelines adopted by the IGP-BDS Learning Network. These six case studies have initiated a process of learning linked to useful and practical outcomes. In the near future, the IGP-BDS Learning Network plans to: develop diagnostic tools that manage and track performance, document learning against current and future learning themes, and distill lessons on the links between better practice and performance.

- Marshall Bear, IGP-BDS Learning Network Facilitator
- Jimmy Harris, Deputy Director, The SEEP Network
- Jennifer Hansel, Program Associate, The SEEP Network

World Education with Concurrence of USAID South Africa

U.S. PVO World Education is working to help disadvantaged MSE contractors identify and benefit from opportunities in the growing construction industry in South Africa. World Education is facilitating the commercial delivery of marketing linkage and quality control services

for MSE contractors. By accessing these services, MSE contractors will be better able to effectively participate in private and public sector tenders that range from small public works projects to larger private sector real estate projects.

Introduction

World Education's Ntinga LINK project was launched in January, 2003 after several months of market research and consultations with a donor and other stakeholders. The broad goal of the project is to mainstream micro and very small enterprises (MSEs) into the construction sector of South Africa via access to and use of viable business development services. The main objectives of the program are to:

- stimulate the commercial provision of business development services (BDS) in the sector by assisting providers to develop and market such services
- catalyze access to and use of such services via linkages between small and large firms
- demonstrate the economic benefits of the services to all players in the sector.

The pre-project stage of selecting and investigating the construction sector was critical to informing the initial program design, analysis of BDS, as well as the application and adaptation of strategies during the implementation phase.

Market Study

LINK undertook an in-depth sub-sector market assessment with a local research partner.¹ The study confirmed growth trends in the construction sector, as well as the existence of large numbers of MSEs most of which were operating at the low-value end of the market.

The study also influenced the geographic targeting of program activities, which were initiated in two of the poorest, more rural provinces of South Africa (KwaZulu-Natal and the Eastern Cape), where a high number and value of construction projects were identified in the pipeline. The third program target area is Gauteng Province, the economic and political hub of South Africa. This area is much more urbanized and has a high concentration of poor, township-based MSEs.

The market research highlighted the following findings:

- Small firms exhibited severe capacity and performance constraints in acquiring and executing construction projects. These problems contributed to the concentration of MSEs at the lower-value end of the industry.
- Small firms were marginalized in terms of information and relationships.

Box 1. Small firm constraints in South African construction sector

- Inability to submit winning tenders, which are the primary vehicle for doing business in the sector.
- Lack of compliance, including legal, technical, and delivery of documentation.
- Inability to negotiate appropriate payment and performance terms with clients.
- Inadequate marketing and relationship-building skills, especially with large firms.
- Lack of access to finance both (i) during pre-construction, which disqualifies MSEs from meeting guarantee and performance bond requirements; and (ii) during construction, which leads to cash-flow problems, incomplete work, and even liquidation.
- Lack of business and contract management skills.
- Limited understanding of project flows and how to access and manage materials for maximum cost and time efficiency.

As a result of these constraints, small firms forego opportunities that appear too big or risky; are not well known or marketed to key sector actors; have problems managing growth when they do win large contracts; and often don't know where to turn for service solutions.

¹The business development services (BDS) market assessment incorporated elements of the GEMINI sub-sector approach, with aspects of demand and supply analysis (based on a market development approach).

- The availability and quality of BDS for MSEs was poor. BDS providers who worked with MSEs identified their own shortcomings, including limited technical skills, management experience, finances (for obtaining new work and/or upgrading skills), and understanding of black economic empowerment policies.
- While sub-contracting and outsourcing have always characterized the construction industry—and would offer opportunities even without the current push for affirmative procurement—the actual number of

links between large firms and MSEs was limited. The prevalence, frequency, and performance of such linkages were uneven and largely unsatisfactory to both sides, which held very negative perceptions of each other.

- The policy push for broad-based black economic empowerment, or BEE as it is commonly known, does and will for the foreseeable future influence MSE growth, development, outsourcing, and relationship issues both positively and negatively.²

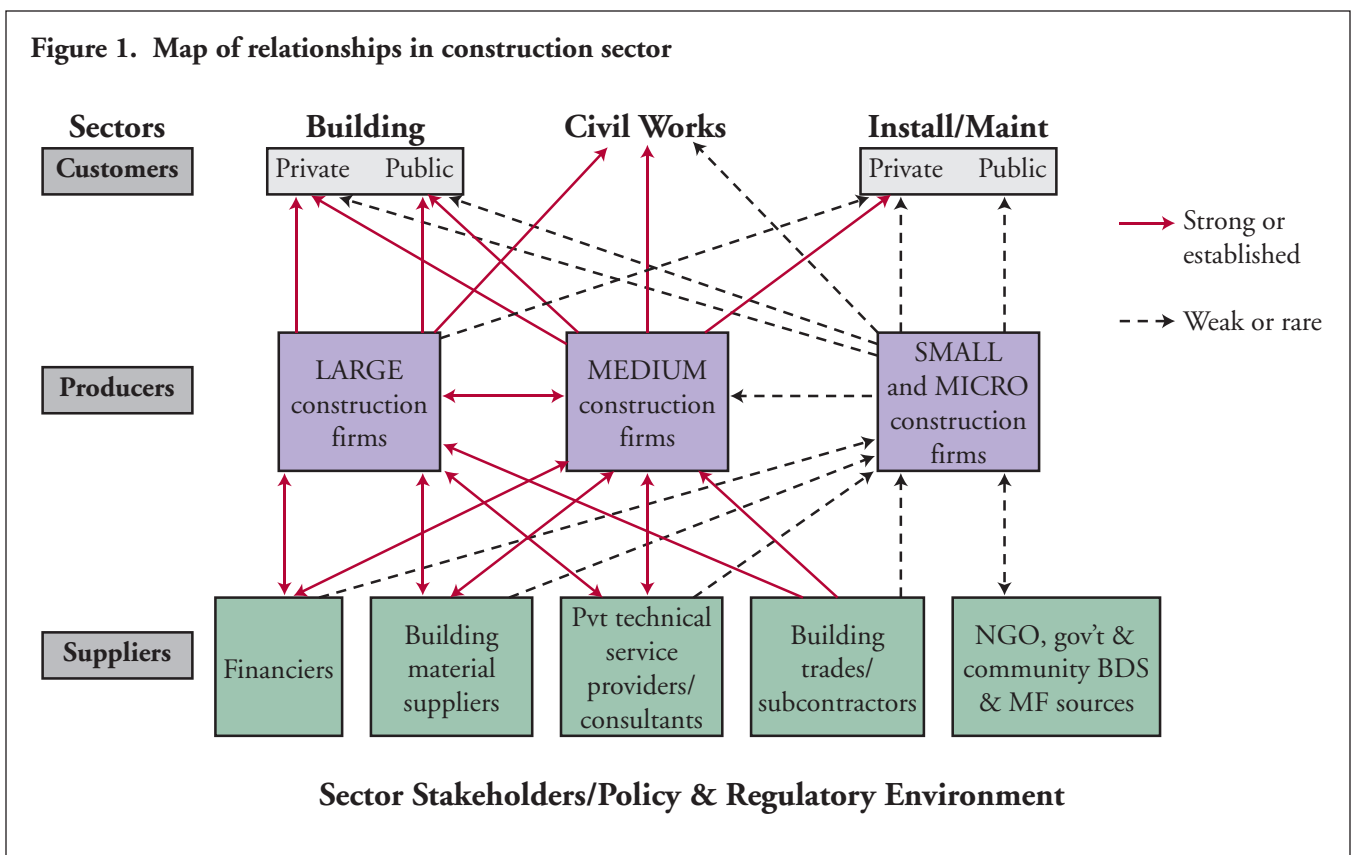
Mapping Industry Relationships

MSEs at the Margins

The inescapable conclusion of the market study was that MSEs were operating at the margins of the industry. The value of their work was, moreover, minimal in comparison to their number. Figure 1 shows a sector map of the relationships among key enterprise categories in the construction sector: large firms, medium firms (both of which are predominantly white or minority owned) and

MSEs (which are predominantly owned by blacks or “previously disadvantaged individuals”).

LINK’s target group—the small, resource-poor micro and small enterprises (MSEs)—fares poorly in relating to most sector players. The main relationships of MSEs appeared to be with non-profit, non-governmental organizations (NGOs) that provide BDS, and public-sector customers and providers. This fact influenced the initial



²See subsection entitled “Drivers, Advantages, and Limits” on page 12.

Figure 2. Relationship matrix in construction sector

	Small firms	Large firms	Business Associates	Materials Suppliers	Gov't	BSP	Client/ Consumers
Small firms	3	2	2	2	3	3	1
Large firms	2	4	5	5	4	5	5
Business Associates/ Coops	3	5	2	5	5	3	5
Materials Suppliers	2	5	5	?	5	2	5
Gov't	3	4	?	?	N/A	3	See note
BSP	3	N/A	2	2	3	2	2
Client/ consumers	2	4	N/A	N/A	See note	2	N/A

Note: In the construction industry, the government (or public sector) is also the consumer or client. In most countries, major infrastructure investment (e.g., the provision of schools, clinics, water and sewer systems, and access roads) is the responsibility of government, which awards competitive tenders to the private sector for building such projects.

Scale

- 1 Weak, rare, very problematic
- 2 Present to limited extent, problematic, not long standing
- 3 Present to greater extent and/or increasing rapidly, but still problematic, uneven
- 4 Present and longstanding, now under pressure (policy, history, etc.)
- 5 Established, repeated, longstanding, still strong
- ? Unsure, don't know enough
- N/A Not applicable (relationship not normally necessary)

outreach and activities of the LINK program, which devoted considerable attention to identifying and working with conventional “generic,” or cross-sectoral, business service providers (BSPs).

Ranking MSE Relationships

It is interesting to compare Figure 1 (developed in 2003) to a network relationship matrix prepared in 2004 (see Figure 2). Utilizing a quantitative comparison, the matrix quickly makes clear which relationships are weakest and which are strongest. Both tools indicate similar patterns and quality of relationships. The relationship matrix in particular illustrates problem and strong relationship areas.

Those relationships that could currently be characterized as “win-win” are ranked as a 4 or 5 on a scale of 1 to 5. These are relationships where both parties stand to

win, although not always to the same extent. In the case of small businesses, it is immediately evident that the majority of relationships are ranked 2 or 3, indicating that they are not win-win relationships for both parties (the one who gains less is normally the MSE). In contrast, the prevalent score for large firms (both contactors and material suppliers) was 4 or 5.

There are several reasons for the disjuncture in relationships between small and large firms in South Africa (see Annex 1), but the principal weakness of MSE relationships derives from:

- **historic factors:** differing business cultures, negative perceptions between small and large firms, and the deeply divisive legacy of apartheid

- **capacity constraints:** widely acknowledged on the part of MSEs, which lack the experience and knowledge to perform profitably on a consistent basis
- **market distortions:** large businesses have been able to establish favorable relationships at many levels, resulting in “closed” markets and “old boy networks”

that have successfully kept out new, perhaps more efficient and competitive, market entrants.³

The experiences of LINK have shown that large entities (contractors, suppliers, and resource or opportunity holders) may also lack a key competency: that of being able to effectively interact with the dynamic and vast MSE

Win-Win Relationship Strategies

LINK developed a two-prong strategy to promote sectoral linkages. The ultimate aim of this strategy is facilitate win-win relationships that have a bottom-line impact on the access of MSEs to business opportunities and their successful execution of such opportunities. Project resource realities meant that the program needed to concentrate on a shortlist of critical relationships to achieve maximum impact. In practice, the strategy has aimed to:

- identify and capitalize on relationship strengths that already exist
- identify, analyze, and target “win-lose” relationships that might be amenable to intervention by concerned third parties and lead to near-term benefits (these relationships turned out to be between MSEs and firms that provided financial services and materials).

Identifying and Strengthening Existing Relationships

As shown in Figures 1 and 2, MSEs typically have the strongest relationships with:

- **cross-sectoral, or “generic,” Business Service Providers:** typically, an NGO or government or donor agency that supports the market entry of MSEs. Most often, these organizations provide a broad range of information, awareness, training, and mentoring services in areas such as basic business planning and management.
- **public sector clients:** government departments that require construction services (often lower-tech products such as low-cost housing, refurbishments or additions, rural access roads, etc.) and have both the inclination and the mandate to undertake and enforce “affirmative” procurement that favors “emerging enterprises”⁴ via tender and quotation processes.

LINK facilitated the strengths of those BSPs with which MSEs typically worked, focusing on improving the relevance, efficiency, and effectiveness of their services through a targeted set of activities that included:

1. facilitating BSP introductions to and interaction with corporations, para-statal organizations, financial service providers, industry associations, and provincial infrastructure developmental authorities
2. research and information dissemination on industry trends, opportunities, and finance
3. BSP development including (a) enhancement of BSP skills in costing, scheduling, and tendering; (b) developing and testing a simplified costing tool (Ulwazi); (3) supporting the development and use of a market-oriented, small contractor database and profiling system (Asande); and (d) joint venture management training
4. BSP collaboration: activities that included helping 15 BSPs in KwaZulu-Natal and the Eastern Cape

Box 2. “Generic” or cross-sectoral BSP

“Generic” or cross-sectoral BSP

Provides general, non-technical business support services such as:

- Business plans
- Management advice
- Tender Costing
- Opportunity leads
- Sourcing finance
- Accreditation
- Compliance

³Old boy networks” exist in several other key sectors in South Africa, including manufacturing, large-scale agriculture, and mining.

⁴“Emerging enterprises” is a general term that denotes mainly micro and small firms owned by previously disadvantaged individuals (PDIs, i.e., citizens of South Africa that were formerly classified as Black, Indian, or Colored). See glossary for more details.

organize into provincial forums, providing collective and individual advice on linkage strategies, and facilitating the formulation of a BSP code of conduct to govern relationships and referrals among BSPs.

At the same time, project personnel worked to establish informational and working relationships with key government departments, such as local agencies in charge of economic and infrastructure development, departments of housing, roads, public works, and education. The aim in establishing these relationships was to ensure that BSPs and their MSE clients would become more aware of business opportunities earlier in the development phase and be able to position themselves to access those opportunities as well as influence the tender process (in terms of making the system more transparent, simpler to understand, and more consistently applied).

Interventions at the BSP level were positively received although engagement with public-sector bodies was impacted by bureaucratic and political issues. Each year, for example, government departments are unable to spend their allotted budget. In the case of one province, this resulted in a much lower number and value of construction

Box 3. User reactions to new BSP tools

“Before, our staff spent 1 to 2 days on one tender. With Ulwazi, they can complete up to 4 tenders a day.”

“With Asande, a KZN BSP secured contracts with four corporations and the municipality to source small contractors.”

projects coming on line than had been planned. Nevertheless, the more technically proficient and entrepreneurial BSPs were able to deliver services that benefited them and their MSE contractor clients.

In the most recent reporting period for the program (January-June 2004), LINK BSPs in KwaZulu-Natal and Eastern Cape provinces indicated that they provided construction sector-related services to 3,975 firms, of which 89 percent (3,532) were micro-enterprises and nearly 35 percent were owned by women. The six reporting partners of LINK assisted approximately 100 micro-enterprises to submit bids on construction contracts worth nearly US\$4 million, with 25 firms awarded construction jobs valued at approximately US\$1.3 million. Two hundred construction jobs resulted from these tender awards.

Targeting Relationships for Improvement: MSEs and Materials Suppliers

Improving MSE-materials supplier relationships has been a relatively recent strategy, pursued in the second year of the project primarily in the Gauteng province, where LINK deliberately downscaled its work with cross-sectoral BSPs.

By taking a broader definition of a business service provider, LINK focused on bringing in two value-chain players into the program:

- providers of financial services (rather than viewing financial services as separate from business development services, the program considers these services a component of BDS)
- large established corporate input suppliers.

The rest of this paper focuses on the provision of “embedded services” with materials. This type of relationship benefits from the existence of market opportunities for both sides as well as the comparatively greater willingness of material suppliers (compared to, for example, large construction firms or banks) to engage with MSEs and non-industry players such as LINK.

Figure 3. Bringing value-chain BSPs into the LINK project

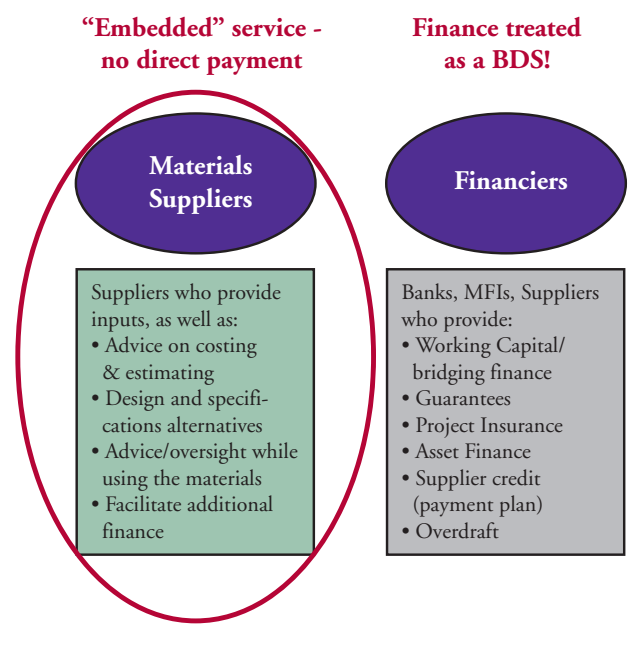
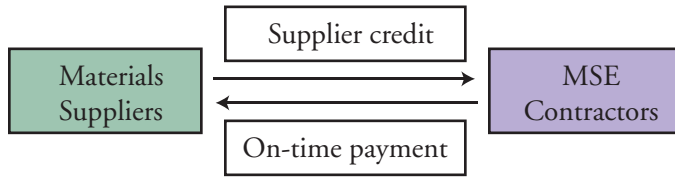
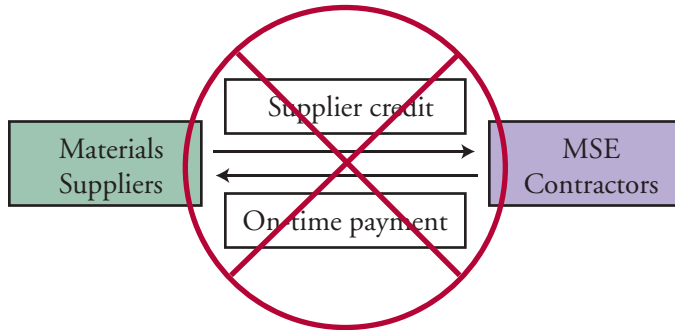


Figure 4. MSE-Materials Supplier Relationship



In a functioning relationship:

- Material supplier provides credit (30-90 day terms)
- Contractor pays on time
- Cycle is repeated



In a typical MSE-materials supplier relationship, the supplier wants cash up front.

If the supplier provides credit, the MSE is often unable to pay on time due to capacity/performance constraints.

The result is a win-lose or lose-lose relationship.

Identifying Win-Win Relationships

Among the key questions the program asked when trying to promote win-win relationships between materials suppliers and MSEs were:

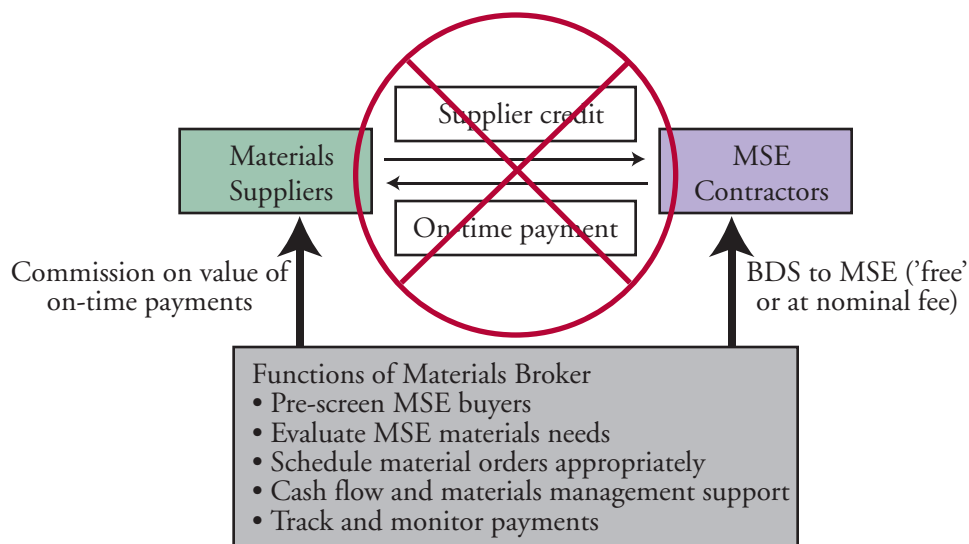
- What is the current status of the relationship between the two parties?
- Why/where does it break down?
- What are existing responses to the breakdown?

- What could LINK do to address the breakdown and turn it into a working relationship that could become self-perpetuating (a win-win relationship)?

Figure 4 illustrates how a relationship between a contractor and a materials supplier works and where it breaks down.

The typical response of suppliers to a relationship breakdown has been to avoid or abandon the MSE market altogether. In recent years, however, due to both policy pressures and the increasing realization among established firms of the market potential of the emerging

Figure 5. Materials broker model



PDI majority in South Africa, materials suppliers (like chain stores and supermarkets) have become more willing to deal with PDIs as consumers and buyers.

A few materials suppliers have adopted two creative strategies: working through a materials broker and embedding business development services in materials delivery.

Working through a Materials Broker

In a commission-based relationship, a materials supplier forges a relationship with a broker, or middleman, who provides project and/or performance management support to the MSE to ensure that the firm can appropriately order and utilize materials. These services enable MSEs to deliver on time and meet client specifications, and thus pay the broker on time. The broker can, in turn,

make on-time payments to the supplier. In this case, the broker earns a commission on the total value of sales from the supplier. It earns the commission only if payments are made on time and on a declining basis, should payments be later than required. Thus the broker assumes the transaction risk, which it mitigates by providing needed services to MSEs—services for which such small businesses would not normally pay, or pay only a nominal fee.

Although the LINK program discovered the potential for this type of relationship early in the implementation phase, the prospects for its replication are not extensive because the main provincial supplier that engaged in the practice decided to cut back on commissions. This policy has made the provision of brokerage services unprofitable for the BSP in question. Eventually, the supplier itself appears to have taken on the function of embedded services.

Embedded BDS among Materials Suppliers

The potential of embedded BDS is to develop and reinforce a virtuous cycle of “win-win” relationships that enhance MSE performance and payment capabilities. Given the prevailing policy context, MSE capacities, and economic imperatives for sector growth, the potential for embedded services is vast.

The evolution of embedded BDS from brokers to materials suppliers offers a promising answer to the needs of MSEs in the construction sector. In this model, a materials supplier provides an MSE contractor—both up front and during the execution of a construction

project—key costing, estimating, technical, and other advisory services that enable the MSE to select and appropriately use the materials, thus increasing the chances of successful delivery and repayment.

In 2004, LINK initiated operations in Gauteng Province (home to the economic and political capitals of Johannesburg and Gauteng), where many national headquarters of major supplier firms are based. Now in its second year of implementation, the LINK program has gained the attention and interest of more commercial players in the sector. At the start of program activities, the LINK team had to build credibility and recognition among established actors—not an easy task, given the outsider role that a facilitator normally plays.

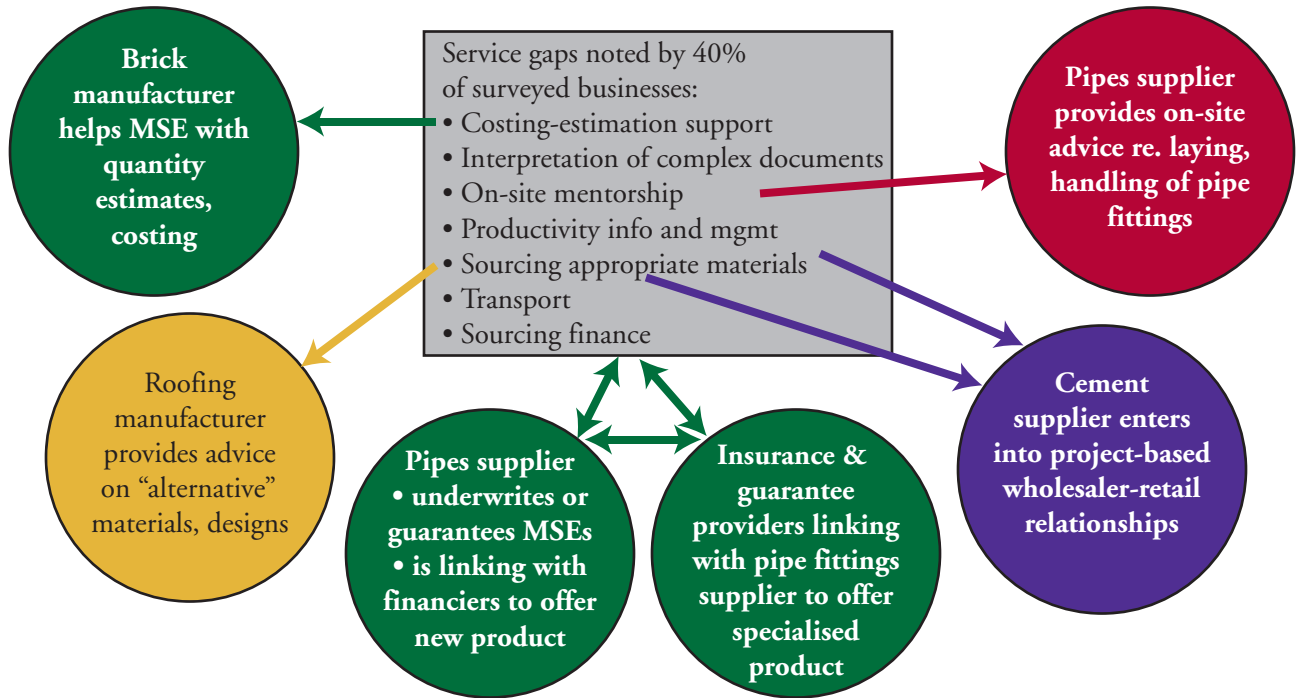
After establishing its *bona fides* with a number of the more effective generic BSPs and building relationships with technical BSPs and industry bodies (while maintaining direct communication with small contractor and MSE associations), LINK was able to approach and engage effectively with materials suppliers, formal finance institutions, and large firms.

Box 4. MSE contractors and their specific service needs

Suppliers’ embedded services dovetail almost perfectly with the service gaps and unmet needs of small contractors that LINK identified during its market assessment, namely:

- costing and estimation support
- interpretation of complex tender and contract documents
- on-site mentoring and project management support
- sourcing appropriate materials and supplies
- transporting materials and labor
- sourcing affordable finance

Figure 6. Embedded services provided by materials suppliers in Gauteng Province, South Africa



Note: The newly designed joint financing-pipe supplier service illustrated at the bottom of the figure is a direct result of LINK facilitation.

Types and Relevance of Embedded Services

Figure 6 cites examples of specific embedded services that materials suppliers are providing to MSEs in the South African construction sector. It is immediately obvious (both from the type of services and the MSE response) that such services are much more relevant and of better quality than the advice and support provided by generic BSPs. In fact, these services directly address the service gaps identified by LINK’s market research (see Box 4).

Facilitation of Embedded Services

Having established that certain materials suppliers were providing embedded services, LINK seized the opportunity to promote such services as a platform for win-win relationships. The first step was to increase awareness, availability, and use of existing services. LINK achieved this goal by supporting a set of buyer-supplier forums, dubbed the “Access to Resources for Small Contractors” seminar series. Since May 2004, three separate seminars have attracted more than 500 MSEs, representatives of up to 15 major construction supply companies, and providers of industry-specific guarantee finance and insurance services.

Getting suppliers of materials, plant, and equipment together with suppliers of financial services, guarantees, and insurance to share information about their core products and embedded services unleashed a flood of interaction with MSE contractors. The seminars also spawned interactions between suppliers, which are now combining their core and support services to offer new, no-cost packages to MSEs.

Box 5. Buyer-supplier forums

The most recent buyer-supplier forum sponsored by LINK was supported by many market actors. The event was co-funded by three suppliers, which contributed nearly US\$1,000 to the event. In addition, the Pretoria municipality provided the use of its City Hall premises and paid for newspaper advertising and refreshments. A major national contractor association and the BEE manager of one of the five largest construction firms both asked to be on the seminar program and 95% of attending contractors gave the event a positive evaluation.

Drivers, Advantages, and Limits to Embedded Services

Advantages

For an MSE, the advantages of obtaining embedded services from a supplier, rather than from a stand-alone or generic BDS supplier, are that the service is:

- credible, because it comes from an established, known, and experienced source
- close to (i.e., accessible to) the small business
- affordable, because separate payment is not required.

For materials suppliers, the advantages of offering embedded services are that such services:

- open up new, larger markets via direct sales or franchise opportunities
- enable them to respond proactively and positively to current policy pressures, and thus avert the threat of sanctions
- take advantage of risk-reduction mechanisms (such as third-party payments and concessions, as well as the current trend of making working capital more readily available to MSEs) that lower the supplier's overall risk.

Disadvantages and Constraints

The relatively small number of suppliers currently offering embedded services, and the fact that these services are offered on a limited basis, carries some disadvantages for MSEs. Since services are supplier-driven, it is difficult for recipient MSEs to shape the services to their exact needs and to demand quality and consistency. In addition, the pool of experienced suppliers is relatively small and familiarity between suppliers and preferred MSEs may not stimulate further competition or innovation.

Even if they cannot clearly define the actual or opportunity cost of providing specific services, suppliers do make cost and risk calculations that limit the volume and depth of services that they are willing to offer MSEs. The fact that more materials suppliers are not offering such services can be traced to a combination of factors, including:

- lack of market knowledge or entrepreneurial flair
- risk of non-payment due to relatively high MSE failure rates (the construction industry is very demand-

ing in terms of performance and delivery, in addition to operating on very slim margins)

- the potential for material losses due to theft, lack of appropriate storage, and MSE mismanagement.

Cost considerations are influenced by the:

- size and value of the specific MSE contract
- size and value of the overall construction project (i.e., potential for new MSE customers)
- level of MSE experience and its need for assistance
- potential for increasing supplier's visibility and exposure, thus improving future positioning.

Risk factors include:

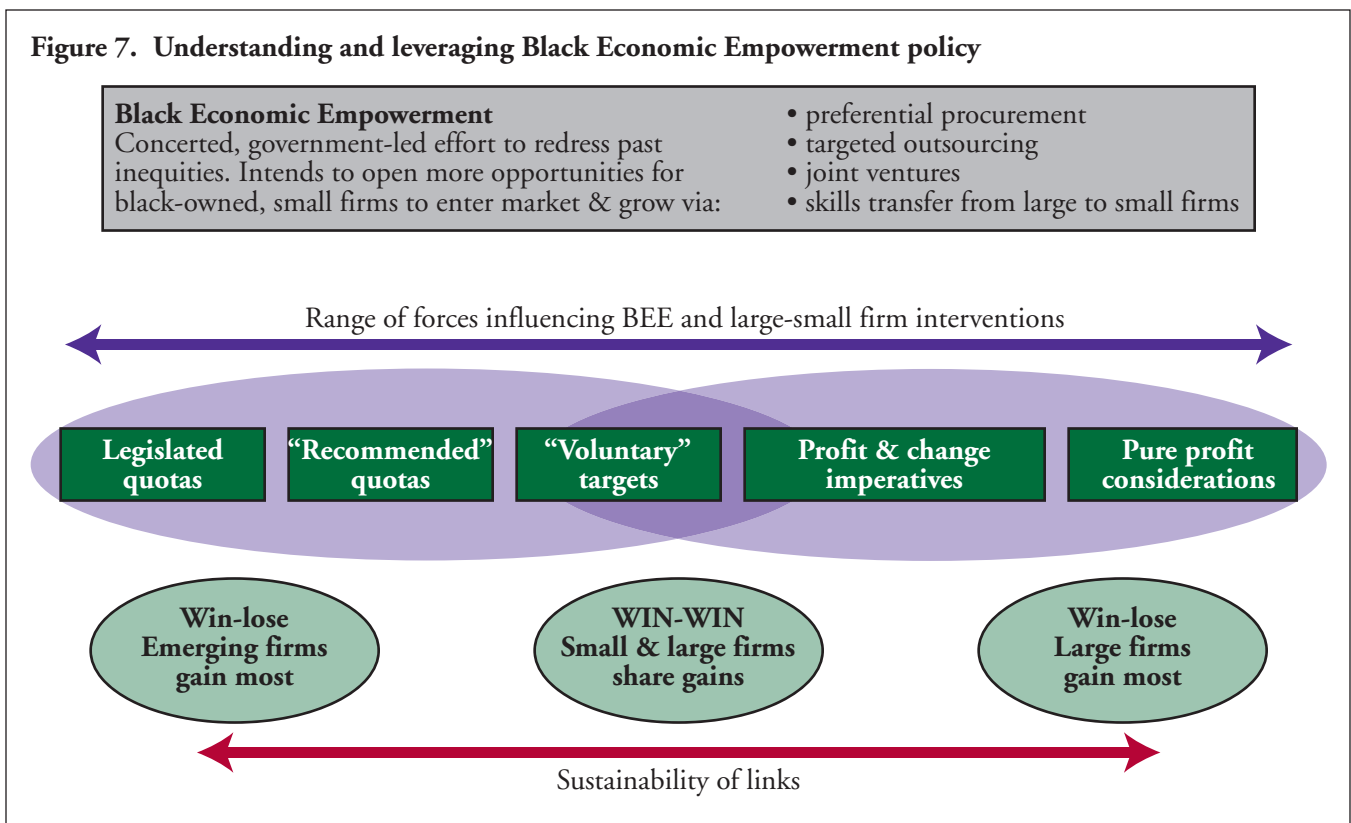
- potential that the materials supplier may be overwhelmed by MSE demand for embedded services, and thus be diverted from its core business
- history of MSE failure to complete projects, which is still relatively high
- systemic contractor payment processing delays, especially for construction works commissioned by the public sector.

Leveraging Black Economic Empowerment Policy

It has been noted that the government policy of Black Economic Empowerment (BEE) is a key driver of embedded and other services in the construction industry. Given South Africa's history and the moral, social, and political imperative of bringing the vastly disadvantaged majority into the economic mainstream, the far-reaching scope and impact of BEE and related legislation cannot be underestimated. Although some people may view the effects of the policy as distorting free-market principles, there is no question that economic transformation and a leveling of the playing field would take much longer without such legislative "stick and carrots."

Given that BEE policy can either support or work against market considerations, LINK occasionally confronts a fine line in staying true to the tenets of market development, including the commercial viability and sustainability of the BDS that it facilitates.

Figure 7. Understanding and leveraging Black Economic Empowerment policy



From LINK’s point of view, the prevailing BEE policy offers opportunities to push the frontiers of service provision to a long-neglected group in South Africa. Yet the policy risks that commercial and non-commercial BDS and other service providers will formulate, design,

and deliver services based solely on legislative imperatives, rather than good business sense or bottom-line considerations. The process may work effectively in the near term, but is likely to become unsustainable and ineffective soon thereafter.

Looking Ahead

LINK needs to be realistic about what it can do to further facilitate the provision of relevant embedded services through materials suppliers, while continuing to unblock other key constraints to MSE access and performance (most notably, finance and large-contractor practices).

What is Possible?

In the near term, LINK will continue to:

- identify existing embedded services among suppliers with the aim of documenting them and raising awareness among MSEs and other industry stakeholders of the benefits of such services
- increase access and use of existing embedded services via introductions between relevant suppliers and MSEs
- promote additional service provision via interaction between existing suppliers and those not yet offering embedded services; provide technical advice and assistance in forging temporary service partnerships
- research and document LINK interventions and share them more broadly within the industry
- help publicize the availability of specific suppliers’ embedded services. Although publicity may be viewed as favoring or pre-selecting a few suppliers to the detriment of the wider market, the need for such services is so high and MSE awareness of their availability so low, that LINK considers publicity a necessary immediate step in bridging the service gap.
- facilitate development of new embedded services between suppliers based on areas of specialization and competitive advantage, especially on larger projects

Box 6. Next steps

As a follow-up to its seminar series (“Access to Resources for Small Contractors”), LINK is now pursuing the following tasks:

- assisting suppliers and MSEs to craft specific business deals with the aim of better understanding and documenting the process, as well as establishing “demonstration” examples
- facilitating supplier-to-supplier discussions on service collaboration, with the aim of action research
- conducting one-on-one research with those suppliers offering embedded services to verify LINK’S anecdotal and experiential understanding of key drivers and constraints.

such as road building and “heritage sights” that require use of a large proportion of local MSEs and labor

- help suppliers and MSEs identify and publicize the pros, cons, and returns on embedded services offered by specific suppliers.

Limits to the Role of Facilitator

The LINK team recognizes that there are limits to facilitating the expansion and use of embedded services, including supplier cost-risk considerations, the highly competitive and cyclical nature of the construction industry, and established patterns of operations among the larger, more powerful commercial players.

Some additional constraints to facilitation are:

- **translating BDS jargon into “supplier-speak” and vice versa.** Such translation is necessary so that LINK can operate within the industry as a credible resource without abandoning its development goals and principles.
- **competition and confidentiality concerns.** Many suppliers are reluctant or unwilling to divulge to an outside party their full reasons and rewards for

offering such services, for fear that such information may be made public, used by competitors, or attract unwanted attention.

- **inability or unwillingness of suppliers to specify cost-benefit calculations.** Suppliers are often unable to clearly articulate the specific factors that led them to offer certain embedded services because the services are still relatively ad hoc, rather than being integrated into normal supply procedures. For example, services may be provided only on an as-needed basis to specific preferred MSEs with whom a relationship has been established. More important, the risk-return rationale may be political rather than financial. While this factor drives much of business in South Africa today it is not something to which most players would readily admit.

LINK is now at a critical phase of implementing two different strategies designed to increase MSE access to services and resources that will enable their successful market entry into the mainstream construction industry. The outreach model being used in Gauteng will be replicated in several parts of the province and will also likely be delivered in the KwaZulu and the Eastern Cape provinces, as LINK moves to close out its direct involvement in those regions by the end of 2004.

Glossary

Affirmable Business Enterprise (ABE), also known as a “PDI” firm or “emerging” firm). Any firm in South Africa with majority “black” ownership or shareholding. In this case study, the term is largely used to refer to the smaller end of the spectrum, i.e., micro or small firms that are owned and run by PDIs.

Affirmative procurement. Similar to BEE, affirmative procurement refers to outsourcing or sub-contracted activities that are usually issued as part of a competitive bidding or tendering process.

Apartheid. The political and legislative system that reigned for decades in South Africa, in which the ruling white minority instituted a system of separate development for various race groups, leading to the severe disenfranchisement and social, economic, and cultural dislocation of 90 percent of the population.

Black. A term used mainly to designate individuals of African descent in South Africa. However, the term is also commonly used as a short form to refer to people classified as “colored” (mixed race) and Indian.

Black Economic Empowerment (BEE). A concerted effort led by the South African government to redress past economic inequities and imbalances. The general

strategy is to promote effective economic participation and benefits for greater numbers of PDIs by increasing their access to business opportunities, ownership, management control, and skills acquisition. BEE is predicated on “outsourcing” opportunities to PDIs at certain minimum levels or percentages, usually 25-30 percent of the total value of a contract.

Department of Roads and Public Works (DRPW). A leader in BEE national affirmative procurement, particularly in the construction sector .

Emerging firms. Interchangeable with PDI firm or ABE. Usually refers to smaller, under-resourced black or PDI-owned businesses.

Previously Disadvantaged Individual (PDI; also known as Historically Disadvantaged Individual, or HDI). A term that refers to Africans (77 percent of the total population of South Africa), Asians (2.5 percent), and Coloreds (8.7 percent), all of whom were officially discriminated against to varying levels degrees until apartheid was formally abolished in 1994. Women of all races are also considered PDIs.

Annex 1:

Characteristics of MSE-Materials Supplier Relationships

Relationship Characteristic	Present Relationship	Current Changes	Future Relationship
Common vs. Rare	<p>Given the number of MSEs in South Africa, the relationship is comparatively rare.</p> <p>Probably more prevalent in urban than rural areas. Where relationships exist, they are generally weak and unstable due to:</p> <p>On the MSE side, problems with:</p> <ul style="list-style-type: none"> • blacklisting (poor consumer credit record) • timely, accurate ordering of materials • ability to care for and manage materials • appropriate, timely use and application of materials • timely, accurate payment for materials <p>On the supplier side, issues of:</p> <ul style="list-style-type: none"> • cash payment • minimum order quantities • traditional lack of trust • reliance on Credit Bureau records 	<p>Suppliers are becoming more familiar and less wary of the MSE market for a number of reasons:</p> <ul style="list-style-type: none"> • increasing contacts with and understanding of MSEs • public sector policy and legislative pressures • public sector support measures (e.g., concessions, 3rd-party payments, guarantees) • risk-management mechanisms, such as embedded services (up-front advice to MSEs on pricing, appropriate material selection, on-site support) <p>MSEs better able to deal with suppliers due to:</p> <ul style="list-style-type: none"> • increased industry exposure and experience • increased skills (especially project management skills) • willingness of financial service providers to ignore bad personal credit history • use of BSPs to provide advice and support 	<p>Expected to become increasingly common due to following factors:</p> <ul style="list-style-type: none"> • size of MSE market (from supplier point of view) is very large and untapped • policy and legislative pressures will force suppliers (as well as principal building contractors) to provide materials directly to small contractors • understanding and use of benefits (such as discounts, payment terms, etc.) by small contractors • embedded services offered by suppliers • increased small contractor skills in materials ordering, management, and pricing

Relationship Characteristic	Present Relationship	Current Changes	Future Relationship
<p>Social vs. commercial</p>	<p>Not linked to social ties. Due to legacy of racial segregation, large suppliers and small contractor community have very little interaction outside the workplace.</p> <p>In contrast, the social ties between large contractors and materials suppliers are very strong and contribute to an “old boy network.”</p>	<p>Not much evidence of increased social ties at present, except that large firms are increasingly moving PDIs up the ladder in sales and management.</p> <p>PDI advancement within existing large firms could help bridge the communication gap between such firms and small contractor customers.</p>	<p>Some change possible as HDIs increasingly own and operate materials supply businesses and franchises located closer to the communities where small contractors live and work.</p>
<p>One-time vs. continuing</p>	<p>Normally, such a relationship is premised on continuity, as both parties meet obligations and benefit. However, due to poor MSE capacity, the payment system often breaks down, leading to a break in the relationship.</p> <p>Continuity of relationship is:</p> <ul style="list-style-type: none"> • More important to the MSE. Access to consistent supplies with 30-60 day payment terms allows MSEs to manage projects within the prevailing phased contract payment system. • Less important to the materials supplier, as order quantities may be relatively small and orders from large contractors remain its bread and butter. 	<p>The relationship is increasingly important to both supplier and small contractor.</p> <p>For the MSE, “affirmative procurement” policies mean that MSEs are being awarded an increasing percentage of contracts, hence their need for materials is growing.</p> <p>For the supplier, selling to MSEs allows it to remain competitive, both financially and politically.</p>	<p>The relationship is expected to be of equal importance to both suppliers and small contractors in near future; both parties stand to gain and/or lose substantially.</p>

Relationship Characteristic	Present Relationship	Current Changes	Future Relationship
<p>One-way vs. two-way</p>	<p>Currently, the economic and financial power factor lies mostly in the hands of the supplier. A supplier can turn down credit applications, does not feel obliged to include transport or other courtesy services, and has little incentive to provide discounts to MSEs.</p> <p>The position of the small contractor is further weakened by lack of:</p> <ul style="list-style-type: none"> • access to transport (location of supply bases often inconvenient to townships or rural areas) • understanding of materials management • storage, theft, spoilage issues 	<p>Some changes.</p> <p>Of note, the political power factor (redressing the wrongs of apartheid) is reducing the importance of economic power in the relationship, and may even overtake it.</p>	<p>Power will shift to the MSE side, as:</p> <ul style="list-style-type: none"> • the viability and size of the MSE market grows and becomes recognized by traditional suppliers • policy pressures continue to require increased access to resources by MSEs • more MSEs/PDIs enter the materials supply business
<p>Transparent vs. manipulative</p>	<p>To date, there has not been much transparency in most sales transactions between materials suppliers and MSEs.</p> <p>In those cases where a supplier is guaranteed payment by an arrangement such as a “cession,” suppliers often:</p> <ul style="list-style-type: none"> • insist that MSEs purchase ALL materials needed for a project up front, which locks up capital and creates storage problems • do not divulge details about “extras,” such as transport, insurance, interest charges, etc. • do not divulge their practice of discounts, payment options, etc. 	<p>The nature of the relationship is changing on a small scale (compared to the vast number of MSE contractors in existence).</p> <p>Through a range of training and education programs, MSEs are becoming more aware of how to negotiate and transact with suppliers—and ask the right questions.</p>	<p>MSEs should be able to obtain at least 30-day payment terms through a combination of factors:</p> <ul style="list-style-type: none"> • easier access to guarantees and working capital • general agreement among financial service providers to give less weight to bad personal credit history of MSE owners <p>Due to normally smaller volumes of purchase, however, MSEs may not uniformly qualify for discounts or first preference in terms of delivery or other additional services.</p>

Relationship Characteristic	Present Relationship	Current Changes	Future Relationship
<p>Favorable vs. negative perception</p>	<p>The negative perception of both sides cannot be overstated and has specific South Africa overtones. It involves:</p> <ol style="list-style-type: none"> 1. Typical small-large firm antagonism: <ul style="list-style-type: none"> • MSEs think the large firms are out to “get them” • Large firms think MSEs are a bunch of unreliable, petty thieves 2. More deeply held are racially and culturally based perceptions: <ul style="list-style-type: none"> • MSEs are nearly 100% “black” owned, representing a group that was traditionally disenfranchised and had their rights and dignity severely abused by the white ruling minority of the previous regime • Large firms are primarily “white” owned, representing a group that has been used to blacks being in a secondary position, is aware of PDI’s lack of education and experience, and has low expectations of their performance. 3. Language barriers hamper communication on both sides. 	<p>The economically dominant white minority is slowly beginning to perceive both opportunities and performance capabilities in the MSE market. However, policy and legislative mechanisms trying to fast-track transformation are creating resentment and stone-walling tactics.</p> <p>The previously disadvantaged MSE majority has perhaps overly high expectations of “getting rich quick” and expects favorable treatment due to background only. Recognition of the need to build a sound business track record is, however, growing.</p>	<p>MSEs are poised to expand their access to opportunity, regardless of whether current racial and cultural perceptions continue to prevail.</p> <p>Large firms and suppliers will either adapt or lose their position and power.</p>

Relationship Characteristic	Present Relationship	Current Changes	Future Relationship
<p>Voluntary vs. mandated/legislated</p>	<p>Government policy directives, growing public expectations and the threat of legislated quotas and punitive sanctions are currently significant factors motivating large firm-small firm interaction.</p> <p>Materials suppliers are perhaps quicker to see and seize the economic opportunities that have arisen as the result of growth in number of MSEs and, perhaps more importantly, of the black middle-class consumer market, which is more inclined to work with black-owned MSEs.</p>	<p>In response to policy pressures, many industries, not least of which the construction industry, are creating “Empowerment Charters” to avert the advent of legislated quotas and sanctions.</p> <p>Charters spell out the percentages of black ownership and management of major firms (large supply conglomerates included) by a certain date. Charters also target annual spending on goods and services acquired from MSE and black firms and offer incentives and support to promote skills and employability among the majority population.</p>	<p>The Construction Charter was postponed and is now due to be issued in mid-2005.</p> <p>In the near-to-medium term, interactions will likely still be motivated more by policy pressures than by profit-margin considerations. (The government’s BEE policy could remain in force well into the next decade.)</p> <p>As the size and depth of the MSE market grows, however, and the performance of these firms improves, the motivation for relationships may come to be driven more by market imperatives on both sides.</p>

