GCR South Africa Corporate Sector Risk Scores June 2019

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Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Corporate Entities, May 2019
Criteria for Rating Real Estate Investment Trusts and Other Commercial Property Companies, May 2019

The GCR South African Corporate Sector Risk Assessment

GCR utilises the sector risk score in conjunction with the country risk score, to determine the operating environment risk score for each individual sector within the South African environment. The following sector risk scores are intended to provide users with an overview of the major factors that impact GCR's assessment of the relative risk of each sector in the local economy. The following list is not a comprehensive list of all sectors of the economy, but largely covers GCR's South African corporate rating universe. Additional sector risk scores will be introduced as necessary.

GCR will continue to monitor trends in the sectors contained in this publication and will update sector risk scores as the underlying factors shift.

South African Corporate Sector Risk Scores

Agriculture, Sector Risk Score 4.

The agriculture sector risk score reflects its inherently highly cyclical nature, with agro-industrial corporates' earnings and cash generation fluctuating widely due to exogenous factors including climatic conditions and commodity price volatility. Domestically, the sector is vulnerable to material disinvestment due to uncertainty in respect of the ongoing land redistribution debate, while an evolving labour landscape, water scarcity and broader environmental considerations remain key risk factors.

Education, Sector Risk Score 8.

GCR's sector risk score for Education reflects the industry's below average cyclicality and moderately high profitability through business cycles. Moreover, the industry evidences low environmental impact risk and moderately low risk of technological disruption, albeit that investment in ICT platforms enhances the learning experience, particularly in long distance and tertiary education, which is a distinct competitive advantage. Nevertheless, these factors are counterbalanced by intermediate barriers to entry which open the industry to potentially many competitors, which could impact industry margins. Further, while the regulatory and legislative environment is largely static, GCR would expect to see the resolution of the funding model for public institutions to bring stability to the tertiary segment.

Against the backdrop of severe capacity shortfalls and deteriorating education standards at public institutions, the attractiveness of private schools, particularly those targeting the mid and lower LSM market segments, continue to maintain a strong baseline of demand. That said, while education is considered a priority in most household budgets, private education costs can be a hindrance, and remain significantly higher than the cost of public schools. This is particularly important in the current domestic economic environment characterised by increased pressures on household disposable income levels, which could curtail student retention and profit margin progression. GCR is of the view that private school enrolment numbers will continue to be muted in the medium until the spending pressure on parents has subsided.

Fast Moving Consumer Goods ('FMCG'), Sector Risk Score 6.

The FMCG sector score is reflective of the stable profitability of the leading players in the South African industry and relatively moderate regulatory risks. Nevertheless, this is moderated by low barriers to entry and high susceptibility to product disruption. Rising consumer strain has, however, significantly curtailed pricing power in the South African FMCG industry over the past 18 months. Consumers have increasingly been downgrading from premium to more competitively priced brands, as a result of which producers have not been able to pass on the additional costs arising from input prices and marketing and distribution expenditure. Although the industry remains profitable, margin pressure is likely to persist in the medium term. For GCR to increase its sector risk score there would need to be a meaningful improvement in consumer health, translating into higher volumes across all product categories.

Healthcare, Sector Risk Score 7.5

GCR's sector risk score for Healthcare is reflective of the low cyclicality of the industry , as well as the stability offered by high barriers to entry, given the substantial capital and expertise required to open new facilities. This, position is, however, somewhat offset by high regulatory risk. In particular, the ongoing investigations into the competitiveness of the industry, and the uncertainty arising from the proposed National Health Insurance have negatively impacted GCR's industry assessment.

GCR considers the oligopolistic structure of the healthcare industry to be supportive of relatively stable margins and continued profitability, notwithstanding the relatively weaker earnings that have been reported by major industry players over the past 12 months. Earnings progression in the sector is likely to remain constrained by the environment of low economic growth and high unemployment, which has curtailed medical aid membership growth and self-pay procedures, as well as the potential of increased regulatory scrutiny in respect of pricing.

Logistics, Sector Risk Score 5.

GCR is of the view that logistic sector presents above average cyclicality and very low barriers to entry. Given the intense competition, the industry generally operates on very thin margins, but growth prospects appear positive as many entities move to outsource their logistics functions to optimise costs, as supply chain management increases in complexity.

Primary Manufacturing, Sector Risk Score 4.

GCR's sector risk score for Primary manufacturing weighs the high cyclicality of the industry against the stability offered by fairly high barriers to entry and relatively low vulnerability to technology disruptions, given the substantial capital investment required in manufacturing plants and significant scientific knowledge required to operate effectively. This, position is, however, somewhat offset by high regulatory and environmental risks, as well as the high susceptibility to labour disruptions.

GCR is of the view that the current challenges, such as subdued domestic demand, pressure on global growth, higher electricity tariffs and rising fuel prices, will continue to constrain the ability of South African manufacturers to drive sustained revenue growth. The opportunities for further efficiency improvements, which have supported earnings growth are also likely to lessen, although the strong efficiencies already implemented should continue to support stable earnings and cash flows. Only once corporates begin to see predictability in volumes and free cash flows that are supportive of expansionary spend does GCR expect to see a sustained uplift to the sector.

Secondary Manufacturing, Sector Risk Score 4

GCR's sector risk score for Secondary manufacturing reflects the industry's above average cyclicality and high susceptibility to technology disruptions. Moreover, the industry is impacted by regulatory and environmental concerns, as well as ongoing labour pressures. Most significantly, industry profitability has been impaired by rising costs (particularly electricity and wages), which have exacerbated the pricing pressures already faced through import substitution. Thus, many secondary manufacturers have ceased operation in recent years, while most of those that continue exhibit weak earnings. The recent election of a new National Government, with its stated its intention to promote job creation by establishing a more conducive environment for manufacturing activity, is positively considered. Nevertheless, GCR would expect to see measurable progress in creating a more supportive regulatory and political environment, before this can be considered in support of raising the manufacturing sector risk score.

Mining, Sector Risk Score 4

GCR's sector risk score for Mining weighs the high cyclicality of the industry against high barriers to entry, low risk of substitution and slow adoption of technological changes domestically. At present, the South African mining industry remains under strain due to electricity price increases, labour tensions and regulatory and political interference. However, the closure of non-profitable operations and, more recently, firmer commodity prices has seen the industry recover from its lows. Nevertheless, GCR considers the resolution of substantive political and labour uncertainties, combined with ongoing global growth, crucial to sustaining industry profitability and an uptick in the risk score.

Property, Sector Risk Score 7

GCR considers the property sector to evidence moderate risk characteristics, underpinned by below average cyclicality, the presence of fixed assets that generate stable annuity income, and generally strong access to capital. Notwithstanding some of the inherent advantages described above, the South African REIT space has entered a subdued phase, reflected in restrained distribution growth and in instances, YoY contractions. This comes after years of steady distribution growth, which was supported by strong acquisitive activity and relatively resilient escalations across a number of property segments.

Softening industry performance metrics is in turn a factor of protracted weakness in the domestic economy, which has filtered through to the real estate space to varying degrees across the different property sectors. Vacancies remain under pressure despite observed improvements in certain sectors (office and industrial in particular), while segments of even the most defensive sectors have begun to reflect a negative creep. These pressures, arising from restrained demand amidst the continued (albeit slower) rollout of new properties, are expected to persist over the rating horizon. That said, REITs with strong funding structures are likely to benefit from opportunities to acquire well priced assets and ensure that their property portfolios retain leadership positions in their respective property classes and geographic nodes.

State Owned Companies, Sector Risk Score 7

The sector risk score for State Owned Companies ('SOC') is underpinned by their low cyclicality and very high barriers to entry. Specifically, most SOCs operate as implementing agencies for government policies and do not face competition, in many cases being the only entity allowed to provide such a service. This is marginally offset by labour risks, which arise as a result of the strength of public sector unions, as well as potential environmental concerns, given the fact that many operate in the infrastructure space. However, the sector risk score has been reduced due to the financial dysfunction affecting many of these companies, underpinned by very high levels of debt and persistent operating losses. Although, the Government of South Africa has, to date, provided financial support to these entities, the National Government's ability to support has been significantly diminished by its financial constraints.

Discretionary Retail, Sector Risk Score 5.5

Discretionary retail depicts above average cyclicality, as volumes are more susceptible to variability through the cycle, while the ability to make timely cost past-throughs are considerably diminished during periods of price deflation, heightened competitive pressures, or declining demand. All retailers benefit from low regulatory oversight and limited environmental considerations, albeit barriers to entry are low. That said, the potential to achieve effective supply chain management, relative cost flexibility and moderately low levels of disruption, together with high levels of consumerism amongst a largely urbanised population with access to credit enables the industry to reflect some stability and to achieve cross-cycle profitability despite the observed demise of some mid-top tier players. Looking ahead, GCR would only consider an uplift of the dynamics score in the event of a sustained improvement in consumer confidence, on the back of a substantive improvement in structural limitations such as rising unemployment and socio-economic uncertainty.

Non-discretionary Retail, Sector Risk Score 6.5

GCR is of the view that FMCG retailers continue to present below average/average cyclicality and relatively sound cash flows, on the back of largely non-discretionary, high repeat business volumes. While relatively low barriers to entry, limited regulatory oversight and low environmental risks increase the potential for competitive pressures to curtail margins, industry stability is supported by extensive supply chain infrastructure, including entrenched relationships with suppliers and relative cost flexibility (including the optimisation of space to mitigate rising all-in occupancy costs) which typically underpin the strong market positions achieved by a small number of top-tier players. GCR does expect improved consumer confidence to be important to further enhancing the dynamics score of the sector, albeit strong baseline volumes are deemed sufficient to continue to support profitability.

Figure 1: GCR South Africa Sector Risk Ranking