GCR Kenya Corporate Sector Risk Scores May 2021

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Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Corporate Entities, May 2020

The GCR Kenyan 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 Kenyan 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 Kenyan corporate rating universe. Additional sector risk scores will be introduced as necessary.

GCR will periodically publish updated "Kenyan Corporate Sector Risk Scores", which will supersede previous publications. This publication supersedes GCR's April 2020 publication and is available at:

https://gcrratings.com/risk-scores/.

Summary of changes since last review

The following risk scores have been updated since the last publication (April 2020)

- *Hospitality sector risk score reduced to 2.5, from 3.0 previously*
- *Property sector risk score reduced to 3.0, from 4.0 previously*
- *Manufacturing sector risk score reduced to 2.75, from 3.0 previously*
- *Non-discretionary Retail sector risk score reduced to 3.25, from 3.5 previously*
- *Construction sector risk score raised to 2.75, from 2.50 previously*

Kenyan Corporate Sector Risk Scores

Construction, Sector Risk Score 2.75 (previously 2.50)

GCR considers the Kenyan construction sector to evidence moderately high-risk characteristics. This is attributed to the highly cyclical nature of the sector spend, which is fundamentally dependent on strong economic performance, meaningful government spending and political stability. While there are only a limited number of domestic construction companies that can undertake large infrastructure projects, there is significant competition at the lower end of the market. More significantly, international companies continue to dominate the large infrastructure projects due to experience and funding arrangements negotiated at the intergovernmental level.

Counterbalancing these concerns somewhat is ongoing government support and potential growth of the industry that is implied by Kenya's long-term infrastructure and housing development plans. This was evidenced through 2020, as the construction sector posted positive growth in the first three quarters, with strong year-on-year growth of 16.2% in 3Q 2020[1]. Further reflecting the strong performance, cement sales rose by 20% through 2020, whilst the National Construction Authority approved 85 large projects, compared to 66 projects in 2019. Construction demand is being driven by counties and parastatals, although activity in the private sector also remains robust. Whilst upcoming elections in in 2022 may result in some delays, cross-cyclical industry profitability is expected to remain ahead of that generally evidenced in the region.

Hospitality, Sector Risk Score 2.50 (previously 3.0)

GCR considers the Kenyan hospitality sector to evidence moderately high-risk characteristics. This is because of the highly discretionary nature of industry spend, being dependent on strong economic performance and consumer confidence in key source markets, which gives rise to above average cyclicality. In addition, the industry is susceptible to exogenous shocks ranging from terrorism, political instability, and disease. Barriers to entry are fairly low and the potential for earnings has attracted a major increase in new hotels and venues in recent years, increasing competition in the industry. Offsetting these concerns is the significant support provided to the industry by the Kenyan government, given the hospitality sector’s critical contribution to economic growth and job creation.

COVID-19 continues to severely disrupt the hospitality industry. International arrivals to Kenya fell by 72% in 2020 and hotel occupancy collapsed by 90%, resulting in many hotels been mothballed. The accommodation and restaurant sector saw its GDP contribution plunge by 83% in 2Q 2020 and by 57.9% in Q3. In total, the hospitality industry estimates that it lost around KES150bn (USD1.4bln) in revenue during 2020. Looking ahead, the industry is likely to remain under severe strain through 2021 because key source markets in Europe have restricted direct travel to Kenya. Tourist volumes are thus only likely to recover once there is a high vaccination rate in the country and concerns regarding COVID-19 dissipate. While there are initiatives to encourage domestic tourism, this cannot substitute for the much higher value foreign tourists. Moreover, the intermittent lockdowns, also adds uncertainty to the domestic segment, having resulted in

[1] Quarterly Gross Domestic Product Report, Third Quarter 2020 (27 January 2021)

sudden cancellations and refunds. The negative impact will continue to be felt broadly amongst the hotel industry, airlines, safari operators, tourist attractions and restaurants.

Manufacturing, Sector Risk Score 2.75 (previously 3.0)

GCR's sector risk score for Kenyan manufacturing reflects the industry's above average cyclicality and high susceptibility to technology disruptions. The manufacture of consumer goods continues to face significant pressure from imported products, with many businesses having been forced to close in recent years. However, domestic manufacturing has been supported by agro-processing, which benefits from *its* close proximity to Kenya's large agricultural sector. Nevertheless, industry margins remain under some pressure due to the weaker consumer environment in Kenya and the problems experienced by some of the large retailers, which provide a key gateway to the market for many manufactured products.

During 2020 there was a shift in manufacturing performance. The best performing manufacturing segments were for primary products such as cement, iron sheets and thinners. In contrast weaker performance from food segments led to a contraction in overall manufacturing output in Q2 and Q3 2020. The easing of lockdown restrictions should lead to a rebound in food segments, although softer demand is likely to constrain overall growth.

Property, Sector Risk Score 3.0 (previously 4.0)

The Kenyan property sector experienced rapid growth over much of the past twenty years, supported by an influx of multinational corporates using Kenya as the gateway into the broader East African market, a growing middle class and expatriate population. However, the sector was already in the midst of a slowdown prior to the COVID-19 pandemic due to an oversupply of retail, office and upper-end residential space, coupled with the constrained supply of credit to the private sector. This was reflected in the declining growth rates in both property prices and rental escalations in recent years, as well as pressure on vacancies. *Nevertheless,* the presence of fixed assets that can generate stable annuity income *does mitigate risk factors somewhat.*

The COVID-19 disruptions significantly exacerbated the weaker trends. In particular, overall vacancies in the office sect rose to around 28% in 2H 2020[2], with negative growth in average rental rates, due to the shift towards work-from-home and companies downscaling. Retail vacancies were reported between 20%-30% as several retailers withdrew from the Kenyan market and others were forced to scale back operations. Conversely, the industrial sector is performing robustly due to the development of high-quality logistics properties. Notwithstanding expectations for renewed economic growth, GCR expects the property sector to remain subdued over the short to medium term, given the lingering oversupply in key sectors, combined with the significant disruptions to traditional property fundamentals occasioned by work-from-home and digital channels. A significant reduction in approvals for new commercial developments since 2H 2020 should help alleviate the oversupply over the medium term.

[2] Knight Frank Kenya Market Update H2 2020

Property Development, Sector Risk Score 1.5 (previously 1.5)

The property development industry is highly cyclical, typified by numerous new projects during times of economic expansion, but the potential for sharp reductions in demand due to even small changes in the economic environment. While high industry regulation materialises in the need to obtain project approvals from various regulatory entities, barriers to entry are low for players with sufficient capital. Kenyan developers carry much more funding risk due to the reticence from the banking industry to take on construction-related risk. This also impacts demand side dynamics, with the take up of residential projects in the low to middle income brackets curtailed by a limited mortgage market.

GCR has considered that developers partially counteract some of these weaknesses by building on internal expertise to garner annuity income from development and other fees, rigorously crafted agreements with development contractors, securing funding from international investors and development agencies, and by entering into joint arrangements with landowners. Nonetheless, overall earnings' stability remains predicated on regular unit uptake and timely completion of projects, with the pace of the former mostly reliant on a sustained improvement in broader per capita wealth levels.

The economic disruptions caused by COVID-19 has had a dampening impact on property development in Kenya, as evidenced by the lower tax income from property sales reported by the National Government. Nevertheless, development activity has continued and there remains pockets of strength. The success of projects has depended to a large extent on their target market. Lifestyle developments, incorporating a live, work, and entertainment offering have become even more attractive to buyers because of remote working. The lower end affordable market remains strong, but in the mid to upper end market a number of projects have been delayed because of the oversupply coming to the market. Given the fluidity of demand, GCR retains its cautious view on the property development industry, which is likely to remain under pressure until economic conditions return to normal.

Non-Discretionary Retail, Sector Risk Score 3.25 (previously 3.50)

Discretionary Retail, Sector Risk Score 2.75 (previously 2.75)

Retailers benefit from low regulatory oversight and limited environmental considerations, albeit that the relatively low barriers to entry, limited regulatory oversight and low environmental risks have resulted in a highly fragmented market, including many small players in the informal sector. That said, the potential to achieve effective supply chain management, relative cost flexibility and moderately low levels of disruption enables the industry to reflect some stability and to achieve cross-cycle profitability.

Within the broader sector, non-discretionary retailers continue to present below average cyclicality and relatively sound cash flows, on the back of largely non-discretionary, high repeat business volumes. Cyclicality is however, greater for non-discretionary retailers as volumes are more susceptible to economic conditions, while the ability to pass through costs is considerably diminished during periods of declining demand or heightened competitive pressure.

Significant competitive pressures have been experienced over the past 24 months as consumer spending lagged expectations, resulting in the failure of several large retail chains and a number of foreign chains exiting the market. COVID-19 further has weakened the retail environment, with negative growth in retail sales during 2020. However, some vacant space has been occupied by emerging local retailers seeking to capitalise on the long-term growth prospects in Kenya, underpinned by a young, urban demographic and steady economic growth.

Security, Sector Risk Score 3.50 (previously 3.50)

Private security depicts below average cyclicality, as the rise of terrorist and other threats in recent years has increasingly made private security an important consideration for business premises and wealthy private homes. Low barriers to entry have resulted in a highly fragmented market, with an estimated 3,000 security companies and 400,000 private security guards, including many small or unregistered players, but this may change going forward as the Kenyan government has established a body to oversee regulation in the industry. Improved enforcement of minimum job protection and service standards should support the large players in the industry who already comply, as industry margins have increasingly been squeezed by the myriad of non-compliant players in the industry, which have been able to undercut pricing. Larger players also have access to high-tech security solutions that provide relative cost flexibility and margin resilience.

COVID-19 did result in an overall decline in the demand for security services, as shuttered sites did not require as many guards and events were cancelled. Nevertheless, GCR expects demand for private security to remain steady, on the back of persistent risks related to crime and terrorism, as well as the need to secure the growing number of infrastructure projects.

Figure 1: GCR Kenya Corporate Sector Risk Ranking