GCR South Africa Corporate Sector Risk Scores
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GCR’s Country Risk Score Report, December 2021
GCR’s South Africa Corporate Sector Risk Score Report, April 2021

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 entity 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.

Summary of changes since last review

There have been no changes to the corporate sector risk scores in the current review. However, the paragraphs below summarise GCR’s updated views on the prospects for each sector.

South Africa, along with most of the world, underwent a significant shock over the past two years due to the COVID-19 pandemic, with GDP contracting by 6.4% in 2020. The pandemic had an immediate impact on all sectors of the economy, which necessitated GCR reducing its sector risk scores in June 2020. However, despite the economy remaining weak through 2021, corporate South Africa has been resilient. Leading corporates across the economy were quick to implement efficiency measures and to restructure operations to meet the new business environment. As such, towards the end of 2020 corporate earnings largely stabilised, and despite further waves of lockdowns through 2021, the corrective action taken has
seen corporate financial health improve further in 2021. Looking ahead there are significant headwinds for the business environment into 2022. Fuel prices are reaching multi-year highs due to geo-political tensions, electricity supply remains uncertain, and inflationary pressures are rising across the globe leading to a tightening in monetary policy. Nevertheless, as is detailed below, GCR expects most sectors of the South African economy to expand in 2022, supported by high commodity prices, which will benefit the domestic primary industries, as well as manufacturing and related service industries. Corporates in these sectors are also likely to find new opportunities in the local economy, as businesses pull back from riskier international operations and supply chains.

South African Corporate Sector Risk Scores

**Agriculture, Sector Risk Score 4.5 (previously 4.5)**

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.

South Africa’s agricultural sector enjoyed a second year of strong performance in 2021, supported by favourable weather patterns and higher commodity prices. Agriculture’s GDP grew by 3.3% for the nine months to September 2021. The combination of improved production and high prices led to record agricultural exports of USD12.4bn in 2021, with key exports being maize, citrus, fruit, grapes, wine, and nuts. Export sales were facilitated by improved coordination between producers, transporters and the ports, albeit bottlenecks still remain. Looking ahead, the excessive rains which have been experienced over much of South Africa during the summer months may result in a slight reduction in acres planted and potentially yields per acre. In addition, steep cost inflation remains a key risk to sector profitability, with the cost of fertiliser having climbed by 50% over the past year, and other inflationary pressures in terms of fuel, electricity, and wages. Nevertheless, actual production is likely to remain above the long-term average, which combined with strong international demand, should result in a robust financial performance from the sector in 2022.

**Construction and Engineering, Sector Risk Score 1.0 (previously 1.0)**

GCR’s sector risk score for the construction and engineering industry reflects the high cyclical against low risk of substitution. Most significantly, industry risk is underpinned by the complex nature of work undertaken and relatively low margins that can be extracted. Thus, construction companies face the ongoing threat of delays and cost overruns, which can result in loss making contracts and substantial cash outflows. A gradual adoption of digital transformation is expected to increase operating efficiencies, thereby improving profit margins. Safety and environmental factors are also ongoing concerns which can lead to large, unexpected liabilities and damage the contractor’s reputation.
The South Africa construction industry had been depressed for several years prior to COVID-19. In particular, public sector infrastructure projects fell well short of expectations, whilst challenges in the mining sector negated any demand for new projects. The onset of the COVID-19 pandemic further impacted the industry, with the value of construction plans passed decreasing by 37% in 2020. This impacted activity into 2021, with construction output remaining around 20% below pre-COVID-19 levels. However, some signs of recovery have begun to emerge. A recent 2022 construction survey reported that 68% of respondents expected an increase in project revenue in 2022, with many expecting double digit growth to be driven by digital transformation and the implementation of new building technologies. Moreover, the Afrimat SA Construction Index rose in the second and third quarters of 2021, supported by a higher number of projects completed (making up for the delays caused by the lockdowns), and strong sales of hardware and building materials. Nevertheless, the lack of a firm order book remains a major concern for the industry. The 2022 national budget set aside R812.5bn for infrastructure projects over the next three years, which should significantly boost the industry. However, the lack of implementation remains a key risk due to fiscal weakness and capacity constraints.

Education, Sector Risk Score 7.0 (previously 7.0)

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 has access to funding due to the important social role its education plays in communities. Nevertheless, these factors are counterbalanced by intermediate barriers to entry as a result of which new competitors, both local and international, continue to enter the market. Whilst the risk of technological disruption is considered moderate, investment in ICT platforms to enhance the learning experience and prepare students for the digital world is increasingly important. ICT adoption, including shared and distance learning platforms, are also critical to fully benefit from the economies of scale available and to provide a cost-effective product.

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. Affordability concerns have materialised through the COVID-19 pandemic, with private education providers reporting a meaningful increase in debtors and some attrition in student numbers. Nevertheless, student enrolments in private schools remain resilient and there appears to renewed growth into 2022.

Fast Moving Consumer Goods (‘FMCG’), Sector Risk Score 5.5 (previously 5.5)

The FMCG sector score is reflective of the stable profitability of the leading players in the South African industry. This is moderated by low barriers to entry and high susceptibility to product disruption, which has seen competition in the industry intensify. Regulatory risks have also gained increased attention as there have been several instances of tainted products slipping into the market. Accordingly, companies have
had to absorb the costs of product recalls, whilst placing renewed focus on supply chains and manufacturing processes.

FMCG sector resilience was evidenced through the COVID-19 disruptions, with positive real growth reported in food and beverage manufacturing, albeit at a relatively moderate level. However, rising producer inflation remains a key risk going forward, due to higher commodity prices, as well as costs associated with fuel, electricity and wages. Wage disputes have in turn led to deteriorating labour relations, which have resulted in a number of protracted strikes that have also disrupted operations. On the other hand, consumer disposable income remains weak, reducing demand for many products and thus producers have limited pricing power. Accordingly, GCR does foresee narrower gross margins in the sector, which will likely be compensated for by even greater focus on product rationalisation and cost efficiencies.

**Gaming, Sector Risk Score 4.5 (previously 4.5)**

Gaming presents above average cyclicality globally, but in most jurisdictions the industry is insulated by considerable regulatory rigour, which translates to high entry barriers. As such, disruption and competition tend to have a much more measured effect than other hospitality and leisure formats. Nevertheless, the industry remains susceptible to illegal gambling, as well as evolving environmental, social and governance factors that could curtail footfalls and, to an extent, investment in the sector in the medium-term. That said, the South African gaming environment presents relatively strong baseline margins and is expected to show better earnings resilience through economic downturns than international destination markets due to its geographic insulation.

The significant disruption cause by COVID-19 to the gaming industry appears to be easing. Operators are benefitting from eased lockdown levels, which appears to have bolstered footfalls through the December 2021 festive season. Moreover, much of the surrounding entertainment offerings are also returning to normal, with restaurants and bars annual growth in excess of 30% in 4Q 2021. Although, gaming operations remain constrained by capacity limitations and other restrictions, patron numbers have been increasing month on month.

Whilst the restrictions on numbers, and some remaining hesitancy from certain segments of the population will continue to weigh on top line growth, gaming profitability and cash flows are likely to evidence meaningful growth in 2022. This, as operators reap the benefits of the efficiency improvements over the past two years, which have substantially reduced the operating cost base. While some variable expenditure will return as business volumes increase, much of the cost savings will be maintained. In addition, improved cash flows should ease the debt service pressures that have been evidenced, and allow operators to refinance existing facilities. Accordingly, GCR no longer views the sector negatively, but remains highly cautious due to the potential for disruption caused by further COVID-19 outbreaks.

**Healthcare, Sector Risk Score 6.5 (previously 6.5)**

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. The outcome of the healthcare enquiry in 2020 has not had a material impact on the industry, but levels of scrutiny remain high. Similarly, plans for a National Health Insurance system remain on the table, but as affordability remains a constraint, little progress has been made in this regard. Thus, GCR does not expect major changes to the healthcare industry in the short to medium term. The more systematic challenge remains the unaffordability of private healthcare, as a result of which medical scheme membership has been stagnant of over the past few years. While COVID-19 highlighted the importance of high-quality healthcare, the loss of formal sector jobs and income saw medical scheme membership decrease in 2020.

The underperformance of the South African private healthcare sector during 2020 was a direct result of the pandemic, due to the suspension of all elective surgeries coupled with generally lower admission levels and the higher costs associated with additional protective measures. As healthcare providers have learned to manage their facilities more efficiently through each of the subsequent waves of the pandemic, industry performance improved during the latter part of 2021, albeit those earnings have still not yet recovered to pre-COVID-19 levels. GCR expects such recovery to be gradual over the short term, with a return to pre-COVID-19 levels only anticipated over the medium-term. Notwithstanding this, GCR projects an improved financial performance during 2022 characterised by stronger earnings, more stable debt levels, and thus a corresponding improvement in credit protection metrics.

General Hospitality, Sector Risk Score 4.0 (previously 4.0)

The hospitality sector presents above average cyclicality, with international trends reflecting overall vulnerability to shifts in local, regional, and global macroeconomic trends. This is largely due to the discretionary nature of spending on hotels and general leisure activities, which compete for disposable income with other forms of non-critical spend. Hotels and leisure sectors are especially susceptible to seasonality and exogenous shocks, as well as international tourism. The low entry barriers also point to higher competition, with susceptibility to substitution observed in certain pricing segments, and comparatively higher potential for disruption relative to other sectors.

The hospitality sector has been the most severely impacted by the onset of the global pandemic and is likely to be the slowest to recover in the face of ongoing disruptions. In this regard, travel and social distancing restrictions continue to negatively impact multiple pockets of the industry, such as hotels, tour operators, travel agents, tourist focussed attractions, as well as sporting and conferencing venues. Nevertheless, green shoots of a recovery phase have emerged through 2021 as pent-up travel demand continues to pick up as lockdown restrictions have eased and more international borders open. Whilst this should continue to support improved lodging occupancies, these remain well below pre-COVID-19 levels, and have largely been underpinned by domestic tourism, particularly last-minute bookings due to new waves and variants curtailing forward bookings. A return of the higher value international and business travel remains key to the sector’s recovery over the medium term, although the business segments are likely to be on a slower recovery path with some permanent loss as a result of the change to more flexible/virtual work conditions.
GCR continues to hold a negative outlook on the sector, as continued volatility in earnings is expected, although increased cost flexibility by hotel operators and with most assets trading should help ease losses.

**Information Communication Technology (“ICT”). Sector Risk Score 5.25 (previously 5.25)**

The ICT sector risk score reflects the industry’s below average cyclicality, but high susceptibility to technology disruptions and import substitution. Moreover, the industry is impacted by low barriers to entry, with markets being generally fragmented. That said, the nature of products could provide an effective entry barrier if specific to the customer and/or patented. The market is generally characterised by competitive price pressure and discretionary spending patterns, although the domestic growth outlook remains positive.

The ICT industry is emerging from the current pandemic stronger, as many of the technologies that have facilitated the ability to work from home, or to shop and interact remotely, have become entrenched in the business infrastructure and people’s lives. This should benefit players across the sector, from suppliers of technology hardware who are experiencing increased demand for upgraded products, to the large telecom providers who have seen usage of data services spike, as well as all the service providers who develop and maintain corporate networks. Robust demand has been borne out in strong recent earnings reports across the sector, with this likely to continue over the medium term.

**Logistics, Sector Risk Score 4.5 (previously 4.5)**

GCR is of the view that the Logistic sector presents above average cyclicality and very low barriers to entry. Given the intense competition, the industry generally operates on very thin margins, although operators in more specialised niche transport fields can command higher prices. Longer term trends appear positive as many entities move to outsource their logistics functions to optimise costs, as supply chain management increases in complexity.

The logistics industry was somewhat insulated from the COVID-19 disruption as many segments were deemed as essential services or support essential services. Accordingly, the recovery in the second half of 2021 was less pronounced, although industry revenues did evidence continued growth through the year. Specialised segments of the logistics industry have proved resilient throughout the disruptions, but general freight remains under pressure due to lower volumes. Similarly, while passenger transport has improved from the lows seen in 2020, it remains below pre-COVID-19 levels. Positively, the transport and warehousing industry reported a 30% increase in capital expenditure in 3Q 2021, signifying expectation of renewed economic activity. GCR thus expects improved prospects to be evident across the sector, but smaller players that do not benefit from long term contracts with large customers may continue to struggle.

**Primary Manufacturing, Sector Risk Score 3.5 (previously 3.5)**

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
South African manufacturing enjoyed a strong 2021 performance, with overall production increasing by 6.4%. Of this, the manufacturing of both metal products and machinery and wood and paper products increased by almost 10%. However, much of this was achieved off a low base and the actual index remains below the 2019 level. Growth has been supported by firmer commodity prices, which have raised the value of primary outputs, as well as increasing demand from the mining and agriculture sectors. Nevertheless, fundamental challenges such as a weak overall domestic economy, higher electricity tariffs and rising fuel prices remain significant constraints on the ability of domestic manufacturers to drive revenue growth. Looking ahead, current geo-political tensions and potential supply chain should bolster the attractiveness of locally produced primary products. Combined with the significant cost saving and efficiency improvements implemented across the primary industries in recent years, GCR expects leading market players to report continued strong earnings.

Secondary Manufacturing, Sector Risk Score 3.5 (previously 3.5)

GCR’s sector risk score for secondary manufacturing reflects the industry’s above average cyclicality and high susceptibility to technology disruptions. The industry is also impacted by regulatory and environmental concerns, as well as ongoing labour pressures. Most significantly, secondary manufacturing’s 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 many of those that continue exhibit weak margins.

Renewed interest in domestic manufacturing was evidenced in 2021, driving a robust performance from key production segments. Textiles, furniture, automotive and electrical machinery all reported overall growth through the year, and an improvement in capacity utilisation. The demand largely derives from local retailers, who have seen the product supply chains disrupted by COVID-19 and shipping challenges, giving preference to local manufacturers. The national government has also provided some incentives to this localisation. Although local producers have to overcome higher electricity prices and other input cost inflation to ensure their products remain price competitive, with logistical challenges and geo-political tensions likely to persist, the demand for quality products that are locally sourced is likely to remain robust, providing further opportunities for manufacturing expansion.

Mining, Sector Risk Score 4.0 (previously 4.0)

GCR’s sector risk score for mining weighs the high cyclicality of the industry against substantial barriers to entry and low risk of substitution. Being an extractive industry, the environmental impact of mining is inherently negative, but this is countered by less evasive mining techniques being employed by leading mining companies as well as the rehabilitation reserves that are required to be provided for. South African mining is also one of the largest investors in rural areas and contributes to the social upliftment of surrounding communities. The industry is highly susceptible to legislative and regulatory changes. In South Africa, ongoing disputes and disagreements over how to interpret key legislation have at times disrupted
operations, whilst persistent delays to regulatory approvals required have discouraged new investment in the sector.

This notwithstanding, the South African mining environment has been robust through 2H 2020 and 2021. Although mining production decreased by 11% in 2020, the lost production was recovered in 2021 with a similar 11.2% increase in production. The continued high prevailing prices across almost all of South Africa’s key commodity baskets saw the value of domestic mining output jump by 39.1% in 2021. The industry is also benefitting from the significant rationalisation and efficiency improvements implemented in previous years, as well as the adoption of new technologies to improve mining and refining techniques. Accordingly, most mining companies have reported record profits through 2021, and substantial cash generation, thus reducing balance sheet risk. Whilst some players have indicated that they are considering new projects, the feasibility of increasing production is negatively impacted by logistics constraints on South Africa’s rail network and at the ports. This has prevented bulk commodity miners (such as coal and iron ore) from raising production. In addition, factors such as unreliable energy supply and the propensity for labour disputes also negatively impact the investment case for new projects.

Whilst the industry is likely to remain highly profitable in 2022 due to favourable commodity prices, the long-term success of domestic mining is dependent on improving the legislative environment and developing the necessary fixed infrastructure.

Property, Sector Risk Score 6.0 (previously 6.0)

GCR considers the property sector to evidence moderate risk characteristics, supported by below average cyclicality, assets that generate strong income through the cycle, and sustained demand for well-positioned properties. Despite these inherent advantages, even prior to COVID-19 the industry was reporting weakness in key fundamentals, such as rising vacancies and lower rental reversions, placing pressure on asset valuations. In the listed property space, much lower share prices (well below reported NAV) due to depressed equity markets, as well as repricing on the debt capital market, led to a deterioration in access to capital. COVID-19 exacerbated many of these challenges, whilst also causing large shifts in fundamentals between different segments of the market.

Listed property funds appear to be broadly on a better footing. Collections across most segments have recovered to pre-COVID-19 levels, allowing REITs to resume dividend payments. Most importantly almost all players have indicated that they would not return to the unsustainable dividend pay-out ratios of 100% that were typical in previous years. Rather, up to 25% of the profits would be retained to fund internal operations and growth, than relying solely on debt funding. Funds with dual share structures are also implementing schemes to collapse the structures into a single equity class, and thereby resolve the distortions caused to the different equity holder interests that materialised during the downturn. Debt funders are also returning to the market, allowing property companies to refinance debt for longer periods, unlike the past two years where most funds could only manage to raise facilities with tenures of around 2 years.
Nevertheless, operating conditions in the property market remain difficult and fluid. The office sector remains under severe strain with vacancy rates of up to 35% in key business nodes. Whilst retail has recovered overall, there are still large pockets of weakness amongst certain large shopping centres in urban areas, whilst even in well-performing centres footfall remains below COVID-19 levels. Lower to mid-range residential property does evidence strong prospects, but there remains an oversupply of higher end units. Logistics and warehousing properties are expected to continue to outperform the market.

Although GCR expects to see firmer operating profits from property companies in 2022, this is coming off a low base. Moreover, performance is likely to be variable amongst the different players depending on what sectors and in which nodes they operate. The rising interest rate environment may also pose additional challenges in terms of asset valuations and transactions, particularly for those looking to dispose of assets required for deleveraging.

State Owned Companies, Sector Risk Score 6.0 (previously 6.0)

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. Most importantly, the score is constrained by the financial dysfunction affecting many of these companies, underpinned by very high levels of debt and persistent operating losses. This is compounded by the National Government’s weak fiscal position.

The outlook for SOC’s remains closely linked to the prevailing sentiments of the National Government. On the one hand, GCR’s view is that the assurance of financial support for SOCs from the South African Government has become much less consistent. This has been highlighted by the relatively restrained government support for the Land Bank, despite its importance to the South African economy, in contrast to South African Airways (SAA). General support was once again demonstrated in the 2022 Budget, where R308bn was set aside to support SOC, including those such as Denel that had defaulted on its obligations. However, little progress was made in reviewing the operating models for these entities to ensure that operations are sustainable. Accordingly, GCR’s expects that SOCs will be provided with sufficient funding to continue operating, especially in socially important sectors, but their financial positions will remain precarious. To ensure these entities become sustainable, legislative and operation clarity is needed with regard to their mandates.

Discretionary Retail, Sector Risk Score 4.5 (previously 4.5)

Discretionary retail depicts above average cyclicality, as volumes are more susceptible to variability through the cycle, while the ability to make timely cost pass-throughs are considerably diminished during periods of price deflation, heightened competitive pressures, or declining demand. Retailers generally benefit from low regulatory oversight and limited environmental considerations, albeit barriers to entry are also low. That said, 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.

The composition of discretionary sales have evolved through the COVID-19 pandemic. Initially there was a very strong (somewhat unexpected) growth in categories such as hardware, household furniture and appliances. However, such sales have cooled into 2021, with discretionary sales being driven more by clothing categories, particularly towards the end of 2021 as the restrictions on certain social interactions were eased. Looking ahead, industry volumes and profitability will again rely on levels of consumer discretionary income, which is likely to remain weak. Thus, while discretionary retailers have evidenced earnings strength through 2021, a slowdown in growth is anticipated for 2022, albeit with retailers remaining in a strong financial position.

Non-discretionary Retail, Sector Risk Score 6.0 (previously 6.0)

GCR is of the view that non-discretionary retailers continue to present below average/average cyclicality and relatively sound cash flows, on the back of largely non-discretionary, high repeat business volumes. Relatively low barriers to entry, limited regulatory oversight and low environmental risks increase the potential for competitive pressures to curtail margins, but industry stability is supported by extensive supply chain infrastructure, including entrenched relationships with suppliers and relative cost flexibility that typically underpins the strong market positions achieved by a small number of top-tier players.

As non-discretionary retailers have been able to trade through the COVID-19 pandemic, there has been less fluctuation in sales levels over the past two years. Aside for 2Q 2021, which corresponded to the hard lockdown in 2020, retail sales in the food and beverage categories have on average been flat. There was, however, very strong growth in pharmaceuticals, cosmetics and toiletries categories through 2H 2021, likely the result of an increase in social activity. Looking ahead, inflationary pressures are expected to be the key challenge for the industry, especially in the food categories. This as competition amongst the leading national retailers remains fierce and consumer spending power is still under strain. Nevertheless, most retailers have strong balance sheets, and while organic growth may prove challenging, sector earnings are likely to remain resilient.
Figure 1: GCR South Africa Sector Risk Ranking

The chart shows the risk ranking for various sectors in South Africa. The x-axis represents different sectors, while the y-axis indicates the risk score ranging from 0.0 to 8.0. The sectors are ranked from high to low risk, with Education and Healthcare being the highest risk sectors, and Construction being the lowest risk sector.
SOUTH AFRICA CORPORATE SECTOR RISK SCORES: UPDATED 07 MARCH 2022

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