

## Impact Of Business Cycles On Industry Sectors: A Structural Economic Change In Kenya

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### Abstract

*Industry groups, investment managers and professional investors notwithstanding: are conscious of differences among alternative industries and organize their analysis and portfolio decisions according to industry groups. Industry analysis is progress towards selecting specific firms and stocks for an investment portfolio. A macro analysis and utilization of a stock market decides whether the expected rate of return from investing in common stocks is equal to or greater than required rate of return. Hence, industrial groups should decide whether to overweight market weight or underweight stocks. Analysis to determine if the intrinsic value of an industry is equal to or greater than its market price is determined. Based on this relationship, it is decided to weight the industry in a stock portfolio. Discussions on results of several studies indicate the benefits and use of industry analysis. Approaches of valuing industries are used. Impact of competitive environment within industry, on potential industry return is considered. Conclusively, a discussion of global industry analysis is given, because many industries transcend Kenyan borders and compete worldwide. The findings are consistent with the trend of industry sectors in Kenya.*

### Keywords:

Industry, Analysis, Performance, Business Cycle, Rates, Returns

### 1.0 INTRODUCTION

Business cycles are in place often in industrialized democracies. These cycles are as well alive and well in the developing world, more so in the most vulnerable ones (Nouriel, 1997). Business cycles in Africa and Kenya in particular are undergoing political and economic reforms. This is evident from fiscal and monetary policy reforms. Efforts to restore industrial sectors concentrate mainly on macro-economic reforms geared towards taming inflation, reduction of unsustainable budget and liberalizing foreign exchange reforms and capital markets (Block, 1999).

## 2.0 FOCUS OF THE STUDY

### 2.1 Business Cycles and their impact on Industry Sectors

Economic trends can affect industry performance. By identifying and monitoring key assumptions. An economy is monitored and gauged through economic outlook and industry analysis. Economic trends take two basic forms. One, cyclical changes that arise from the ups and downs of the business operations and two, structural changes that occur when the economy is undergoing a major change in how it functions. When excess labor and capital exist in some sectors; shortages of labor and capital exist elsewhere. When countries go through transitions for example from socialist to market economies, and from a manufacturing to a service economy; all these show dramatic structural changes. Industry analysis must examine structural economic changes for the implications they hold for the industry. Industry performance is related to the stage of the business cycle. Industry analysis is challenging in that every business cycle is different and that determine future market performance trends (Reilly & Brown 2007).

Rotation strategy takes place when switching from one industry group to another over the course of a business cycle. Investors need to identify variables related to economic trends and industry characteristics. During recession, financial stocks rise in value. Investors anticipate that banks' earnings will rise as both the economy and loan demand recover. Stock brokerages become attractive investments because their sales and earnings are expected to rise: one, investor's trade securities, two, and businesses sell debt and equity, three; there is an increase in mergers during the economic recovery. Industry selections assume that when the recession ends there will be an increase in loan demand, housing construction, and security offerings.

During recovery, consumables from firms which produce expensive consumer items become attractive investments because a reviving economy will increase consumer confidence and personal income. Businesses begin modernizing, renovating, and purchasing new equipment to satisfy rising demand hence reducing costs. Capital goods industries become attractive. Cyclical industries whose sales rise and fall along with general economic activity are attractive investments during the early stages of an economic recovery which is attributed to high degree of operating leverage. There is benefit from sales increases during an economic expansion. Industries with high financial leverages likewise benefit from rising sales volume.

When the economy is at the peak, the rate of inflation increases as demands starts to outstrip supply. Basic materials industries which transform raw materials into finished products become investor favourites. However inflation has little influence on the cost of extracting these products and they can increase prices. These industries experience in the long run higher profit margins. Further during recession, some industries do better than others. For example consumer, pharmaceuticals, food, and beverages, outperform other sectors during this period. If a weak domestic economy causes a weak currency, industries with large export components to growing economies may benefit because their goods become more cost competitive internationally. Certain industries make attractive investments over the course of the business cycle. Investors are advised not invest based upon the current economic environment which is situational because the efficient market has already incorporated current economic news into security prices. Rise investment is called for.

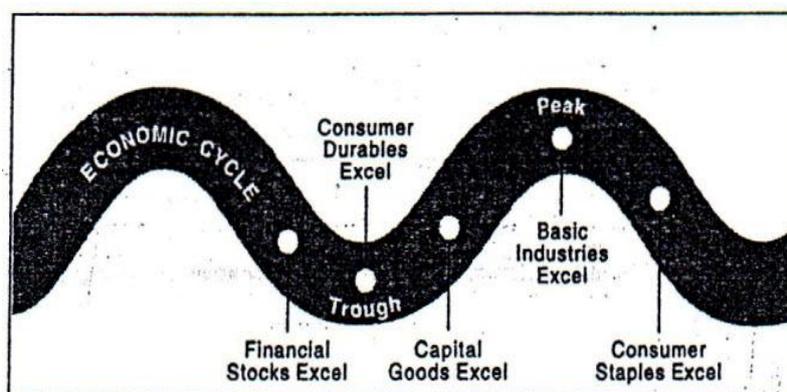
Higher inflation is negative for the stock market. It causes higher market interest rates. It increases uncertainty about future prices and costs. It impedes firms that cannot pass through

their costs increase. Some industries benefit from inflation. For example, natural resource industries benefit if their production costs do not rise with inflation. Their output will likely sell at higher prices. Financial institutions, including commercial banks, are affected by higher rates because they find it difficult to pass on these higher rates to customers. High interest rates hamper the housing and the construction industries. Further, high interest rates benefit retirees whose income is dependent on interest income.

Both domestic and overseas events may cause the value of the Kenyan Shilling to fluctuate. A weaker Kenyan shilling helps Kenyan industries because their exports become comparatively cheaper in overseas markets while the goods of foreign competitors become more expensive in Kenya. A stronger Kenyan Shilling has an opposite effect. Economic growth in world regions or specific countries benefits industries that have a large presence in those areas. The creation of free trade zones, such as the East African Common Market Protocol and the ECOWAS, assist industries that produce goods and services that previously faced quotas or tariffs in partner countries. Consumption spending has a large impact on the economy. Optimistic consumers are more willing to spend and borrow money for expensive goods, such as houses, cars, new clothes and furniture. Therefore, the performance of consumer cyclical industries will be affected by changes in consumer sentiment and by consumers' willingness and ability to borrow and spend money (Figure 1).

Figure 1 exhibits the trend business cycles as exemplified clearly in the stock market.

**Fig 1: The Stock Market and the Business Cycle**



Source: Susan E. Kuhn, "Stocks are Still Your Best Buy", *Fortune*, 21 March 1994, 140.

### 3.0 THEORETICAL FRAMEWORK

#### 3.1 Industrial Cycle Model

This study is established on the basis of 'Industrial Cycle Model' characterized on how the stock market reveals how business cycles emerge due to the economic mood swings.

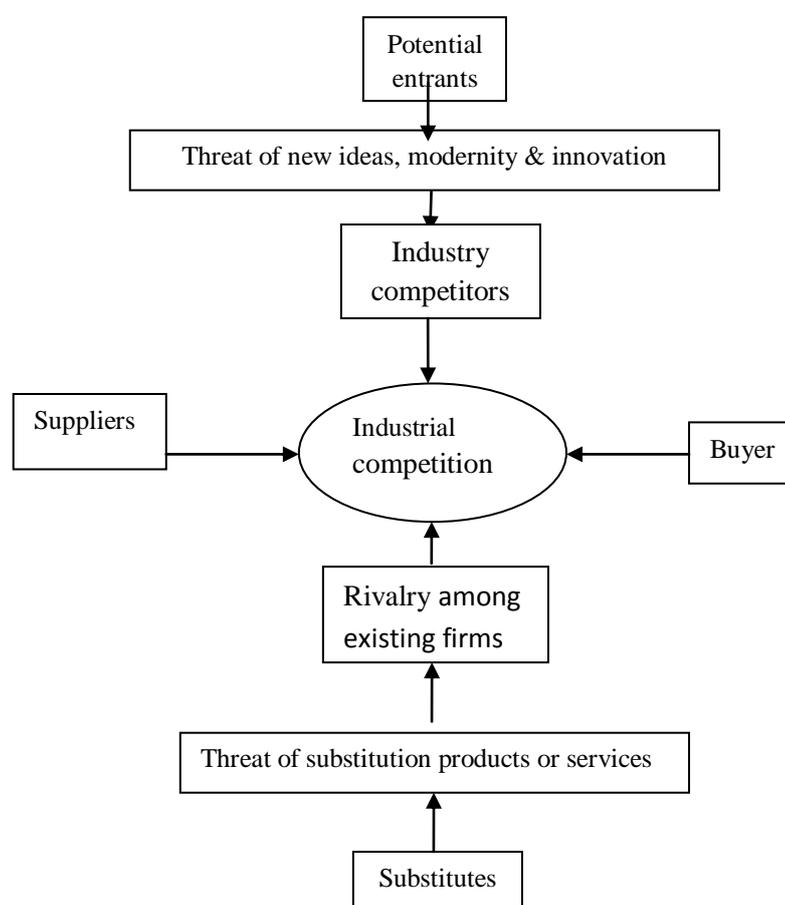
According to Nest and Mangematin (2004), the Industrial Life Cycle model which exhibits two phases: First, radical and rapid technical change. New technologies may destroy the traditional barriers to entry, representing a threat to incumbents using the old set of technologies and secondly, technological consolidation and stabilization around a dominant design. New firms may be created on the basis of their differentiated knowledge for testing, refining and exploiting such activities. These entrants eventually grow and gain access to preferable positions on new market segments.

New technologies pass through distinct stages of birth, growth, maturity and decline. One introduced in the market, the new product accompanied by entry of new firms seeking to exploit the market niche, followed by growth in demand. This growth trajectory is characterized by turbulence, as declines in demand are succeeded by the leveling off in demand as the market becomes saturated. Market entry is easy when the new technology is introduced. At this stage it is faster, cheaper, more powerful technology is experienced. As firms move towards maturity, they experience relatively stable growth and it is much easier to survive since the available economies of scale have been exhausted and competition has fallen. Marketing concerns dominate technology concerns. However, at maturity stage, where technology is a commodity, user experience and marketing dominate. Younger firms have a higher probability of failure than older ones. Further, younger firms may have higher growth rates than older firms (Hallberg, 1999).

(Aduda and Kaane, 1999) opine that, this model is clearly applicable to Kenya. From a policy perspective, the life cycle theory points to the need for systematic planning for the replacement of technology as it evolves through birth, nurturing, consumption and obsolescence. Similarly, it therefore can be used to explain why some local firms have transited from small local firms into medium and large growth-oriented concerns. However, the theory may be limited in explaining why the majority of subsistence/survivalist enterprises have stagnated and failed to grow.

#### 4.0 CONCEPTUAL FRAMEWORK

Fig. 2. Industrial Competition



Source: Own conceptualization

The above conceptual framework guides investors to analyse competitive forces among industries in order for them to understand their returns. Each of these factors guide investors determine a competitive environment .For industry structures change with time. Each factor determines profit potential in a given industry.

## **5.0 RESEARCH METHODOLOGY**

This research focuses on the impact of business cycles on industry sectors a structural economic change in Kenya. This study covers Kenya's sectors in various industries. Kenya has a special place in East, Central and Africa at large. The study adopts descriptive research design which is suitable for document analysis.

## **6.0 DISCUSSIONS AND RESULTS**

### **6.1 Structural Economic Changes and Alternative Industries**

Influences other than the economy are part of the environment. Demographics, changes in technology, and political and regulatory environments also can have a significant effect on the cash flow and risk prospects of different industries.

#### **6.1.1 Demographics**

The study of demographics includes much more than population growths and age distributions. Demographics also include the geographical distribution of people, the changing ethnic mix in a society, and changes in income distribution. Demographic trends attempt to project their effect on different industries and firms. The changing age profile of people has implications for resource availability, a possible shortage of entry-level workers leading to an increase in labor costs and difficulty in finding qualified persons to replace the retiring ones. The aging population also affects saving patterns in the economy, as people in the 40 to 60 age bracket usually save more than young people. This is good for the financial services industry, which offers assistance to those who want to invest their savings. Alternatively, fewer younger workers and more 'saving seniors' may have a negative impact on some industries such as the retailing industry. (Reilly & Brown, 2007)

The changing population and labor force have important impacts both on private investment through changes in the expected marginal product of capital as well as on consumption and saving decisions. The increase in the labor force in developing countries raises the marginal product of capital and stimulates higher investment, with the investment to GDP ratio 4 percent higher by 2025 .(Bating et. Al, 2006)

#### **6.1.2 Consumer Behaviours**

Consumer behaviours are about Lifestyles on how people live, work, and form households, consume, enjoy leisure and educate them. Consumer behaviour is affected by trends and fads. The rise and fall of styles in clothes illustrate the sensitivity of some markets to changes in consumer tastes. The increase in divorce rates, dual-career families, population shifts away from cities, and computer-based education and entertainment have influenced numerous industries, including housing, restaurants, automobiles, convenience and catalogue shopping, services, and home entertainment. There is a perception in style that foreign goods have higher quality than those produced locally. Sales in several industries have benefited from this exercise of consumer choice overseas.

According to Sessional paper,(2012) Kenya's high level of informality in Kenya's wholesale and retail sectors which has the potential to result in several kinds of market distortions, that tilt the economy from its growth especially in taxation, labour employment and produce marketing. This Informality leads to lower tax revenues to Government from a sector that uses public services and facilities. Albeit the informal sector is the source of livelihood for many people who cannot access the formal employment market, the sector, when unregulated, it comes with other social and environmental costs, such as environmental degradation, non-enforcement of health standards and infringement of copyright laws (e.g. in music and film industries). All these costs are bound to have a negative impact on Kenya's local and international competitiveness, which is a major goal of Vision 2030.

### **6.1.3 Information and Communications Technology**

Trends in technology can affect numerous industry factors including the product or service and how it is produced and delivered. There are literally dozens of examples of changes that have taken or are taking place due to technological innovations. Changes in technology have spurred capital spending in technological equipment as a way for firms to gain competitive advantages. The future effect of the internet is phenomenal. The retailing industry is a user of new technology. Some forecasters envision relationship merchandising, in which customer databases will allow closer links between retail stores and customer needs. Rather than doing market research to focus on aggregate consumer trends, specialized retailers can offer products that particular consumer segments desire in preferred locations.

Reilly and Brown (2007), continue to argue that technology may allow retailers to become more organizationally decentralized and geographically diversified. Major retailers use bar-code scanning, which speeds the checkout process and allow the firm to track inventory and consumer preferences. Use of customer credit cards allow firms to track customer purchases and send customized sales announcements. Electronic funds transfer allows retailers to move funds quickly and easily between local banks and headquarters.

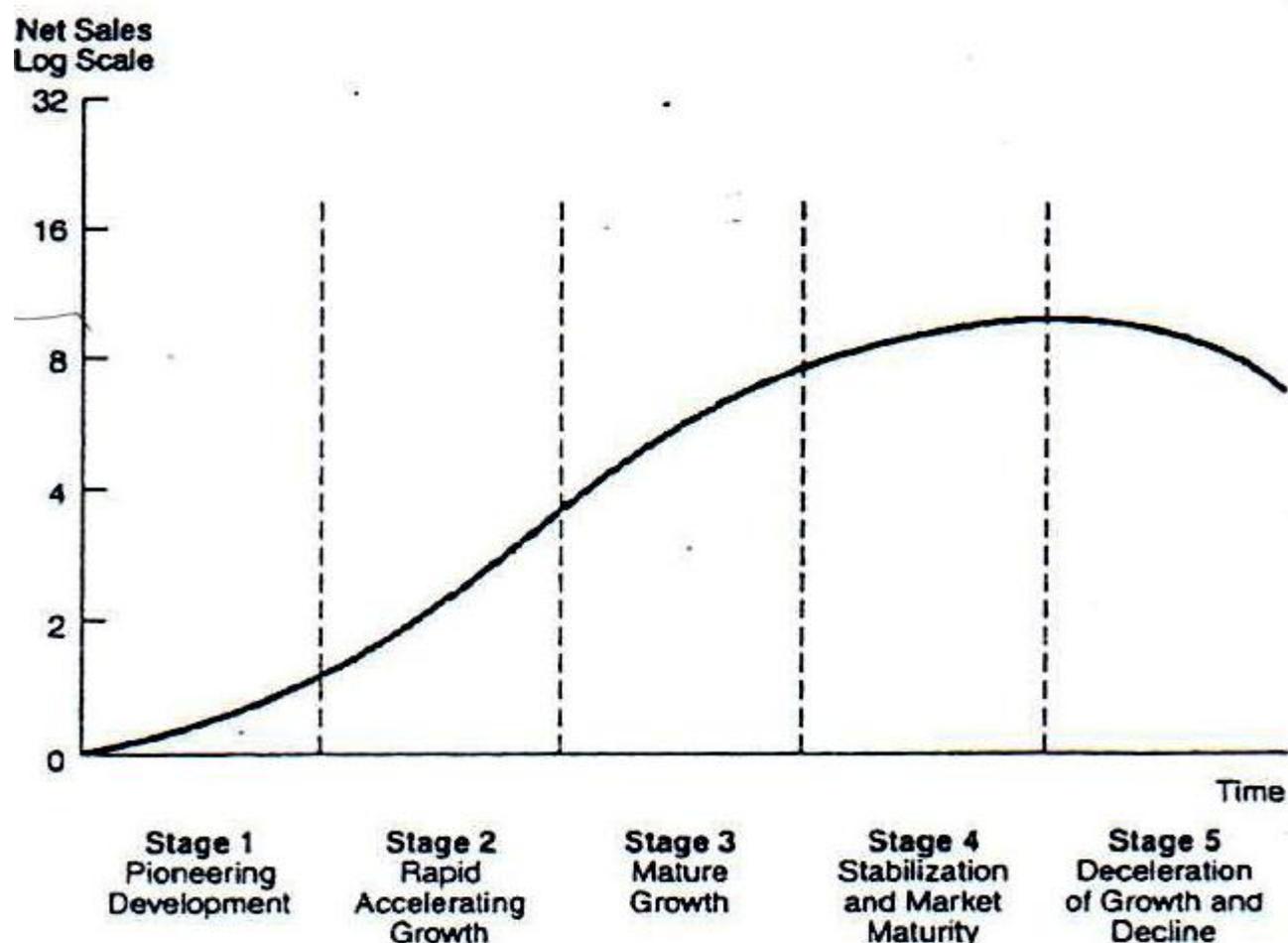
### **6.1.4 Politics and Regulations**

Because political change reflects social values, today's social trend may be tomorrow's law regulation, or tax. The industry analyst needs to project and assess political changes relevant to the industry under study. Some regulation and laws are based on economic reasoning. Due utilities' position as natural monopolies, their rates must be reviewed and approved by a regulatory body. Some regulation involves social ends. Regulatory changes have affected numerous industries. Changing regulations and technology bring participants in the financial service industry –banking, insurance, investment banking and investment services-together.

### **6.2 Industrial Life Cycle Analysis**

When predicting industry sales in profitability is to view the industry over time and divide its development into stages similar to those that human progress through birth adolescence, adulthood middle age, and old age. A five-stage model would include: Pioneering development, Rapid accelerating growth, mature growth, Stabilization and market maturity and Deceleration of growth and decline. (Figure 3)

**Fig3: Life Cycle of an industry**



**Source: Reilly and Brown, (2007)**

Besides being useful when estimating sales, this analysis of an industry's life cycle also provides some insights into profit margins and earnings growth, although these profit measures do not necessarily parallel the sales growth. The profit margins series typically peaks very early in the total cycle and then levels off and declines as competition is attracted by the early success of the industry

In the pioneering stage the industry experiences modest sales growth and very small or negative profit margins and profits. The market for the industry's goods or services is usually small and the industries involved usually incur development costs. Stage two indicates that rapid growth stage which a market develops for the products or services and demand becomes substantial. The limited number of firms in the industry faces little competition and the individual firms can experience substantial backlogs. Stage three relies on the success of stage two where future sales growth may be above normal but it no longer accelerates. Rapid growth of sales and the high profit margins attract competitors to the industry, which causes an increase in supply and lower prices, which means that the profit margins begin to decline to normal levels.

Stage four is the longest phase. The industry growth rate declines to the growth rate of the aggregate economy. Investors can estimate growth easily because sales correlate with an economic series. Profit growth varies by industry because the competitive structure varies by industry and by individual firms within the industry because the ability to control costs differs among companies. Finally at stage five, the industry's sales growth declines because of shifts in demand or growth of substitutes. Profit margins continue to be squeezed. Some firms experience low profits or even losses. Firms that remain profitable may show very low rates of return on capital. In the end, investors begin thinking about alternative uses for the capital tied up in this industry. Conclusively life cycle stages of an industry depict a comparison between sales and earnings growth of an industry which is in tandem with the growth in an economy.

### **6.3 Macro-Economic Evolution Trends vis-a-vis Structural Sector Changes in Kenya since Independence**

The first two decades after independence saw a very strong economic growth. The same economy degenerated afterwards. The economy grew at an average of 5 percent between 1963 and 1970 but accelerated further to 8 percent by 1980 better than it were in 1963. This transition had an impact on the economy cutting across all sectors. Really growth experienced in the 1970s was a culmination of good market conditions conducive for farmers especially rural farmers. Between 1974 to 1982, rural economy grew by 5%. (Swamy, 1974). Industry mutually benefited from good strategy by government based on import substitution which enabled and encouraged exports rather than imports. This was a foundation for rent seeking industrial sector.

Structural changes in the economy were set off by rapid expansion of state owned enterprises which involved many factoring, financial services, processing and marketing of agricultural products. Low productivity experienced in the economy increased efficiencies and decreased the economy's capacity to adjust to changing external conditions. This was also an indication of poor and weak policy response. (Appendix 1)

With increasing trade deterioration in the 70s, balance of payments crisis was experienced in 1974-80. External balance followed suit, fell in the second oil shock which finally led to the devaluation of the Kenyan shilling. The 1990s and early 2000 experienced poor economic performance epitomized with high real interest rate, high transactional costs and high business uncertainty which resulted in low employment. Weak macro-economic management, slow progress in structural reforms, failure of governance, 1984, 1997 – 2000 droughts, the 1998 elnino floods and the rising HIV/AIDS prevalence. These factors contributed to the loss of livestock, crops and income, threatened family structure and viability of social services. Even though there has been an introduction of market oriented policies epitomized with financial, trade, and agricultural market liberalization, divestment of state owned enterprises notwithstanding, they are yet to break the pattern of growth decline.

#### **6.3.1 Public Sector Reforms**

Public sector enterprises should have been a panacea to the ills that afflicted the economy. By the 1980s, the government held interests in about 250 commercial enterprises and held majority interest in at least half of them. They represented about a tenth of GDP but contributed nothing to economic growth causing negative productivity.

In 1991, the government announced its intention to rationalize the parastatal sector. At that time the government held stake in 240 commercially oriented enterprises. Of these 33 were deemed strategic and five of them earmarked for restructuring. The government would divest from the remaining 207 enterprises. The medium term target was modest, with only 10 firms set for privatization and only 5 actually privatized by 1995. But privatization continued through the 1990s with a total of 165 enterprises being sold or liquidated. The economic impact of divestment was small because, with the exception of Kenya Airways sold in 1996, the remaining were small or medium enterprises. Furthermore, transactions lacked transparency, political support was weak, strategy unclear and institutional and administrative arrangements inadequate (IFC, 2000).

The Kenyan government announced a renewed privatization strategy in 2000, which took into account previous experience and focused on increasing private sector participation in the enterprises previously deemed strategic. It approved the privatization of telecommunications (Telkom Kenya), energy (KPLC, the Kenya Pipeline Company, and Kengen), transports (Mombasa Port and Kenya Railways), banking (Kenya Commercial Bank and Kenya Reinsurance), sugar and water. This programme however stalled for example Telkom Kenya. As part of a successful bidding process, the Mount Kenya consortium won a 49 percent stake in Telkom Kenya with a 325 million dollar bid in 2001. But the process was derailed in mid-course, when the government announced the breaking off of negotiations on the basis of political reasons (Oxan 2001). This was a costly course of action. Kenya not only lost international credibility and fiscal revenues but also missed a window of opportunity to repair the poor state of telecommunications in the country. (Appendix 2&3)

## 7.0 CONCLUSIONS

This paper presented the impact business cycles have on industry sectors in Kenya. We presented micro-economic evolution trends on structure sector changes in Kenya since independence. Kenya's economic growth was very strong. We showed that Kenya's policy trend did falter which paved way for the inefficiency of the economy. Inefficiency was faltered in state owned institutions which caused low productivity and returns across the board. Kenya suffered various economic shocks in the 1990s. The 2000 decade showed market oriented policies. This is the time the government announced a renewed privatization strategy. This process was derailed because of a turbulent political environment. Business cycles presences in Kenyan economy are a testimony of structural changes within the framework of existing sectors. Our focus therefore, encourage further theoretical development innovatively to enable the improvement of Kenyan economy.

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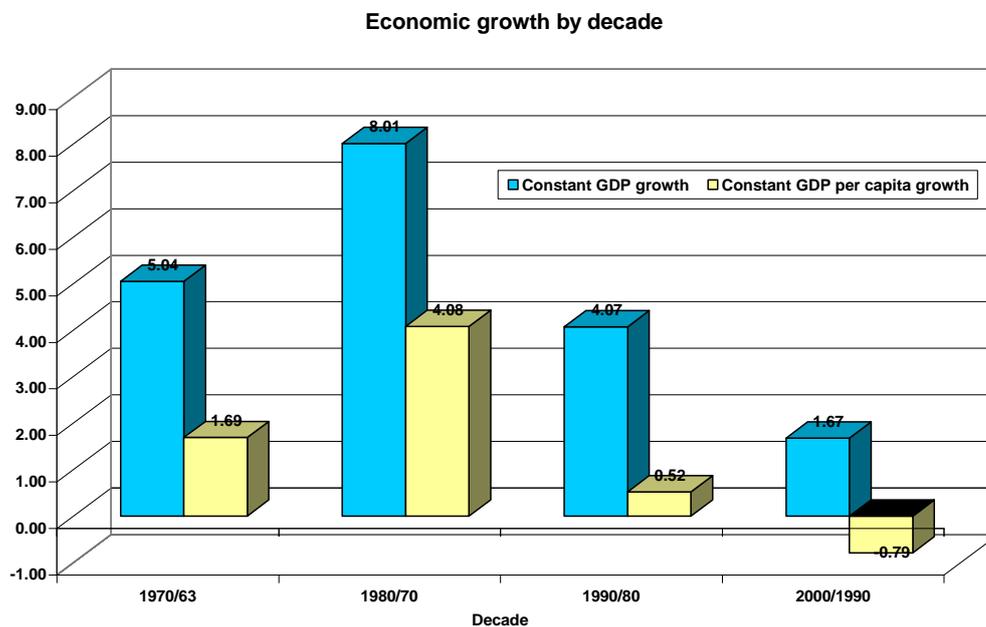
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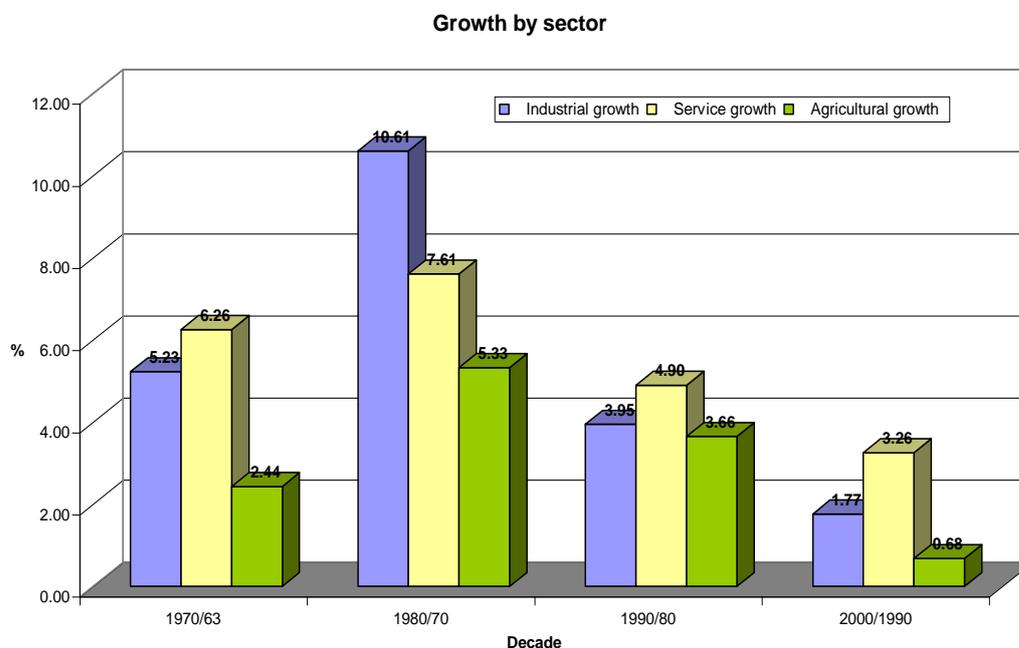
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## Appendices

### Bar Graph 1



### Appendix 2



### Appendix 3

