EFFECTS OF COMPETITION ON THE PROFITABILITY OF CEMENT MANUFACTURERS IN KENYA

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ABSTRACT

The main objective of this study was to identify the effects of competition on the profitability of cement manufacturers in Kenya. This study adopted a survey research design while, stratified random sampling was used. Secondary and primary data collection methods specifically questionnaires and interviews were utilized in this study while both qualitative and quantitative research methods were also used. The study drew the sample of the study from the five cement companies operating in Nairobi Kenya. A response rate of 90% was achieved. The researcher found out that competition does impact on a company's profitability either to some extent or to a great extent. Therefore, the researcher concluded that that for in terms of improving capacity of cement firms in Kenya in terms of countering competition, cement manufacturers should integrate innovation, quality service delivery, value chain adoption, integration of state of the art equipment, good financial management practices and constant re-evaluation in regard to profitability. This should also be realigned with the local realities in regard to Vision 2030, through establishing a regulatory authority, modernization of equipment, strong regional integration, proper infrastructure and regulation of the cement industry such that monopoly does not interfere with the industry.

Keywords – *Competition, Innovation, Modernization, Profitability and Value chain.*

1.Introduction

There are five cement producers in Kenya: Bamburi Cement, Athi River Mining (ARM), East African Portland Cement Company (EAPC) Mombasa cement Company, backed by Taiheiyo Cement Corporation- the largest cement producer in Japan *and the most recent National cement company*. After a period of anemic growth, Kenya's manufacturing sector picked up in 2004/05, with output rising 4.1%. This was in response to rising demand and due to government incentives in the sector. Expansion included the cement sector. Lafarge has a 72% controlling interest in Bamburi Cement and a 41% shareholding in EAPC. Bamburi and EAPC have a combined output of approximately 1.8 million tonnes, representing over 80% of the domestic market. The Kenyan Government is keen to increase the level of competition in this sector and has stated its intention to sell its 52% stake in EAPC (split between the Government of Kenya (25%) and the National Social Security Fund (27%) (World Bank, 2007).

EAPCC also sells cement in Uganda, Southern Sudan and parts of Central Africa. It has a market share of about 28% in Kenya and 5% in Uganda. EAPC built an extra mill which starting operating in 2008 with an extra capacity of 600,000mts. Its annual capacity, now reaching about 1.3 million tonnes. The deal cost the company KES 1.8bn (USD 25 million). EAPC plant is located in Athi River. Additionally, EAPC has also increased production to meet demand in southern Sudan, Rwanda and the Democratic Republic of Congo for road and housing building (East African Portland, 2010*)*.

Bamburi is not only the largest company but also the most efficient cement plant in the country, resulting in larger profit margins relative to its competitors. Bamburi's subsidiaries include Himcem Holdings Ltd, which has a 70% holding in Hima Cement Limited, a cement company incorporated in Uganda, and Bamburi also has a 15% stake in ARM. The Bamburi group currently has an estimated 56% market share of the East Africa cement market. Bamburi's capacity in Uganda and Kenya is approx 1.6 million tonnes. Bamburi has two plants, one located in Mombasa, which is the second largest cement plant in Sub-Saharan Africa, and the other in Nairobi (Lafarge, 2009).

ARM exports around 30% of its production. It has subsidiaries in Tanzania and South Africa which have been established to increase exports. Although it is smaller than its counterparts in terms of revenue and profits, its diversified product range (cement, limestone, minerals, sodium silicate and fertilizer) as well as revenue base affords it a competitive advantage and the potential for earnings growth going forward, even if the local construction market were to cool off. The cement division currently contributes 42% towards overall sales. ARM has recently invested in a cement plant which became operational in H2 06 and increased cement production capacity to 300,000 tonnes. All of ARM's divisions are thought to be running at full capacity at present. However, it is aggressively expanding its divisions, especially on the sodium silicate side, where it remains the supplier of choice for most large consumers regionally. ARM's cement plant is located in Kaloleni, near Mombasa. Similar to the Nigerian companies, the Kenyan cement companies have shown a strong growth in sales coupled with improvements in Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA) margins (United Nations Conference on Trade and Development, 2005).

2. Statement of the Problem

With industries contributing 18 percent of GDP (World Bank & OECD, 1998), the industrial sector in Kenya is a relatively small, albeit important one. Some of the major industries include small-scale consumer goods producers (plastic, furniture, batteries, textiles, soap, cigarettes, and flour), agricultural products processing, oil refining, and cement. Industrial production is confined exclusively to the urban centers, such as Nairobi and Mombasa. Until the early 1990s, the Kenyan government pursued a strategy of import-substitution industrialization (ISI) in the manufacturing sector. ISI sought to stimulate local manufacturing capacity by blocking manufacturing imports from abroad. The government of Kenya has replaced ISI with a strategy of export-oriented industrialization (EOI). The latter is premised on the idea of stimulating manufacturing industries by engaging in competition and free trade. It has been criticized for not taking into account the possibility that highly competitive foreign manufacturers will depress nascent Kenyan firms if they are granted access to Kenya's markets through trade liberalization. In 2008, Kenya had 3 cement manufacturers, and the dominant cement player had an estimated market share of around 65%. By 2010 a new firm has entered the market, and the market share of the largest firm has decreased to around 50%.

In July 2008, the East African countries abolished duty on cement imports in their respective national budgets in a bid to meet the region’s growing demand for the building material, probably quite unaware of the detrimental effects the move would have on the sector. Cement players in Kenya, Uganda, Tanzania, Burundi and Rwanda now urge the governments to move with speed to protect them from marauding foreign investors from, especially, Middle East and Pakistan which are now reportedly capitalizing on the opportunity to monopolize East Africa’s once-lucrative cement market by a deliberate dumping. According to the East African Cement Producers Association (EACPA, 2009), the Pakistani Government extends heavy subsidies to its cement sector, a move that has made their products cheap on the market.

In Pakistani it costs between $11 and $17 to transport one tonne of cement from the Asian country to East Africa, with the government footing 35 per cent of the total cost (EACPA, 2009). Cement consumption in East Africa is still growing and this forms a key indicator that shows the economic strength of a country. However, the government needs to step in and cushion the country against a rising influx of cheap cement into the country. The tax waiver on imported cement creates an unfair competition in the Kenyan market, which if unchecked could lead to the closure of some companies, stopping production or sending workers on leave. The local cement companies and the national economy in general will come down crumbling because they cannot match production and they have fixed costs that are not calculated on the imports.

The success of a company‘s competitive strategy depends on how it relates to its environment. Although the relevant environment is very broad, encompassing social as well as economic forces, the key aspect of the company's environment is the industry or industries in which it operates. Industry structure has a strong influence in defining the rules of the competitive game as well as the strategies potentially available to the company. With this knowledge in mind, this research aims to identify the effects of competition on profitability of cement manufacturing firms in Kenya and what needs to be considered within the cement industry leading to greater economic development and sustainability of this sector in the country.

3. Literature Review

Two features of many developing countries render them particularly prone to anticompetitive business practices, in particular abuses of dominant position. The first is that a small, or very small, number of firms tend to dominate many sectors, so *de facto* competition is limited. In part this arises because they are small markets that can only sustain a few large firms; in principle, openness to imports could provide competition, but in practice there is protection (or, for some utilities that have features of natural monopolies, the goods or services are non-traded). In part it may reflect a tradition of State-owned enterprises, which may even be monopolies; while privatization addresses this, it is necessary to ensure that privatization actually introduces competition (rather than a private monopoly replacing a public one) (Jenny, 2005).

The second is that the institutional framework is weak – the legal contract system and property rights enforcement may be weak, and there is no tradition of competition policy. However, it is precisely because these countries are prone to abuses of dominant position, whether by domestic or foreign firms, that it is important to invest the time and resources required to establish the institutions to address basic competition policy. Although there are no reliable estimates of the cost to an economy of the absence of a competitive environment, there is widely accepted evidence that competition *per se* encourages lower prices and increased efficiency, facilitating a business environment conducive to investment and growth. There are many policy options that can increase competition in the domestic market – deregulation, trade liberalization and other market opening policies are examples (Pittman, 1999).

Competition policy may then be seen as the institutional mechanism that ensures that the newly freed markets remain accessible and contestable, and the Competition Authority (CA) is its organizational counterpart. All these instruments should be seen as complements rather than substitutes (International Competition Network, 2003). As it is desirable to promote competition, and difficult to keep a close eye on the invisible hand (market mechanisms are less than perfectly transparent and firms have considerable scope and incentives to engage in restrictive business practices), there are potential benefits to be had from establishing some level of competition policy in developing countries. “The evidence that competition policy *can* be made to work in developing countries indicates that it can have a positive impact on the institutional environment” (Holmes, 2003, p12).

While competition policy can be implemented effectively at the country level, regional cooperation and coordination are important, given trade and foreign investment, and EPAs can support this also. Furthermore, in the context of EPAs, improved trade facilitation (Milner *et al.*, 2008) and increased investment (Morrissey, 2008) can increase competitiveness and competition in domestic and regional markets, increasing the need for some competition policy. While trade policy limits the misbehaviour of governments (in the trade arena), competition policy limits misbehaviour by firms, which is even more important when trade (and investment) are liberalized (Jacquemin *et al.*, 1998). Competition policy aims to ensure that markets remain competitive (through anti-trust or anti-cartel enforcement) or become competitive (through liberalization). This is especially relevant for most utilities where network economies of scale imply that many of these markets are natural monopolies (telecommunications is probably an exception given the rising importance of mobile phones (OECD, 2006).

In the context of utilities, regulation may be as important as competition *per se*, and privatization does not in itself address competition issues. However, regulation is an element of competition policy and it remains true that viable competition is desirable, as it tends to be associated with greater efficiency and lower prices, while competitive markets are associated with greater levels of technological innovation and enhanced welfare. Singh (2002) argues that it is important for developing countries to establish formal competition policies, primarily because of structural changes due to privatization and deregulation. Many privatized firms are natural monopolies while the international cross-border merger movement during the last decade (previous merger waves were mostly national) have seen firms trying to achieve a dominant position in specific markets and bigger size in a global market. Although the incidence of cross-border takeovers via FDI is much lower in developing countries as compared with developed countries, it is a trend. There are also mergers between large corporations within developing countries (Falvey, 1998 & Evennet, 2002).

The cement industry in Kenya is an industry in a perpetual state of crisis traceable to a number of factors ascertainable through an examination of the evolution and structure of the market (Ayodele, 2009; Kenya Association of Manufacturers, 2006). In the years following independence from Britain in 1960 and in furtherance of government's import substitution policy, the government invested heavily in the setting up of cement factories across the nation- a venture which was made particularly viable by the abundant availability of major raw material (limestone) in those locations. It is generally believed that the decline in local production is the direct consequence of government's policy which liberalized the importation of bagged cement in the mid to late 1980s, thus leading to unbearable pressure and almost to a demise of the local cement production facilities. In a bid to find a solution to the problems of declining local capacity, low quality imported cement and high cost of the product, the government adopted a policy of import substitution in the industry. In this section we concentrate on three main issues: The importance of institutions in developing healthy market economies; the sequence of institutional building and reform; and finally the New Institutional Economics (NIE) approach in explaining how institutions are formed.

4. Research Methodology

Survey design was used in this study for the selected cement companies in Kenya. The population consisted of two respondents randomly selected from the five core departments (Human Resource and Administration, Operations, Finance, Marketing and Engineering) of each company. This study adopted probability sampling method through stratified random sampling. A total sample size of 50 respondents, was identified through stratification of the five core departments. Primary data was used due to its accuracy and control over error. Qualitative data was used to give descriptions of events and also to give good understanding of the cement industry. The data collection tool that was used was questionnaires. The study used both descriptive and content analysis to analyze the collected data.

5. Findings

Table 1.Extent competition has affected profitability

Competition	Frequency	Percent
Not at all	11	24.4
To a little extent	8	17.8
Neutral	5	11.1
To some extent	12	26.7
To a great extent	9	20.0
Total	45	100.0

From the findings above, competition had affected profitability on various extents. 26.7% of the respondents indicated that it was to some extent, 24.4% stated that competition had not affected at all, and 20% stated that it had affected to a great extent. Porter (2004) argues that the major driving force of an industry is its domestic environment, the "home base" as the author calls it. Porter (2004) states that attributes of an industry which provide it with an advantage in a certain sector over other industries, are created and sustained in its home base. Porter further stresses that the home base is where company strategies are set and core process technologies are developed and sustained. Competitive advantage is factor conditions which are the factors of production necessary for an industry to operate. It includes mainly the availability of natural resources; human resources, the availability of skilled or unskilled labor; knowledge resources, which are mainly related to the number of research centers, universities etc; capital resources; and the infrastructure, such as transportation, communication, the banking system etc. This supports the findings on how competition has affected the number of employees in a given firm.

Table 2. Impact of competition on company's profitability

Impact of competition on company's profitability	Frequency	Percent
Not at all	1	2.2
To a little extent	2	4.4
Neutral	6	13.3
To some extent	14	31.1
To a great extent	22	48.9

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The findings in Table 4.4 indicate that 31.1% and 48.9% of the respondents indicated that competition does impact on a company's profitability either to some extent or to a great extent. These findings are supported by literature that states Kenya has five cement manufacturing firms, and the dominant cement player has an estimated market share of around 65%. It is also the case that the largest firm has ownership stakes in the other cement manufacturers. This could potentially mean that they have some degree of influence over the other firms (for example through joint directorship), or knowledge about their competitive strategies, which could potentially result in reduced competition between the five firms (Business Daily, 2007). The domestic cement producers are increasing capacity, and other new entrants are poised to enter the market over the next few years such that the cement market in Kenya may become more competitive going forward. Market entry by new independent cement producers bodes well for competition in the market, and may result in lower prices, resulting in cheaper construction and infrastructure development, and more jobs and exports, all of which contribute to growth (Evenett & Jenny, 2004).

6.Conclusion and Recommendation

The domestic cement producers are increasing capacity, and other new entrants are poised to enter the market over the next few years so the cement market in Kenya may become more competitive going forward. Market entry by new independent cement producers bodes well for competition in the market, and may result in lower prices, resulting in cheaper construction and infrastructure development, and more jobs and exports, all of which contribute to growth. Switching barriers are another important retention strategy in business today. Due to competition, business is not only looking to maintain a relationship but hold customers hostage in order to prevent them from defecting. Therefore, due to customers having increasing choice and the competitive nature of market, businesses may look to create innovative switching barriers to retain customers and hence maintain profits. In recent time's business have also been increasingly influenced by the use of technology in managing customers. New programs allow for segmentation that provides managers with information in order to create strategies that will target particular customer (such as ones who may be about to defect as their purchase behaviour may be low). Technology will therefore play an increasingly important role for management and retention strategies due to competition. With the above mentioned points in mind, the evolution of marketing from a focus on customer and sale to retention and management focus is evident in many businesses today.

This study concludes that for in terms of improving capacity of cement firms in Kenya in terms of countering competition, effects of volatile fuel prices, cement imports and sales promotion strategies on profitability; cement manufacturers should integrate innovation, quality service delivery, value chain adoption, integration of state of the art equipment, good financial management practices and constant re-evaluation in regard to profitability. This should also be realigned with the local realities in regard to Vision 2030, through establishing a regulatory authority, modernization of equipment, strong regional integration, proper infrastructure and regulation of the cement industry such that monopoly does not interfere with the industry. The cement industry's goal is to out-think, out-plan and out-maneuver other forces or competitors. The firms' have to size up the forces shaping competition in the industry. Build defenses against these competitive forces, build relevant competitive advantages and also identify, utilize and nurture its synergies in order to maximize on profitability.

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