

AFRICA RISK CONSULTING**Kenya Monthly Briefing December 2016****Kenya Summary 6 December 2016**

The treasury publishes its budget review and outlook paper for 2016/2017, lowering both projected revenue and expenditure targets. The treasury plans to raise \$1.5 billion on the international markets in the first quarter 2017 to cover budgetary expenditure. Mauritius-based Stock Exchange of Mauritius (SEM)-listed banking group SBM Holdings Ltd plans to acquire Kenya-based Fidelity Commercial Bank Ltd. Nairobi County assembly fails in its attempt to impeach governor Evans Kidero.

Treasury publishes 2016/2017 budget review

The treasury published its budget review and outlook paper for the 2016/2017 fiscal year on 2 November, detailing lower than projected revenue and expenditure figures.¹ The decrease in both is indicative of government capacity constraints. The treasury document revises downwards the fiscal deficit from the 9.4% of gross domestic product (GDP) contained in the budget to 8.1% of GDP, amounting to 586.1 billion Kenyan shillings (KSh) (\$5.8 billion).² This compares unfavourably to the estimated deficit of 7.9% of GDP in 2015/2016. The treasury projects that the deficit will decrease to 6.4% of GDP in 2017/2018, compared to an earlier projection of 6.4%, and 5.3% in 2018/2019, unchanged from an earlier projection.³ The treasury revises projected revenue downwards by 5.4%.⁴ The treasury also revises expenditure downwards by 8.4%, largely due to a 25.7% decrease in capital outlays to KSh601 billion (\$5.9 billion).⁵

The treasury has revised its financing sources. The government will increase its domestic borrowing from its initial target of KSh236.1 billion (\$2.3 billion) to KSh294.6 billion (\$2.9 billion).⁶ Domestic borrowing will reach 4.1% of GDP compared to 3.3% in the original budget.⁷ Foreign financing will reach KSh287.6 billion (\$2.8 billion), 4% of GDP compared to 6.3% in the original budget.⁸ Treasury cabinet secretary **Henry Rotich** cited less favourable international market conditions for the decreased foreign borrowing.⁹ Nevertheless, the government plans to raise \$1.5 billion on the international markets in the first quarter 2017 to cover budgetary expenditure and increase its foreign exchange reserves.¹⁰ The government is looking to international markets to diversify its funding sources, and avoid crowding out the private sector with high domestic borrowing. The government is reportedly considering both commercial loans and bond issuances.¹¹ A bond issuance would reportedly attract a yield of between 8.5% and 9.5%.¹² The government has solicited proposals from banks on how best to put together the financing, and will announce a lead arranger in mid-

¹ www.centralbank.go.ke

² www.centralbank.go.ke

³ www.centralbank.go.ke

⁴ www.centralbank.go.ke

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⁶ www.centralbank.go.ke

⁷ www.centralbank.go.ke

⁸ www.centralbank.go.ke

⁹ www.centralbank.go.ke

¹⁰ Bloomberg, 1 Dec 2016.

¹¹ Bloomberg, 1 Dec 2016.

¹² Bloomberg, 1 Dec 2016.

December.¹³ The government's 2016/2017 fiscal framework revised downwards its budget deficit estimate from KSh586.1 billion (\$5.8 billion), approximately 8% of GDP, to KSh516.5 billion (\$5.1 billion), approximately 6.9% of GDP.¹⁴ Foreign sources are expected to cover 55.6% of the deficit, with commercial financing comprising the majority of international financing.¹⁵ Other financing options reportedly under consideration include panda bonds, samurai bonds and diaspora bonds.

The treasury on 29 November published data showing that public debt increased by KSh743 billion (\$7.3 billion) between September 2015 and September 2016 to reach KSh3.57 trillion (\$35.04 billion).¹⁶ The debt stock is approximately 50% of GDP. Total debt decreased slightly in the third quarter from \$35.8 billion in the second quarter.¹⁷ Domestic debt increased 33.6% year-on-year to KSh1.85 trillion (\$18.1 billion).¹⁸ External debt stood at KSh1.71 trillion (\$16.8 billion) at the end of September, an increase of KSh224 billion (\$2.2 billion).¹⁹ This was due to a decrease in external debt repayments to the **African Development Bank (AfDB)** and the **International Monetary Fund (IMF)**, and the absence of new bilateral or private sector borrowing.²⁰ New domestic obligations were therefore twice the value of the increase in external debt. The treasury projects that domestic borrowing will exceed foreign borrowing in both 2017/2018 and 2018/2019.²¹ The treasury now projects that public external debt will peak at 27.7% of GDP in 2015/2016 before decreasing to 24.9% in 2018/2019.²² Domestic debt will increase from 27.9% of GDP to 28.9% during the same period.²³

The IMF on 5 November praised Kenya's economic performance and government plans to accelerate economic and financial structural reforms.²⁴ Kenya is in broadly favourable standing with the IMF and other international financial institutions. The IMF review was the first under the Stand-By Arrangement and Stand-By Credit Facility. The IMF projected that growth reached 6.1% in the first half of 2016, compared to 5.6% in the corresponding period in 2015.²⁵ The IMF cited favourable weather and increased public investment as reasons for the growth.²⁶ The IMF noted that the current account deficit had decreased to 5.5% of GDP in the 12 months to September 2016, compared to 6.8% in the same period in 2015.²⁷ The IMF attributed the decrease to low international oil prices, improved tea and horticulture exports, and increased remittances inflows. The IMF noted that the exchange rate has remained stable and that foreign exchange reserves increased to \$8.2 billion in September, equivalent to over five months of imports.²⁸ The IMF praised the government's structural reforms, including improving efficiency and transparency of public financial management, inflation targeting monetary framework, banking supervision and regulation, and quality of macroeconomic data.²⁹ The IMF advised the government to continue targeting the deficit (see above). The IMF, however, warned about the economic impact of the **Banking Act (Amendment) 2015** and its cap on commercial bank deposit and lending rates (see below).³⁰ The IMF warned that the cap will curb financial inclusion, and undermine the effectiveness of monetary policy.³¹

¹³ Bloomberg, 1 Dec 2016.

¹⁴ Bloomberg, 1 Dec 2016.

¹⁵ Bloomberg, 1 Dec 2016.

¹⁶ The Star, 29 Nov 2016.

¹⁷ The Star, 29 Nov 2016.

¹⁸ The Star, 29 Nov 2016.

¹⁹ The Star, 29 Nov 2016.

²⁰ The Star, 29 Nov 2016.

²¹ www.centralbank.go.ke

²² www.centralbank.go.ke

²³ www.centralbank.go.ke

²⁴ www.imf.org

²⁵ www.imf.org

²⁶ www.imf.org

²⁷ www.imf.org

²⁸ www.imf.org

²⁹ www.imf.org

³⁰ www.imf.org

³¹ www.imf.org

SBM acquires Fidelity Bank

Mauritius-based Stock Exchange of Mauritius (SEM)-listed banking group **SBM Holdings Ltd** confirmed on 22 November that it plans to acquire Kenya-based **Fidelity Commercial Bank Ltd**.³² The announcement is indicative of increased merger and acquisition activity in the Kenyan banking sector following the signing into law of the Banking Act (Amendment) 2015 (see *ARC Briefing Kenya October 2016*). A cap on commercial bank lending rates came into force on 14 September, limiting the commercial bank lending rate at 400 basis points above the **Central Bank of Kenya (CBK)** benchmark central bank rate.³³ Banks that violate the interest rate restriction can face criminal sanctions.

“Transaction advisers privy to the deal say it is the beginning of a buying binge for Kenya’s banking assets by local and international investors.”³⁴

In a filing with the SEM, SBM said it would acquire Fidelity’s entire share capital for KSh100 (\$0.98) once it had received approval from both Mauritian and Kenyan regulators.³⁵ SBM committed to an injection of KSh1.45 billion (\$14.2m) into Fidelity.³⁶ The CBK expects the completion of the acquisition by 31 December.³⁷ Fidelity transformed from a non-banking financial institution to a commercial bank in April 1996, and currently has a limited market share of only 0.39%.³⁸

*“The deal will save the small **Nairobi**-based lender from a near shutdown by regulators due to the bank failing to meet statutory capital requirements.”³⁹*

SBM Holdings has hinted that it is in the market to buy two additional banks in Kenya: **Chase Bank Ltd**, which was placed under receivership on 7 April after a run on the bank, (see *ARC Briefing Kenya May 2016*) but reopened on 27 April, and an undisclosed bank.⁴⁰ **Consolidated Bank**, which is partly owned by the government, is also searching for a strategic investor, as is **Jamii Bora Bank**.⁴¹

The aforementioned banks are CBK classified Tier 3 banks. The CBK classifies commercial banks into three peer groups using a weighted composite index that comprises net assets, customer deposits, capital and reserves, number of deposit accounts and number of loan accounts. A bank with a weighted composite index of 5% and above is classified as a large bank (Tier 1). A medium bank (Tier 2) has a weighted composite index of between 1% and 5% while a small bank (Tier 3) has a weighted composite index of less than 1%. There has been pressure on small or Tier 3 banks to consolidate and the CBK has in the past tried unsuccessfully to push for the merger or acquisition of small banks so as to create larger and more structurally sound banks. Small banks make up 21 of the 40 banks operating in Kenya but these 21 banks have a combined market share of 9.24%, a sharp contrast from the seven large banks that have a combined market share of 58.2%.⁴²

“Some of the attempts that have been made to consolidate the small banks include increasing capital requirements but proposed amendments to the banking laws have been thrown out in parliament. The capping of interest has however proved to be the silver bullet as small banks are now feeling the effects of reduced margins.”⁴³

³² PANA Press, 22 Nov 2016.

³³ Capital FM, 27 Jul 2016.

³⁴ Source, journalist, Nairobi

³⁵ PANA Press, 22 Nov 2016.

³⁶ PANA Press, 22 Nov 2016.

³⁷ PANA Press, 22 Nov 2016.

³⁸ PANA Press, 22 Nov 2016.

³⁹ Source, journalist, Nairobi

⁴⁰ Source, journalist, Nairobi

⁴¹ Source, journalist, Nairobi

⁴² Source, journalist, Nairobi

⁴³ Source, journalist, Nairobi

Unlike their large competitors, small banks have a higher cost of capital since depositors require a higher rate on their deposits due to their perceived risk and as a result they incur higher costs relative to bigger banks.

“Smaller banks were however able to pass these costs to their customers by offering higher interest rates and normally they would lend to a niche market but the cap has voided this option. With all banks charging the same interest rates small banks are now at a disadvantage since their costs are higher and hence the scouting for strategic investors who can pump in capital needed to keep them afloat and increase their competitiveness.”⁴⁴

Jamii Bora Bank, for instance, reported a third quarter loss and attributed the performance to the high operating expenses following the introduction of rate caps and is now looking for a suitable partner to merge with.⁴⁵ To maintain their profitability momentum, banks have to aggressively grow their loan books but such an increase in lending would result in a corresponding increase in non-performing loans.

“As small banks go back to the drawing board to look for survival options, thousands of employees are the immediate and the biggest casualties. Therefore banks, both large and small, have resulted in cost cutting, the biggest of which is declaring redundancies on the eve of the Christmas holidays. Thousands of jobs have been lost, a trend that is expected to continue towards the end of the year and in 2017.”⁴⁶

Nairobi County assembly fails to impeach Kidero

Members of the **Nairobi County** assembly on 28 November launched an unsuccessful bid to impeach governor **Evans Kidero**.⁴⁷ The dispute will slow development projects in Nairobi, thereby increasing the likelihood of the ruling **Jubilee Party** winning the governorship in the August 2017 general election. Tension between the county assembly and the county executive started in October over a disagreement over office allocation in city hall.⁴⁸ Interior cabinet secretary **Joseph Nkaissery** failed to mediate a resolution to the dispute.⁴⁹ Assembly members subsequently accused Kidero of marginalising them, leading to the impeachment attempt, which seemed to have failed to gain significant traction at the time of writing. Nairobi county speaker **Alex ole Magelo** confirmed that the county assembly and executive had suspended all cooperation on 24 November.⁵⁰ This had stopped work on the proposed KSh34.1 billion (\$334m) supplementary budget.⁵¹ Delays to the supplementary budget raise the risk that the government will face a cash crunch. The assembly has also stopped work on the county annual development plans for 2016/2017 and 2017/2018, and the county fiscal strategy paper for 2017/2018.⁵²

Implications

Despite the treasury’s revised figures, the economy is broadly positive. Growth was sustained across 2016 on the back of the agriculture and services sector. Strong exports of tea and horticulture and a resumption in tourism have resulted in positive external-sector performance. The main risks to economic growth over 2017 are the impact of the commercial interest rate cap, and the impact of the August 2017 general election on both investor sentiment and the fiscal deficit.

The interest rate cap means banks will reject high-risk borrowers, namely small and medium enterprises most in need of access to credit. Small banks, which depend on expensive deposits, will

⁴⁴ Source, journalist, Nairobi

⁴⁵ Source, journalist, Nairobi

⁴⁶ Source, journalist, Nairobi

⁴⁷ Daily Nation, 28 Nov 2016.

⁴⁸ Daily Nation, 28 Nov 2016.

⁴⁹ Daily Nation, 28 Nov 2016.

⁵⁰ Daily Nation, 28 Nov 2016.

⁵¹ Daily Nation, 28 Nov 2016.

⁵² Daily Nation, 28 Nov 2016.

come under more pressure than large banks and this will result in a series of mergers and acquisitions.

While the attempted impeachment of Kidero appears to have failed, it is indicative of the disruptive impact that the general election will have on development projects and policy making alike. Likely candidates to contest the Nairobi governorship include **Esther Passaris, Miguna Miguna** and defeated 2013 presidential candidate **Peter Kenneth**.

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