

AFRICA RISK CONSULTING

Kenya Monthly Briefing July 2015

Kenya Summary 20 July 2015

President Uhuru Kenyatta (2013- present) launches a crackdown on illegal alcohol that triggers violence targeting distillers and distributors. The mismanaged campaign highlights that poor governance continues to pose business challenges. Treasury secretary Henry Rotich introduces the 2015 budget predicated on an 8.7% budget deficit. The Central Bank of Kenya (CBK) adopts both monetary and market intervention strategies to shore up the shilling. The Dock Workers Union begins a strike at the Port of Mombasa in a dispute over National Hospital Insurance Fund (NHIF) contributions.

Government mismanages illegal alcohol crackdown

President **Uhuru Kenyatta's** (2013- present) crackdown on illicitly brewed alcohol has left the government facing significant legal costs and highlights continuing governance and business challenges in **Kenya**. Kenyatta launched a four-day crackdown on illegal alcohol in late June, mandating members of parliament and all those supportive of the drive to go “door to door” closing all outlets that manufacture and sell illicit drinks.¹ Kenyatta’s directive aimed to curb the manufacture of substandard alcohol that targets the bottom end of the market. High taxes on beer and spirits have made legally manufactured and sold alcohol unaffordable for all but the wealthy. Politicians from central Kenya had warned Kenyatta that illegal alcohol was contributing to “increased disorder”.² Kenyatta appears to have made the directive as a concession to his political allies in central Kenya³ where alcoholism and its socio-economic consequences are an increasing concern. Kenyatta placated their concerns with a directive that appears to have no basis in Kenyan law.⁴ This raises concerns about due process and the impact of arbitrary decision making on business.⁵

The directive has triggered violence targeting distillers and distributors. Affected bar owners and liquor stores have seen mobs destroy their properties.

“They have used this opportunity to marshal gangs who have broken into pubs, distributors and manufacturing plants. They have destroyed property and burned stock. This has resulted in death and destruction and the government now faces a huge legal bill from distillers and bar owners who have lost millions of shillings in lost earnings over the past weeks.”⁶

Local and national politicians have exploited the directive to further their own interests, including those in the distilling and distribution markets.⁷ The future of Kenyan-owned and **Naivasha**-based **Keroche Breweries** is especially uncertain. Local MP **John Kihagi** led a mob into the Keroche Breweries manufacturing plant and ordered tests on the alcohol produced.

*“On the face of it, the march by the legislator resembled a ‘moral’ crusade but closer scrutiny showed less than noble intentions. Keroche Breweries CEO **Tabitha Karanja** had previously*

1 Capital FM, 2 Jul 2015

2 Source, journalist, Nairobi

3 Source, journalist, Nairobi

4 Source, journalist, Nairobi

5 Source, journalist, Nairobi

6 Source, journalist, Nairobi

7 Source, journalist, Nairobi

*refused to pay off local officials. The irony is that government officials are harassing Keroche Breweries only months after industrialisation minister **Adan Mohammed** opened the plant's KSh5 billion (\$50 million) facility, citing the enterprise as an example of what local investors should be doing.”⁸*

The directive has negatively affected legal distillers and distributors, despite the bureau standards certifying their products.

“The move was initially meant to stop the sale of counterfeit and sub-standard products but implementation of the directive has been done by mobs who are not discerning between dud and genuine businesses and products.”⁹

United Kingdom (UK)-headquartered **SAB Miller**, **Diageo** subsidiary **East African Breweries Ltd (EABL)**, **London Distillers** and the partly state-owned **Kenya Wine Agencies Ltd** have all said that the violence has affected their business. EABL has started legal action to halt the presidential directive. EABL is already facing losses from its key brands that target the lower end of the market. The company is relying on low end spirit **Jebel** to make up for lost sales from **Senator Keg**, a brand that EABL aimed at the lower end of the market until new taxes pushed up the cost, resulting in sales decreasing by more than 90% from 2013.¹⁰

“It remains to be seen how the three court cases that have arisen out of the presidential order will go but the move has sent fears that politicians can easily disrupt businesses with disregard for the law.”¹¹

Government introduces stimulus budget

Kenya's 2015 budget signals government commitment to its expansionary fiscal strategy. Treasury secretary **Henry Rotich** introduced the 2015 budget on 11 June.¹² The \$20.6 billion budget is predicated on growth of between 6.5 and 7.0%.¹³ This compares to 5.3% in 2014. The government faces a budget deficit of 8.7% in the next financial year, compared to 7.8% this year and the 7.4% projected in January's medium term budget policy statement, raising concern about Kenya's debt exposure.¹⁴ Rotich forecast that revenue collection would reach KSh1.358 trillion (\$13.99 billion), equivalent to 20.8% of GDP. This will depend on the effective implementation of new and existing taxes. The main rates of income tax, corporation tax and VAT remain unchanged. Fuel duty increases by a third to KSh12 (\$0.12) per litre and tax on rental income is now 12% of gross income rather than 30% of net income. Excise taxes on tobacco and alcohol will also increase, but the exact rate will depend on a future excise bill that aims to simplify the regime.

Expenditure will increase 10.8%, reaching 30.7% of GDP.¹⁵ The budget increases spending on recurrent items (8.3% increase), capital projects (12.7% increase) and transfers to the county level (15.3% increase).

The government aims to meet the deficit through domestic borrowing (3.5% of GDP) and international borrowing (5.2% of GDP), further increasing Kenya's debt profile. Expenditure is forecast at 30.7% of GDP.¹⁶ Rotich said the government will ensure that state spending does not limit private sector access to credit. The government will instead rely on external concessional financing, and is likely to return to the international markets. In reference to the oversubscribed 2014 **Eurobond**, Rotich said,

⁸ Source, journalist, Nairobi

⁹ Source, journalist, Nairobi

¹⁰ Source, journalist, Nairobi

¹¹ Source, journalist, Nairobi

¹² Daily Nation, 11 Jun 2015.

¹³ Daily Nation, 11 Jun 2015.

¹⁴ Daily Nation, 11 Jun 2015.

¹⁵ Daily Nation, 11 Jun 2015.

¹⁶ Daily Nation, 11 Jun 2015.

"We intend to continue sourcing these type of funds, including from export credit agencies and syndicated loans."¹⁷

The increased deficit raises concerns about Kenya's fiscal discipline. Parliament on 26 June approved a KSh193.7 billion (\$1.96 billion) supplementary budget for the current financial year ending 30 June.¹⁸ If approved, this will increase total expenditure for the year to KSh1.4 trillion (\$14.1 billion). In the supplementary budget, recurrent expenditure accounts for KSh12.8 billion (\$129.5m) and development expenditure KSh180.9 billion (\$1.9 billion).¹⁹ The transport state department will – if approved – receive an additional KSh138 billion (\$1.3 billion) funding for the standard gauge railway and other infrastructure projects.²⁰ The energy ministry will receive KSh13.5 billion (\$136.6m) for geothermal electricity generation and power transmission.²¹ The treasury did not provide details about the provenance of the additional expenditure. According to Kenyan law, parliament cannot pass supplementary expenditure legislation after the end of the financial year.

Rotich has committed to improving the business regulatory environment. The most notable provision in the budget is the removal of the 5% capital gains tax on share sales that, since its implementation in January, had decreased activity on the **Nairobi Securities Exchange (NSE)**. Rotich introduced a 0.3% withholding tax on the transactional value of shares.²² Rotich also proposed exempting real-estate investment trusts and asset-backed securities from stamp duty to increase tax compliance in the real estate sector. Rotich proposed increasing the minimum core capital requirements for banks from KSh1 billion (\$10.2m) to 5 billion (\$51.1m) by December 2018.²³ This will encourage 24 of Kenya's 44 banks to either secure new capital or to merge. In the shipping sector, the budget decreases eligible tonnage for capital allowance from 495 tonnes to 125 tonnes.²⁴ The rate of investment deduction has increased from 40 to 100%.²⁵

CBK intervenes to stop currency slide

The **Central Bank of Kenya (CBK)** has adopted both monetary and market intervention strategies to shore up the shilling. The CBK monetary policy committee on 7 July increased its benchmark lending rate for the second consecutive meeting. The increase suggests that the CBK will be hawkish and proactive under new governor **Patrick Njoroge** and that the CBK will prioritise the containment of inflation and the preservation of price stability. The CBK increased its benchmark lending rate by 150 basis points from 10% to 11.5% as it tightened policy to defend the exchange rate.²⁶

While the increase was unexpected, economists expect another increase later this year.²⁷ The CBK warned of *"elevated risks to the inflation outlook mainly attributed to the pressures on the exchange rate"*.²⁸ The annual inflation rate was 7% in June, within the government's 2.5 -7.0% target range. The increase came on the same day as the shilling breached 100 to the **United States (US)** dollar on the back of decreased foreign currency earnings in the key tourism and tea sectors.²⁹ It is not clear how successfully the interest rate increase will shore up the shilling in the face of the strengthening dollar. The shilling remained relatively unchanged on 8 July, staying above 100 to the dollar. The continued currency weakness is likely to result in the **Energy Regulatory Commission** announcing increased

¹⁷ Daily Nation, 11 Jun 2015.

¹⁸ Daily Nation, 23 Jun 2015.

¹⁹ Daily Nation, 23 Jun 2015.

²⁰ Daily Nation, 23 Jun 2015.

²¹ Daily Nation, 23 Jun 2015.

²² Daily Nation, 11 Jun 2015.

²³ Daily Nation, 11 Jun 2015.

²⁴ Daily Nation, 11 Jun 2015.

²⁵ Daily Nation, 11 Jun 2015.

²⁶ Business Daily, 8 Jul 2015.

²⁷ Bloomberg, 8 Jul 2015.

²⁸ CBK statement, 7 Jul 2015.

²⁹ Business Daily, 8 Jul 2015.

petroleum prices.³⁰ The CBK also introduced a three-day repurchase rate to improve liquidity management.³¹ In addition, the CBK increased the **Kenya Banks' Reference Rate**, which sets a base rate for all commercial lending, from 8.54% to 9.87%.³² The CBK said that private sector borrowing was above its target by the end of May.

The CBK has also intervened in the market, injecting US dollars to shore up the shilling.³³ The CBK intervention suggests it appreciates that monetary policy alone is insufficient to shore up the currency and curb inflation. The CBK injected dollars on consecutive trading sessions on 13 and 14 July. The CBK's intervention came after the shilling weakened to 103.85 to the dollar, a three and a half year low.³⁴ The shilling firmed to 101.50 on the back of the intervention before trading at 102.20 on 14 July.³⁵ The shilling is down approximately 13% against the dollar in 2015³⁶ due to Kenya's increasing current account deficit and decreasing tourist numbers. The CBK announced that its monetary policy committee will meet on 5 August, only one month rather than the usual two after its last meeting.

Strike action hits the Port of Mombasa

The **Dock Workers Union** began labour action at the **Port of Mombasa** on 1 July in a dispute over **National Hospital Insurance Fund (NHIF)** contributions.³⁷ As part of the labour action, workers refused to unload cargo from vessels and blocked trucks from entering or exiting the Port of Mombasa. The labour action will result in import bottlenecks both in Kenya and the wider **East African Community (EAC)** region. Container traffic through Mombasa increased 11.9% in 2014 on the back of increased capacity and congestion issues at Mombasa Port are already encouraging shippers to look to **Dar es Salaam (Tanzania)** as an alternative.³⁸ The Port of Mombasa is facing a challenge to its position as the gateway to the region from the \$11 billion **Chinese**-financed and constructed **Bagamoyo Port** to the north of Dar es Salaam. The first stage of construction is expected to be completed by 2017-2018. Bagamoyo will have the capacity to handle 20 million twenty-foot equivalent units a year.

The Dock Workers Union was the first **Trade Union Congress (TUC)** affiliate to begin strike action, with the **Union of Kenya Civil Servants**, **Kenya National Union of Teachers** and **Kenya National Union of Service Employees** threatening to follow suit.³⁹ In February the government gazetted increased monthly NHIF salary deductions from KSh320 (\$3.22) to KSh1,700 (\$17.13). The TUC failed in June to reach a compromise agreement with the government and issued strike notices for its affiliated unions.

Implications

The crackdown on illegal alcohol highlights the political, economic and operational risks that investors in Kenya continue to face. While the 2010 constitution improved Kenya's governance record, poor decision and policy making persist. This includes unilateral decision making designed to reward specific constituencies rather than the broader good. Poor, short-sighted decision making can lead to unintended consequences such as those following the crackdown on illegal alcohol, contrary to the stable, predictable environment that investors seek.

³⁰ Business Daily, 8 Jul 2015.

³¹ Business Daily, 8 Jul 2015.

³² Business Daily, 8 Jul 2015.

³³ Reuters, 14 Jul 2015.

³⁴ Reuters, 14 Jul 2015.

³⁵ Reuters, 14 Jul 2015.

³⁶ Reuters, 14 Jul 2015.

³⁷ Daily Nation, 1 Jul 2015.

³⁸ Reuters, 1 Jul 2015.

³⁹ Capital FM, 1 Jul 2015.

The budget statement shows a continuation of Kenya's expansionary policy by drawing upon both domestic and international sources of financing to meet high levels of spending. This will increase pressure on the fiscal deficit, though higher revenue collection in the short-term is possible and could go some way to addressing concerns about the sustainability of the capital expenditure targets.

The CBK will continue to prioritise currency stability and inflation reduction under new governor Njoroge. The CBK's interest rate increase will increase the cost of credit and borrowing costs, undermining consumer sentiment and slowing growth. Whether the currency stops its slide depends as much on external developments as on policy making. These include monetary tightening in the United States, political uncertainty in the **Eurozone** and slower growth in **China**.

While the Dock Workers Union strike is a short-term impediment for shippers, infrastructure bottlenecks and probable delays to the construction of the standard gauge railway will encourage them to look to Tanzania. The regional flow of trade will begin to shift to Tanzania in 2017 as Bagamoyo Port becomes operational.

About Africa Risk Consulting:

Africa Risk Consulting (ARC) is a pan-African consulting company that provides timely, relevant information and advice that enables its clients to take informed investment decisions and to safeguard their reputations.

ARC's core consulting services include integrity due diligence and corporate investigations, political advisory and country assessments, opportunity monitoring and reputation risk management. Most relevant to private equity firms is ARC's integrity due diligence and corporate investigations capability. Specifically, ARC offers pre-deal integrity checks to highlight red flags before negotiations start; full detailed multi-jurisdictional reputation due diligence; and supplier and senior hire vetting and repeat due diligence for compliance programmes. ARC is unique in that it offers a 10-day delivery for a routine integrity due diligence. ARC also offers a suite of corporate investigations services from immediate investigation, evidence gathering, e-discovery, forensic accounting and whistleblower support on one end to crisis media management and regular monitoring on the other.

www.africariskconsulting.com

About ARC Briefing:

ARC Briefing is ARC's essential online business information service.

Companies at any stage in their Africa expansion, whether building or communicating an Africa strategy, investing directly, expanding current operations, financing other investors, doing the legal leg-work or researching the Africa growth trend, need ARC Briefing.

ARC Briefing is an online information service keeping you:

- Up to date with Country Chronologies of business-critical events
- In the know via Country Briefings on political, economic, business and operating trends. Written in-country, ARC experts analyse and comment
- Ahead with Country Planner which details future elections, budgets, regulatory changes etc.

www.briefing.africariskconsulting.com

Getting in touch

Please contact us by email info@africariskconsulting.com or call + 44 (0) 20 7078 4080

Follow us on Twitter: [@ARCBriefing](https://twitter.com/ARCBriefing)