

## AFRICA RISK CONSULTING

### Kenya Briefing August 2015

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#### Kenya Summary 16 August 2015

**United States (US) president Barack Obama (2009- present) describes Kenya as “at a crossroads” during his visit to Nairobi. Obama’s visit coincides with the signing of numerous business deals in infrastructure and energy sectors, and an anti-corruption agreement. An official audit into the 2013/2014 budget reveals that only 26% of government funds and 1.2% of government expenditure were properly accounted for. The Kenya Revenue Authority (KRA) and the Kenya Association of Manufacturers (KAM) are in dispute over excise tax licences. Kenya Airways reports a \$252m full year loss.**

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#### Obama completes visit to Nairobi, with series of business deals...

**United States (US) president Barack Obama (2009- present) completed a visit to Nairobi on 26 July.** Obama’s visit focused on furthering economic ties between the US and Kenya, as well as raising issues around human rights and corruption. The visit to **East Africa**, which included **Ethiopia**, is probably Obama’s last before his term ends in January 2017. Obama held direct talks with President **Uhuru Kenyatta (2013- present)** but not with deputy president **William Ruto** who faces ongoing charges at the **International Criminal Court (ICC)**.

*“Obama’s meeting with Kenyatta could not have happened while the ICC charges remained active.”<sup>1</sup>*

The talks with Kenyatta focused on security, with Obama praising Kenyan efforts to curb **al Shabaab** militancy. Obama opened the **Global Entrepreneurship Summit (GES)**, an initiative he launched in 2009, and praised Kenya’s capacity for innovation and entrepreneurship.<sup>2</sup> However, Obama warned that ethnic division and corruption pose threats to Kenya’s continued growth. Obama described Kenya as

*“...at a crossroads, a moment filled with enormous peril but also enormous promise. Corruption is not unique to Kenya, but the fact is too often corruption is tolerated because that is how things have always been done. Just because something is a part of your past doesn’t make it right.”<sup>3</sup>*

Obama’s visit also provided a platform for the signature of a number of agreements. Bilaterally, the US and Kenya signed a memorandum of understanding (MoU) for **Lamu Port South Sudan- Ethiopia Transport (Lapsset)** corridor infrastructure projects.<sup>4</sup> The MoU is a potential challenge to **China**, which has won a number of tenders related to Lapsset. Kenya-based power and infrastructure developer **Aeolus Kenya Ltd** is leading discussions with the US government and US-based companies over Lapsset.<sup>5</sup> Aeolus named **Bechtel Group Inc** as one of the interested US-based companies.<sup>6</sup> **General Electric Africa** announced a \$155m partnership with **Kipeto Energy Ltd** to build a 100MW

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<sup>1</sup> Source, private sector CEO, Africa

<sup>2</sup> Daily Nation, 25 Jul 2015.

<sup>3</sup> Daily Nation, 25 Jul 2015.

<sup>4</sup> Daily Nation, 25 Jul 2015.

<sup>5</sup> Bloomberg, 27 Jul 2015.

<sup>6</sup> Bloomberg, 27 Jul 2015.

103 wind turbine farm in **Kajiado County**.<sup>7</sup> The US government's **Overseas Private Investment Corp (OPIC)** will provide the majority of financing for the project.

Other bilateral agreements covered security, HIV/AIDS, energy and climate change. Officials also confirmed that the US and Kenya are jointly working on the start of direct flights before the end of the year, and the extension of limits on business and student visas.<sup>8</sup>

US-based companies announced a number of deals at the GES. **SkyPower** announced a \$2.2 billion contract with the Kenyan government to install 1000MW of solar power over the next five years on a "build-own-operate" model.<sup>9</sup> **Chase Bank** committed to lending \$600m over three years to small enterprises, and the **Global Enterprises Network** \$100m for business start ups.<sup>10</sup> The US government will also provide an additional \$200m to a small and medium sized enterprise fund jointly run by OPIC and Kenya-based **Equity Bank**.<sup>11</sup>

### ... and anti-corruption agreement

Kenya and the US published an agreement to address corruption and increase transparency and signed it following Obama's visit.<sup>12</sup> The agreement commits the US to supporting the attorney general office's ongoing review into current anti-corruption legislation and regulations covering both the detection and investigation of corruption and the seizure of assets.<sup>13</sup> The agreement commits Kenya to joining the **Egmont Group** to combat money laundering and terrorism financing, the **Extractive Industries Transparency Initiative (EITI)**, the **US Africa Partnership on Illicit Finance** and the **World Bank's Financial Action Taskforce**.<sup>14</sup>

The anti-corruption agreement coincides with auditor general **Edward Ouko's** official audit into the 2013/2014 budget. The audit revealed that only 26% of government funds and 1.2% of government expenditure were properly accounted for.<sup>15</sup> The report highlights the systemic mismanagement of government funds that has allowed a culture of corruption to take root. Ouko published the report on 29 July. The audit reveals an improvement on the previous year, when only 12% of the budget was properly accounted for.<sup>16</sup> Nevertheless, the audit warns of "*still persistent and disturbing problems in collection and accounting for revenue*"<sup>17</sup> and "*disturbing problems*"<sup>18</sup> in government accounting procedures. Ouko's report reveals that 16% of government financial statements including revenue and spending were "*misleading*".<sup>19</sup> Ouko also noted the transfer of \$2 billion to an offshore account against government regulations.

The report accused government ministries of spending 24.6 billion Kenyan shillings (KSh) (\$243m) beyond what the government had budgeted for them.<sup>20</sup> According to the report, the infrastructure ministry spent an unbudgeted KSh 77m (\$761,501).<sup>21</sup> Parliament must by law approve any extra spending outside budgetary allocations.<sup>22</sup>

<sup>7</sup> Company press release, 26 Jul 2015.

<sup>8</sup> Daily Nation, 25 Jul 2015.

<sup>9</sup> Daily Nation, 25 Jul 2015.

<sup>10</sup> Daily Nation, 25 Jul 2015.

<sup>11</sup> Daily Nation, 25 Jul 2015.

<sup>12</sup> Daily Nation, 2 Aug 2015.

<sup>13</sup> Daily Nation, 2 Aug 2015.

<sup>14</sup> Daily Nation, 2 Aug 2015.

<sup>15</sup> Auditor general 2013 – 2014 report

<sup>16</sup> Auditor general 2013 – 2014 report

<sup>17</sup> Auditor general 2013 – 2014 report

<sup>18</sup> Auditor general 2013 – 2014 report

<sup>19</sup> Auditor general 2013 – 2014 report

<sup>20</sup> Auditor general 2013 – 2014 report

<sup>21</sup> Auditor general 2013 – 2014 report

<sup>22</sup> Daily Nation, 2 Aug 2015.

The report also details ministry's debts: the devolution ministry owes KSh 1.1 billion (\$10.8m) and the land ministry KSh 392.5m (\$3.8m).<sup>23</sup> Treasury secretary **Henry Rotich** responded to the audit, claiming that the government has "since established that there were no resources"<sup>24</sup> but provided no evidence to substantiate this assertion. Kenya's position on **Transparency International's** corruption perception index deteriorated from 136 in 2013 to 145 in 2014.<sup>25</sup>

### Kenya Revenue Authority licence dispute hits manufacturing sector

Tensions are increasing in the manufacturing sector after the **Kenya Revenue Authority (KRA)** denied issuing licences to a large number of companies, effectively stopping them from selling any products from their factories. The KRA published in national newspapers a list of companies that were issued with excise tax licences, the source of tension between the KRA and the **Kenya Association of Manufacturers (KAM)** lobby group. The KAM says that four out of five of their members were left out of the list, potentially creating a wave of factory closures which would in turn lead to job losses.

*"The KRA list left out a number of well-established firms causing fear within the industry since retailers and food outlets cannot sell goods from companies that do not have excise tax licences."*<sup>26</sup>

The KAM says that the KRA has made compliance difficult due to its administrative inefficiency and unilateral implementation of new tax procedures.<sup>27</sup> In June, beverage manufacturers complained that the KRA was rolling out the excise goods management system (EGMS) that would require juices, bottled water and other beverages such as wines to have KRA-approved stickers on their products without clearly informing manufacturers and other service providers on how the new systems will work. The EGMS is expected to increase revenues and at the same time remove counterfeits from the market. The KAM complained in a statement at the time that the lobby group had asked the KRA for a meeting to give clarity on how the EGMS will be implemented and other issues such as compliance costs but the tax authorities were non-responsive. Small manufacturers said that implementing the new system would cost them as much as \$50,000 and asked the KRA if it would be possible to have one company to print all stickers instead of having different vendors which will result in higher costs.

Manufacturers obtained a reprieve after the KRA agreed to meet them at the end of the July where they managed to iron out most issues. The KAM and the KRA decided that manufacturers who are not on the KRA's list could continue with operations and would be issued with an interim letter until they have sorted their issues with the tax authorities, meaning that retailers can stock their goods.

*"The zealotry of the tax authorities has however sent fears amongst local manufacturers and would-be investors since it has shown that the government can unilaterally and unpredictably disrupt business operations."*<sup>28</sup>

Kenyan tax authorities are increasingly aggressive as the government needs to plug the deficit that now stands at 8.2% of GDP and is set to continue rising due to the ongoing massive infrastructure spending and the government's growing payroll. In June, the **Kenya National Union of Teachers (KNUT)** won a court case awarding teachers a 60% pay increase. The education ministry has since gone to the court of appeal to contest the award. If it loses at the court of last resort it has no choice but to award teachers the pay increase. Rotich has given the KRA a target of \$12.5 billion for the 2015-2016 fiscal year, which is nearly 25% more than the \$1.01 billion collected a year before.<sup>29</sup>

<sup>23</sup> Auditor general 2013 – 2014 report

<sup>24</sup> Standard, 1 Aug 2015.

<sup>25</sup> www.transparency.org

<sup>26</sup> Source, journalist, Nairobi

<sup>27</sup> Auditor general 2013 – 2014 report

<sup>28</sup> Source, journalist, Nairobi

<sup>29</sup> Auditor general 2013 – 2014 report

## Kenya Airways reports \$525m losses

**Nairobi Securities Exchange**-listed **Kenya Airways Ltd** on 29 July reported a \$252m full year loss, compared to \$28.9m in the year before.<sup>30</sup> The government is considering a bailout of the airline in which it holds a 29.8% stake. This may involve a partnership with a **Gulf**-based airline, and the reduction of **Air France-KLM's** 27% stake.<sup>31</sup> Observers have mooted **Emirates, Qatar Airlines** and **Etihad** as potential partners. A possible concern for the government is that Gulf-based airlines tend to seek an integrated model in which they control airport operations. It is uncertain whether the **Kenya Airways Authority** is to cede control over **Jomo Kenyatta International Airport (JKIA)** in particular in exchange for the required investment. Rotich has said that the government is considering a cash injection in the form of debt and equity to dilute KLM's share. The financial results will, however, make it harder for Kenya Airways to access long-term debt.<sup>32</sup> Kenya Airways estimates that it requires KSh 60 billion (\$594m) to return to profitability.<sup>33</sup>

Kenya Airways cited the impact of increased competition from **Middle East** carriers on fares and passenger numbers, and high operating costs including a misjudged fuel hedging plan for the loss. Kenya Airways has also embarked on a debt-financed fleet modernisation programme putting the company in a negative equity position. Finance costs doubled from \$23.1 million in 2013 to \$45.2 million last year. The fleet ownership costs doubled to \$249.9 million in 2014, up from \$120.3 million a year earlier. The fuel hedging plan has prevented Kenya Airways from benefitting from low international oil prices. The **African Export-Import Bank** has provided \$200m bridge financing to help Kenya Airways, and is advising Kenya Airways on debt restructuring. Kenya Airways has also said it is expecting to raise \$100m from the sale of aircraft and land in Nairobi.<sup>34</sup>

## Implications

Obama's visit highlights the increasing economic and security ties between the US and Kenya. It also symbolically marks the end of frosty relations with the west over the ICC. As well as the deals signed, Obama's visit will boost investor perceptions of Kenya. US support for Kenya's anti-corruption efforts show an appreciation that words alone are not enough to address the systemic culture of corruption that has taken root.

The argument between the KAM and the KRA shows the implications of poor, short-term decision making to maximise returns from the private sector. It sends mixed signals to investors. On one hand the government is on a charm offensive aimed at having Kenyans buy more Kenyan-made goods but on the other hand the tax authorities are making life difficult for manufacturers.

The strategic importance of Kenya Airways increases the probability of a government bailout. Kenya Airways' economic outlook is more promising. A number of the costs including the fleet modernisation programme were one off investments, while passenger numbers remain constant. Kenya Airways is well positioned to increase its regional presence, with international airlines including **British Airways** and **Brussels Airlines** withdrawing services from **Entebbe (Uganda)** and Nairobi respectively.

<sup>30</sup> The Star, 29 Jul 2015.

<sup>31</sup> The Star, 29 Jul 2015.

<sup>32</sup> Citizens TV, 3 Aug 2015.

<sup>33</sup> The Star, 29 Jul 2015.

<sup>34</sup> The Star, 29 Jul 2015.

### About Africa Risk Consulting:

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**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.

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