Administration as a Business Restructuring Option & Cytonn Weekly #37/2022

Focus of the Week

Recently, Kaluworks Limited successfully exited administration after struggling financially over the last few years on the back of weak sales and increased competition from other manufacturers. Key to note the company was under receivership for a period of fifteen months, and is now slated to resume operations. As such, we saw it fit to cover a topical on administration as a business restructuring option to shed light on the recent administrations and key lessons to draw from them.

A business is said to be insolvent when it cannot be able to raise enough cash to meet its obligations. Generally, there are two types of insolvency i) Where the company's liabilities are more than the assets, and, ii) Technical insolvency where the assets exceed liabilities but cannot be easily liquidated to pay off the obligations that are due. However, mere insolvency does not afford enough ground for lenders to petition for involuntary bankruptcy of the borrower, or force liquidation of the business. On the contrary, Kenyan laws provide alternatives on how a technically insolvent business can be assisted to get back to its feet and be able to service its creditors' obligations and protect the interests of the other stakeholders. The available options include: (i) Administration, (ii) Company Voluntary arrangements, and, (iii) Liquidation. To read more on the options, please see our topical on Business Restructuring Options. Similarly, if the cause of business distress is uptake of debt, there are various means to restructure the debt to not only ensure continuity but to realize a better return of value to the stake holders as opposed to liquidation. For more information, please see our topical on Debt restructuring.

In this week's topical, we shall focus on Administration as a business restructuring option in Kenya. We shall do this by taking a look into the following:

I. Background and Overview of the Topic,
II. Case Studies,
III. Key learnings, and,
IV. Conclusion.

Section I: Background and Overview of the Topic

Administration was introduced by the Insolvency Act, No. 18 of 2015 as an alternative to liquidation, with the following key objectives;

i. To maintain the company as a going concern,
ii. To achieve a better outcome for the company's creditors than liquidation would offer, and,
iii. To realize the property of the company and make distributions to secured or preferential creditors.

The process of administration is headed by an Administrator, a certified Insolvency Practitioner, who may be appointed by an administration order of the court, unsecured creditors, or a company or its directors. An administrator of a company is required to perform the administrator's functions in the interests of the company's creditors as a whole. The administrator is deemed an officer of the Court, whether appointed by the court or not.

Once the Administrator is appointed, they are entitled to all the records of the company and are required to present a proposal to the creditors on their plan to salvage the company. The Administrator assumes control of all the property the company is entitled to manage as well as the company's property. While under administration, creditors may undertake procedures to enforce security over the company's property, with approval from the court or an agreement with the administrator. The Administrator must therefore set a date for the creditors meeting and invite all the creditors that it knows of, having had access to the books of the company. Only creditors who have filed proof of debt before 4.00 pm of the day before the Creditors meeting are entitled to vote at the said creditor's meeting.

At the Creditors' meeting, the Administrator must present their proposal to the Creditors who shall vote on it. The percentage of an individual vote shall be determined by the amount of debt owed to the creditor. The creditor may opt to either vote for the proposal without amendments, vote for the proposal with amendments, or reject the proposal altogether. The decision of the creditors meeting shall be final.

Section II: Case studies

In this section, we look at the various companies that have experienced financial distress and consequently invoked the Insolvency Act. We shall thus look at Nakumatt Holdings, Athi River Mining (ARM) Limited, and more recently, Kaluworks Limited.

i. **Case Study of Nakumatt Holdings**

Background: Nakumatt Holdings is a Kenyan supermarket chain. Until February 2017, Nakumatt was regarded as the largest Kenyan retailer, with 62 branches across the region, (45 in Kenya, 9 in Uganda, 5 in Tanzania and 3 in Rwanda) and a gross turnover of Kshs 52.2 bn. However, what was fueling Nakumatt's rapid expansion was funded through debt. This included short-term borrowings, bank loans and letters of credit to its numerous suppliers. Following the collapse of Imperial Bank, the Commercial Paper market, which Nakumatt had been relying on, dried up and Nakumatt started experiencing serious cash-flow difficulties in 2016. The retailer was therefore unable to meet its financial obligations to landlords, its suppliers and employees. It was for these reasons that the administrator was appointed by an order of the court pursuant to an application filed by unsecured creditors, and Nakumatt Holdings was placed under administration in January 2018.

Following the assessment of Nakumatt's financial position, the administrator, PKF Consulting Limited (PKF) determined that if a liquidation route was used, then out of the total creditors with amounts worth Kshs 35.8 bn, Kshs 30.6 bn was unlikely to be paid. This represented a significant 85.0% potential loss to the creditors. In essence, all unsecured creditors, namely Trade Creditors, Commercial Paper Holders and Short Term Noteholders, as well as private placement loan providers would suffer the maximum 100% loss of their debt amounts, as the available assets would first pay off secured creditors. Since Nakumatt's business model could support a better outcome for all the creditors as compared to a liquidation scenario, the Administrator set out to come up with a restructuring proposal to achieve this outcome based on the company remaining a going concern. Nakumatt's administrator came back to creditors with proposals, which we highlighted in our focus note, Restructuring an Insolvent Business, that the creditors were supposed to take a vote on. The creditors rejected the proposal which entailed a debt waiver and restructuring into equity in order to ease the debt burden for the company and turn the business around. The plan would have seen bank debt, Kenya Revenue Authority and Employee liabilities were treated as preferential creditors; thus exempting them from the 25.0% waiver that non-preferential creditors took on their debt, as well as the 75.0% debt to equity mandatory conversion.

Our View: In our view, the proposals brought forth were not equitable and fair to all creditors. In addition, they failed to inspire confidence especially with the major stakeholders, required to turn around the business, more so suppliers, landlords, and employees. We thus concurred with the creditors who rejected the deal.

We noted that the best-case scenario for all creditors was a debt to equity conversion of their creditor claims, as liquidation was not in the best interest of anyone. This should have included even the banks who had taken preferential debt. Case in point being, the recent restructuring of Kenya Airways. In the case of Kenya Airways' restructuring, the Government and several banks converted their debt into equity to the tune of Kshs 59.0 bn. The Government's stake in Kenya Airways rose to 46.5% from 29.8% before the debt to equity conversion, while the bank's consortium (KQ Lenders Co.) ended up owning 35.7% of the company. Ordinary shareholders who did not inject additional equity were diluted by 95.0%.

In conclusion, we note that the proposed procedures, in line with the Insolvency Act, accorded Nakumatt with a second chance, to pursue the ongoing recovery strategy, dubbed "Nakumatt Bounce Back" but it was later in 2020 voted that the company could not continue with its operations and the creditors voted for its winding up.

It is noteworthy that almost all of Nakumatt branches have now been taken over by competitors such as Naivas and Carrefour, which points to the fact that they business had potential had the restructuring been undertaken earlier and more effectively.

ii. **Case Study of Athi River Mining (ARM) Cement**

Background: ARM is a Kenyan manufacturing company listed at the Nairobi Securities Exchange, with operations in Kenya, Tanzania and Rwanda. The firm specializes in the production of cement, fertilizers, quicklime, and other industrial minerals. ARM cement, once a stable company, started experiencing difficulty in 2016, as the firm's revenue lines started decreasing. Revenues declined by 32.0% from Kshs 12.8 bn in FY'2016 to Kshs 8.7 bn in FY'2017 while operating expenses rose by 34.8% to Kshs 3.1 bn from Kshs 2.3 bn in FY'2016. This saw the operating loss widen to Kshs 4.2 bn in FY'2017 from Kshs 0.3 bn in FY'2016, and consequently the loss after tax widened by 87.5% to Kshs 7.5 bn in FY'2017 from Kshs 4.0 bn in FY'2016. The shrinking revenue lines were largely attributed to stiff competition in the cement industry both in Kenya and Tanzania, the company's main revenue contributors. The declining performance pushed the company into a negative working capital position, further exacerbating the poor performance, thereby rendering the company unable to service its debt obligations to various creditors, such as:-

i. UBA Bank Kenya, which provided the company with a Kshs 500.0 mn short term loan,
ii. Africa Finance Corporation (AFC), which provided a Kshs 4.6 bn loan, and,
iii. Stanbic Bank Kenya, which provided the company with a Kshs 3.2 bn loan.

The company was then placed under administration in August 2018, with PwC's Muniu Thoithi and George Weru appointed as the administrators. The administrators, having full control held a creditor's meeting in October 2018, where creditors voted to give the administrators up to September 2019, to revive the company. The creditors also approved the sale of some or even all of the company's assets, and capital injections from strategic investors as part of the strategies to revive the company. The administrators wrote off the Kshs 21.3 bn in loans advanced to its Tanzanian Subsidiary, due to alleged misrepresentation of the loan given that it had been non-performing for several years and that the subsidiary was deemed unable to repay the loan. As such, the company slipped to a negative equity position of Kshs 2.4 bn, effectively meaning a complete write-off for shareholders in the event of a liquidation, and that only secured lenders could be fully covered by the then Kshs 14.2 bn asset base. Proposed moves to look for a strategic investor such as several major companies like Dangote Cement and Oman Based Raylat limited did not bear fruit.

Despite the Insolvency Act enabling the company to remain operational as it undertook the turnaround strategy, ARM failed to revive and the administrators only option was to sell the salvageable assets in an attempt to return value to the creditors and shareholders. In October 2019, National Cement, owned by the Devki Group, acquired all cement and non-cement assets and businesses of ARM Cement at a cost of Kshs 5.0 bn. However, this was still a drop in the ocean with the listed Cement manufacturer owing its creditors in upwards of Kshs 28.4 bn. In May 2020, ARM sold its Tanzania subsidiary Maweni Limestone Limited to a Chinese firm Huaxin Cement, in a deal priced at Kshs 11.9 bn. When it was clear that all creditors and shareholders' demands could not be met, the administrators in April 2021 advised liquidation and subsequent delisting from the Nairobi Securities Exchange (NSE).

Disclosures made by PwC's Muniu Thoithi and George Weru as at 31st July 2022 revealed that following liquidation, the net amount available for distribution to secured, preferential and unsecured creditors of ARM stood at USD 52.0 mn (Kshs 6.2 bn), with the creditors having suffered a combined shortfall in upwards of USD 100.0 mn (Kshs 11.9 bn). As a result, there would be no disbursement to shareholders. The disbursement is summarized in the table below;

Item	Amount (Kshs bn)			
Net realized amount from liquidation	6.2			
Utilization of funds				
Item	**Amount owed (Kshs bn)**	**Amount paid (Kshs bn)**	**Amount Lost (Kshs bn)**	**Haircut**
Preferential creditors	0.3	0.3	-	-
Secured creditors	8.0	5.2	2.8	35.0%
Unsecured creditors	9.0	0.7	8.3	92.2%
Shareholders	5.3*	0.0	5.3	100.0%
***Based on last traded price of Kshs 5.5**				

Source: Administrator filings

Our View: We are of the opinion that there existed mechanisms of restructuring ARM and its debt to ensure that the company continued operations and avoid total wiping off of shareholder's equity. Similar to debt to Equity conversion done at Kenya Airways, where it restructured Kshs 59.0 bn owed to the Government and several banks, this would have ensured that ARM had a stronger fighting chance.

iii. **Case study of Kaluworks Limited**

Background: Kaluworks is a manufacturer of cook wear and building materials which was founded in 1929. The company operates as a subsidiary of Clovis Co Ltd, a Bermuda registered Investment Holding Company owned by Comcraft Group, whose Chairman is Manu Chandaria.

Kaluworks was one of Kenya's leading aluminium products such as utensils and roofing sheets, before the country started to see an influx of imports of similar materials. This came at a time when Kaluworks was on an aggressive expansion drive and had invested Kshs 1.8 bn to upgrade its factory in Mariakani Mombasa, both initiatives largely funded through debt from Commercial banks. This was also followed by interruptions brought about by the COVID-19 pandemic, which saw a slowdown in building activities in the country. As at May 2021, Kaluworks had liabilities of Kshs 12.6 bn against total assets of Kshs 1.3 bn. One of the main creditors, NCBA placed Kaluworks under receivership on May 27th 2021 by NCBA Group, by virtue of being holders of a qualifying floating charge of Kshs 4.3 bn. Other creditors include Cooperative Bank, owed Kshs 4.8 bn, while other unsecured lenders such as I&M Bank, commercial paper holders such as Sanlam Kenya held a combined of Kshs 3.5 bn. NCBA appointed an insolvency practitioner, Pongangialli Rao in a bid to recover the amounts owed to them.

In a gazette noticed dated 25th August 2022, the High Court of Kenya in Nairobi, consented to the termination of administration of Kaluworks Limited, tabled by the receiver manager, Pongangialli Rao in agreement with Kaluwork's secured creditors. In the tabled agreement, Kaluworks shareholders agreed to a Kshs 1.2 bn capital injection, with a section paid to the secured lenders as is in the schedule below;

Kaluworks' Limited disbursement to creditors (Kshs bn)

Lender	Amount owed (Kshs bn)	Amount paid (Kshs bn)	Amount written off (Kshs mn)	Haircut
NCBA	4.3	0.6	3.8	88.0%
Cooperative Bank	4.8	0.6	2.6	55.0%
Other Creditors (CPs)	3.5	-*	-*	100.0%*
Total	**12.6**	**1.2**	**6.4**	**51.0%**

***Not disclosed**

Source: Administrator's filings. CPs stands for Commercial Paper

As seen in the table above, the secured creditors (NCBA Group and Cooperative Bank) got into an agreement with the administrator and Kaluworks Limited to write off a total Kshs 6.3 bn out of the total Kshs 9.1 bn owed to them, equating to a 70.6% haircut. Additionally, the main shareholders (Comcraft Group), agreed to inject Kshs 150.0 mn into the business in order to revive operations and the business remaining a going concern.

Our View: The Insolvency act gave Kaluworks Limited a fighting chance, and its successful exit from administration highlights how collaborative efforts from all stakeholders are crucial in saving a business. We expect that the company will regain its footing, resume operations and fulfill its potential not only in the country but in the region.

Section III: Key learnings

From the above case studies, it is key to highlight the following points about administration,

i. Administration offers struggling businesses a second chance to reorganize themselves and come out stronger and viable businesses,
ii. Administration offers a better deal for creditors as compared to other restructuring options such as liquidation given that it allows continuity of a trade or business which goes a long way in preserving the assets of a company. Similarly, it is easier for a business to source for finances to restore operations as a financier will view it more as a rescue than a gone case,
iii. It encourages entrepreneurship by providing a path to redemption in the case of a viable venture that has run into turbulence and just needs room to restructure and re-strategize. Research has shown that the availability of reorganization frameworks encourages entrepreneurship, and,
iv. Administration allows a company in operation to continuously chart its way out of administration by allowing for the Company Voluntary Agreements, a schedule or restructuring plan fronted by

the Company to pay back its creditors, should they adopt the plan.

Additionally, we identified key challenges which in our view, have led to most administrations not being as successful:

i. **Getting into administration too late:** As was the case with Nakumatt, it got into administration too late when it was too late to resuscitate the business,
ii. **Administration costs are too high:** As was the case with ARM, spending Kshs 2.5 bn on administration costs is too high, given that it was over 40.3% of amount recovered. It is important the administration costs are kept low to ensure creditors recover meaningful amounts and service providers align with the interest of creditors,
iii. **Administrations take too long:** In the case of ARM, it started in 2018 and ended in 2022, almost 5 years, this can only be beneficial to the service providers around the administration, and not the creditors. It would be helpful if administrations were conducted and closed as fast as possible,
iv. **Creditors failure collaborate:** In the case of Nakumatt, the retail creditors who held the commercial paper were not collaborative with the administrator and insisted on either full refunds or liquidation. They ended up with 100.0% loss, yet an equity restructuring would have given them value, which is now being enjoyed by competitors such as Carrefour,
v. **Failure to accept reality by shareholders:** In the case of Nakumatt, shareholder management wanted to stay in control and would not cede control to possible new investors until it was too late to bring in new investors as the business had unraveled by the time they were willing to cede control,
vi. **Lack of knowledge around administration:** Many creditors, and even regulators and businesses, are yet to understand or accept administration as a legitimate business restructuring option,
vii. **Lack of leadership to align interests:** Administration has various actors, whose interests may not be aligned. Each administration requires firm leadership to align all the conflicting interests to face one direction in the interest of restructuring the business, and,
viii. **Negative publicity around administratio**n: Administration especially when not well understood by all stakeholders, poses as a risk to the business continuity. This is because the process often attracts negative publicity and uncertainty which deals inadvertent blows to the business and may lead to total collapse

Section IV: Conclusion

While evaluating the administration process, it is paramount for the stakeholders to view and approach it from a Win-Win mindset and be open to the various possible options to get the business back on track and return value to all stakeholders. Liquidation as an option gives the least value for all stakeholders. In the case of Nakumatt, unsecured lenders got zero while the secured lenders got very little out of the sale of assets. Similarly, for ARM, the creditors recouped slightly more than a third of their investments, underlining Liquidation as a first resort is not viable. Companies under administration and moratorium after invoking the Insolvency Act, are not subject to debt repayment obligations, as the administrators focus purely on the best possible resolution strategy to the creditors and to the shareholders. This, in our view, encourages entrepreneurship by giving business owners time to restructure and possibly regain financial stability in case of financial distress when faced by unprecedented challenges.