Privatization of State Enterprises, & Cytonn Weekly #12/2023 Executive Summary

Focus of the Week

Privatization generally refers to transfer of ownership of an entity or a corporation from public to private sector. Privatization typically aims at enhancing economic efficiency by improving a company's performance, cease or reduce the need for government economic intervention. Further, privatizations have been used to induce competition in monopolized sectors. Globally, one of the notable privatization of State Owned Enterprises (SOEs) was British Airways in 1987 when it was listed on the London Stock Exchange. Closer home in developing nations such as Kenya, State Owned Enterprises have been touted as major contributors to the nations expenditure and public debt, given that whenever these companies borrow, the state guarantees the debt. As at the end of FY'2021/22, publicly guaranteed debt by SOEs stood at Kshs 145.4 bn, a 7.5% decline from Kshs 157.2 bn in FY'2020/21. To put this in perspective, the current regime targets to reduce government expenditure by Kshs 300.0 bn, and the current stock of debt guaranteed for SOEs stands at 48.4% of the austerity target. As a result, privatization of SOEs has been earmarked as a fiscal enhancement strategy and has been one of the conditions set by multilateral lenders such as the International Monetary Fund (IMF) to access concessional borrowing facilities.

Kenya privatization process has been exceedingly slow over the years, despite the previous regime earmarking 26 parastatal to be privatized in 2016, none was achieved. However, the new Kenya Kwanza regime has been keen on fast tracking the process as part of its fiscal consolidation measures. In October 2022, the new administration announced plans to privatize 6 to 10 of State Owned Enterprises (SOEs) in the agricultural, energy and financial sectors, within 12 months. As a result, a new Privatization Bill 2023 was introduced, and if approved by the parliament, it will replace the Privatization Act 2005. The bill is set to address the long ambiguous process of privatization stipulated in the privatization act 2005 by eliminating the multi-level approvals. Some of the entities lined up for state divesture by the Privatization Commission includes; the Kenya Pipeline Company, the Kenya Ports Authority, the Consolidated Bank, the Development Bank of Kenya and the Kenya Tourist Development Corporation among others. As such, the initiative is expected to revitalize capital markets and spur new listing at the Nairobi bourse. In this week's focus, we shall cover the following;

I. History of privatization of Kenya,
II. Privatization bill 2023,
III. The goals of Privatizing State Owned Enterprises,
IV. Privatization strategies and procedures,
V. Recommendations and Conclusion.

Section I: History of privatization in Kenya

After independence, many parastatals were established in order to expedite economic and social development while also addressing regional economic imbalances. However, following a comprehensive review of public enterprises performance through the Report on the Review of Statutory Boards in 1979 and the Report of the Working Party on Government Expenditures in 1982, the reports revealed evidence of prolonged inefficiency, financial mismanagement, and malpractices in many parastatals. The report further stated that private sector initiatives had been hampered due to existence of parastatals in commercial activities. As a result, various recommendations were made, including the government to divest from its investments in commercial and industrial enterprises and to transfer active participation to the private sector through shareholding. In addition, it was recommended that the government to reduce exposure to risk in areas in which the Private Sector could assume risk without government intervention.

Following the review, several measures were put in place, such as the enactment of state corporation act, the purposes of the act was to streamline the management of SOEs. Nevertheless, the strategy did not bear fruit, as most corporations' performance continued to deteriorate. The state enterprises relied on public sector finance which was not adequate. They relied on government loans that were ultimately channeled into equity, some of the state enterprises borrowed loans on government guarantees and later defaulted, requiring the National Treasury to settle the debt on their behalf. Furthermore, the entities internally generated funds were inadequate due to huge debt burdens, high expenses, non-viable ventures that siphoned away resources from the enterprises, as well as corruption and mismanagement.

In July 1992, the government outlined the scope of public sector reform Programme, the institutional framework and guidelines of privatizing State Owned Enterprise. A total of 240 commercial SOEs were classified into two categories; the first category contained 207 non-strategic SOEs that were to be privatized and the second category contained 33 strategic commercial SOEs which were to be restructured and retained under the state control. Although numerous SOEs were privatized during the first phase of the implementation of the framework, its impact was limited mainly because most of the SOEs privatized during the phase were small and self-sufficient, most large companies were considered strategic and therefore not privatized. Furthermore, there were institutional and process weaknesses associated with the programme arising from failure to entrench the procedures and accusation of corruption. There were also limited participation by individual Kenyans due to the transaction methods applied.

A new strategy, the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC) was put in place from 2003 to 2007. Under ERSWEC, a number of key privatization took place as outlined in the table below;

Cytonn Report: Government of Kenya Completed Privatizations

Company	Year	Method of Privatization	Government Share Before	Government Share After	Sector
Kenya Electricity Generating Company	2006	IPO	100.0%	70.0%	Energy
Telkom Kenya	2007	Strategic Sale	100.0%	49.0%	Telecommunication
Kenya Railways Corporation	2006	Concessioning	100.0%	100.0%	Transport
Mumias Sugar Company 2nd Offer	2006	IPO	38.4%	20.0%	Manufacturing

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Company	Year	Method of Privatization	Government Share Before	Government Share After	Sector
Safaricom	2008	IPO	60.0%	35.0%	Telecommunication
Kenya Reinsurance Corporation	2007	IPO	100.0%	60.0%	Insurance

Source: Privatization Commission of Kenya

Kenya privatization process has been exceedingly slow over the years and despite the previous regime earmarking 26 parastatal to be privatized in 2016, none was achieved. In October 2022, the new administration announced plans to privatize 6 to 10 of State Owned Enterprises (SOEs) in the agricultural, energy and financial sectors, within 12 months. In a bid to expedite the process, the Privatization bill 2023 was brought up and it is set to replace the current privatization act 2005 if approved by parliament.

Section II: Privatization Bill 2023

Recently, the Kenya Cabinet approved the Privatization bill 2023 that is set to replace the Privatization Act 2005 if approved by the parliament. The new bill is set to address the inhibiting legislative and regulatory framework provided in the privatization Act 2005 that led to long processes of approval of SOEs for privatization. Among other key objectives of the bill includes;

i. Encourage more participation of the private sector in the economy by shifting the production and delivery of products and services from the public sector to the private sector. Furthermore, broadening the base of ownership in the Kenyan economy by encouraging private ownership of entities,
ii. Improve the infrastructure and the delivery of public services through the involvement of private capital and expertise,
iii. Generate additional revenue for the government through proceeds from privatizations and reduce the demand for government resources by non-strategic SOEs,
iv. Improve the regulation of the economy by reducing conflicts between the public sector's regulatory functions and commercial functions, and,
v. Improve the efficiency of the Kenyan economy by making it more responsive to market forces and enhance development of the capital markets in Kenya.

The key provisions that have been amended include;

I. **Establishment of the Privatization Authority**: The new authority shall be responsible for advising the government on aspects of privatization of SOEs as well as implementation of the privatization programme. The authority will be headed by a chairperson appointed by the President,
II. **Privatization programme:** A new programme shall be formulated by the Cabinet Secretary for the National Treasury and approved by the cabinet, specify the SOEs identified and approved for privatization and to serve as the basis point upon which privatization shall be undertaken,
III. **Identification of entities for privatization**: The Cabinet Secretary for the National Treasury shall identify and determine the entities to be included in the privatization programme, taking into consideration the need to avoid a privatization that may result in an unregulated monopoly, the expected benefits to be gained from the privatization and sustainable development and protection of the economy.
IV. **Approval of the privatization proposal:** Upon preparation of the privatization proposal, the authority with the concurrence of the Cabinet Secretary for the National Treasury shall approve

it. This is a major change from the current process which entails different levels of approval including the consideration and approval by the parliament. Under the proposed bill, the privatization authority will have the sole power to identify a public entity for privatization, prepare the privatization proposal and approve it, thus removing ambiguity with respect to the role and functions of parliament.

V. **Methods of Privatization:** The bill proposes three methods of privatization;

- Through the initial public offering of shares which shall be undertaken in accordance with the capital markets act,
- Through sell of shares by public tendering, a new method proposed in the bill which will involve publishing the notice of invitation to tender on the sale of shares in the Government tenders' portals or on the Authority's website and in at least two newspapers of nationwide circulation. Upon closure of the tendering period, the tender evaluation committee shall prepare an evaluation report containing a summary of the evaluation and comparison of tenders which shall be approved by the Board with the concurrence of the Cabinet Secretary for the National Treasury and
- Through sale resulting from the exercise of pre-emptive rights.

Section III: The goals of Privatizing State Owned Enterprises

I. **Fiscal benefits**

Privatization has often been recommended by international organizations such as International Monetary Fund (IMF) and World Bank as a strategy of fiscal enhancement. In the medium term, it is a way of raising capital while reducing huge subsidies and bailout to loss-making SOEs that weigh on the government budget. According to the public debt management report 2021/2022, the government outstanding guaranteed debt to SOEs stood at Kshs 145.4 bn as at the end of June 2022. The SOEs that had been issued guarantees include Kenya Electricity Generation Company (KENGEN) (Kshs 34.0 bn), Kenya Ports Authority (KPA) (Kshs 33.5 bn), and Kenya Airways (KQ) (Kshs 77.8 bn). In particular, KQ defaulted on the loan repayment forcing the government to intervene and the cabinet gave approval for government to repay the loan arrears on behalf of KQ, thus weighing on government budget.

II. **Effective control**

Privatization has been widely used as a way of improving performance of SOEs. As the control of the entity is shifted from the public sector to private sector, exposing it to competitive environment forcing it to maximize returns and production. Furthermore, the company will be compelled to report in a standard format to investors on a regular basis and are susceptible to analysis and criticism from investors and analysts as such encouraging corporate efficiency.

III. **Development of capital markets**

Privatization of SOEs is one way of encouraging participation in the stock market by individual investors as well as attracting foreign direct investment and stimulate development of the private sector and financial markets in general.

Section IV: Privatization Strategies and Procedures

I. **Public Offers**

Privatization through public offers is one of the widely used methods to transfer ownership of SOEs to the private sector. It is mostly preferred since it promotes wide ownership as all members of the public are invited to participate in the offer. However, one drawback of this method is the difficulty in pricing the issue due to relatively little information available to the government or its advisors as to the likely demand of the shares.

II. **Tenders**

Pricing privatization of SOEs is usually a hard task, as such tenders are used to help in collecting market’s collective estimates of the value of the SOEs. Therefore, this method helps the government to maximize revenue as it is a superior way of estimating the value of the company compared to an individual investment banker estimates.

III. **Exercise of Pre-Emptive Rights**

This method entails giving the existing shareholders the right but not obligation to purchase additional shares in the future issue before they are offered to the public. The method is useful as it shield investors against dilution of their shares in the future, by giving them the first priority during additional issuance of a company shares.

Section V: Recommendation and Conclusion

While the proposed bill is positive, we recommend to allow for sale by a direct negotiations where an IPO, public tender and pre-emptive rights all fail to achieve a privatization. We also recommend the government to embark on measures to improve the operating efficiency of the cash strapped SOEs in order to make them more attractive to investors during privatization. As a result, the government will be able to raise decent amount of revenue from the privatization and use the proceeds to enhance public service delivery. However, in our view, the removal of the parliamentary approval stage in privatization of SOEs, might lead to lack of transparency due to lack of enough oversight and as such may limit public participation. All issues considered, we expect upon ratification of the Privatization Bill 2023 by the Parliament, the government will be able to expedite the privatization process and easily offload the non-strategic SOEs that continue to burden public expenditure. We also expect the move to spur new listings at the Nairobi bourse, which will increase activity and diversify the bourse’ offerings which will subsequently attract foreign investors.