Cytonn INVESTMENTS

The Insolvency Act - A Second Chance for Struggling But Viable Businesses, & Cytonn Weekly #50/2018

Focus of the Week

In this week's focus note, we look at the Insolvency Act 2015, and how companies that are under financial distress are using the legislation to navigate through the restructuring process, and in the process protect the interests of creditors, and other stakeholders in the company such as shareholders. Since its enactment in September 2015, a number of companies have invoked the Insolvency Act 2015, including Nakumatt Holdings, as discussed in our focus note Restructuring an Insolvent Business, A Case Study of Nakumatt Holdings, and Athi River Mining Cement (ARM) Limited, and Deacons East Africa PLC

A business becomes insolvent when its liabilities exceed its assets. However, in practice, insolvency comes about when a business cannot raise enough funds to meet its obligations as they fall due. Properly called technical insolvency, it may occur even when the value of a business' total assets exceeds its total liabilities. Mere insolvency does not afford enough ground for lenders to petition for involuntary bankruptcy of the borrower, or force liquidation of the business. Prior to the enactment of the Insolvency Act on September 11th 2015, liquidation was often the creditor's only recovery option. The Insolvency Act improved the options by providing additional alternatives such as: (i) Administration, and (ii) Company Voluntary arrangements.

Since its enactment, we have seen several insolvent companies come under administration as prescribed in the law, thereby ensuring they remain a going concern, and in the process ensure all the stakeholder's interests are protected. We shall look at the various companies that have invoked the Insolvency Act, and how it has assisted the companies' in managing their financial distress situation. As such, we shall cover the following:

i. Resolutions Mechanism Prior and After the Introduction of the Insolvency Act
ii. Case Studies, and,
iii. Our View

Section I: Resolutions Mechanism Prior and After the Introduction of the Insolvency Act

Prior to the enactment of the Insolvency Act in 2015, insolvency proceedings of both corporate entities and individuals, was dealt with under the winding-up provisions of the Companies Act, and the Bankruptcy Act. For corporations, the resolution of insolvency proceedings often involved the commencement of winding up proceeding, which involved the liquidation of the company under financial distress, and paying the firm's creditors. This effectively meant that creditors and other stakeholders in firms ran the risk of failing to recover total amounts of interest, especially in the event the company's assets failed to cover the total amounts due. Thus in an attempt to remedy this, the Insolvency Act was enacted in 2015. The Act consolidated the insolvency proceedings for both incorporated and unincorporated companies, previously under the Companies Act, and those of

individuals, previously under the Bankruptcy Act, into one document. The Act seeks to redeem insolvent companies through administration as opposed to liquidation. It focuses more on assisting insolvent corporate bodies whose financial position is deemed as redeemable, to continue operating as going concerns so that they may be able to meet their financial obligations to the satisfaction of their creditors.

The rescue mechanisms under the Insolvency Act, 2015 include;

i. Administration of Insolvent Companies,
ii. Company Voluntary Arrangements, and,
iii. Liquidation

I. **Administration of Insolvent Companies**

Administration is a fairly new development in Kenyan Law. It 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 in order to 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 the affairs, and property of the company. While under administration, creditors may undertake procedures to enforce security over the company's property, with an 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.

II. **Company Voluntary Arrangements**

Company Voluntary Arrangements were also introduced in Kenyan law by the Insolvency Act, No. 18 of 2015. This arrangement is entered into when a company is insolvent and the directors, administrator or liquidator as the case may be, make a proposal to the company's shareholders and its creditors on the best way to save the company from liquidation. However, there are restrictions placed on Company Voluntary Arrangements, with the arrangement not being an option in the case of the following:

i. banking and insurance companies,
ii. companies under administration or liquidation,
iii. a company in respect of which a voluntary arrangement has been carried out,

iv. companies in public-private partnerships, and
v. companies with liabilities of over Kshs 1.0 bn.

The Directors must appoint a person, who must be a licensed insolvency practitioner, to supervise the company for the process of implementing the voluntary arrangement. The Supervisor must within 30 days of the proposal or a longer period allowed by court, submit a report to the court detailing their opinion on the viability of the proposal and whether a meeting of the creditors should be called to vote on it and the date and time of such a meeting.

On the date of the creditors' meeting, the creditors shall appoint a chairperson who shall divide the creditors into groups of secured creditors, unsecured creditors and preferential creditors. The Creditors shall then vote either to approve the proposal as is, approve it with modifications or reject it altogether. The proposal is approved if voted for by a majority of the members and a majority of each group present at the meeting. The proposal if approved shall be binding on the company and the creditors.

III. **Liquidation**

It is also worth noting that the Insolvency Act also provides liquidation as an option, for insolvent companies. There are two modes in which a company may be wound up:-

1. Compulsory winding up by the court.
2. Voluntary winding up:-
   a. Members' voluntary winding up.
   b. Creditors' voluntary winding up.

(i) Compulsory Winding Up by the court

A company may be wound up by a court under the following circumstances.

a. The company has by special resolution resolved that the company be liquidated by the Court;
b. Being a public company that was registered as such on its original incorporation-
   i. The company has not been issued with a trading certificate under the Companies Act, 2015; and
   ii. More than twelve months has elapsed since the company was registered;

c. The company does not commence its business within twelve months from its incorporation or suspends business for a whole year;
d. Except in the case of a private company limited by shares or by guarantee, the number of members is reduced to below two;
e. The company is unable to pay its debts;
f. At the time at which a moratorium for the company ends, a voluntary arrangement made does not have effect in relation to the company; and,
g. The Court is of the opinion that it is just and equitable that the company should be liquidated.

(ii) Voluntary Winding Up

A company's members/ creditors may make an application for winding up, regardless of whether the company is insolvent or not. Under voluntary liquidation, liquidation is sought by the members or creditors of the company without the interference of the court. The purpose of voluntary liquidation is that the members and creditors are left free to settle without going to court. According to section 425 of the Insolvency Act, an application to the Court for the liquidation of a company may be made by any or all of the following:

a. The company or its directors;
b. A creditor or creditors (including any contingent/prospective creditor(s));

c. A contributory or contributories of the company;
d. A provisional liquidator or an administrator of the company;
e. The liquidator- if the company is in voluntary liquidation,
f. An Official Receiver or any other person authorized under the other the provisions of the Act, may make a liquidation application to the Court in respect of a company that is in voluntary liquidation.

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 Deacons East Africa PLC. The table below summarizes all the companies that have invoked the Insolvency Act 2015:

Companies That Have Invoked the Insolvency Act

Company	Date taken under Administration	Administrators	Approximated Debt Amount (bn Kshs)
Spencon Ltd	9th January 2017	Kuria Muchiru & Muniu Thoithi of PwC	Undisclosed
Nakumatt Holdings	22nd January 2018	Peter Kahi of PKF Consulting	35.8
ARM Cement Ltd	18th August 2018	Muniu Thoithi &George Weru of PwC	21.7
Midland Energy	16th November 2018	Anthony Makenzi &Julius Mumo of Ernst & Young LLP	Undisclosed
Deacons East Africa PLC	18th November 2018	Peter Kahi & Atul Shag of PKF Consulting	0.7

Case Study of Nakumatt Holdings

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. However, due to a number of reasons, 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.

PKF Consulting Limited (PKF) was appointed as Nakumatt Holdings' administrator. This was in order to assess the possibility that the company could be revived after a full assessment of the company, and for all creditors of Nakumatt to come forward and register their claims with the retailer.

Following the assessment of Nakumatt's financial position, the administrator determined that if a liquidation route was used, then out of the total creditors of Kshs 35.8 bn, Kshs 30.6 bn are unlikely to be paid. This represents a significant 85% potential loss to the creditors. In essence, all unsecured creditors, namely Trade Creditors, Commercial Paper Holders and Short Term Note holders, and private placement loan providers will suffer the maximum 100% loss of their debt amounts, as the available assets would first pay off secured creditors. Since the business model of Nakumatt can

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, and if deemed fit, the company shall adopt as the way forward. 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, especially suppliers, landlords, and employees. We thus concur with the creditors who rejected the deal in the current format.

We noted that the best-case scenario for all creditors is a debt to equity conversion of their creditor claims, as liquidation is not in the best interest of anyone. This should include 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 a number of 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%. Kenya Airways recently reported a 28.8% decline in loss after tax, to Kshs 4.0 bn in H1'2018 from, Kshs 5.2 bn in H1'2017 results, although registering a negative Kshs 3.8 bn equity position, from a negative equity position of Kshs 44.9 bn in H1'2017, which can partly be attributed to the positive effects of the debt to equity conversion, owing to a significant reduction in the company's debt servicing obligation.

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", with the retailer recently opening a branch along Uhuru Highway, taking up 40,000 sqft. We are of the view that this presents the best scenario for the firm's creditor's to recoup their lent amounts to the retailer.

Case Study of Athi River Mining (ARM) Cement

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, with revenue declining by 32.0% from Kshs 12.8 bn in FY'2016 to Kshs 8.7 bn in FY'2017, coupled with the rising operating expenses, which 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 was 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.

Unable to service these obligations, 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. With the administrators writing 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 any time soon, 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 are now fully covered by the current Kshs 14.2 bn asset base. The administrators have appointed Knight Frank to undertake a valuation of the company's fixed assets, amid concerns of misrepresentation, and suspicious dealings amounting to Kshs 153.0 mn. With the company currently operating at a 30.0% capacity in Kenya and 25.0% in Tanzania, it requires urgent capital injection, as it would not be sustainable for long, so as to boost its working capital position, and thereby normalize operations, and consequently improve the topline revenue, which has shrunk to Kshs 2.3 bn for the half year to June 2018. With the administrators currently engaged in the asset sales of the various subsidiaries, this would provide the company with a capital base to boost and streamline the core operations. We also note that the proposed move to look for a strategic investor may also provide reprieve, with several major companies such as Dangote Cement and Oman Based Raylat limited expressing interest in acquiring the troubled lender. The Insolvency Act has thus enabled the company to remain operational as it undertakes the turnaround strategy, focused on ensuring the company attains good financial health, and consequently improving its debt-servicing capability to its creditors.

Case Study of Deacons East Africa PLC

Deacons East Africa is a homeware and apparel retailer in Kenya that manages retail establishments, including franchise and department stores that sell ladies, men and children clothing, footwear, home-furnishings, cosmetics and sporting goods. The company started experiencing financial difficulty in 2016, on increased operating inefficiencies, as revenue lines started declining and costs rose, with revenue declining by 13.0% to Kshs 2.0 bn in FY 2017 from Kshs 2.3 bn in 2016, and operating expenses increasing by 15.4% to Kshs 1.5 bn from Kshs 1.3 bn in FY'2016. These coupled with the rising debt obligations saw the company's loss after tax widen by 166.7% to Kshs 0.8 bn in FY'2017 from Kshs 0.3 bn in FY'2016. The firm attributed the declining performance in top line revenue to declining foot traffic in various malls where it was a tenant, coupled with other factors such as the selling of Kenya's Mr Price stores to South African franchise owner Mr Price Group of South Africa, and increased competition from other retailers. The financial distress led to the company invoking the Insolvency Act, in November 2018, as the company's board resolved to place the company under administration, with the primary objective being to enable the administrators to explore the possibility of rescuing the company as a going concern, thereby achieving a better outcome for the creditors than would likely be the case if the company were to be liquidated. This saw the company appoint Peter Kahi and Atul Shah of PKF Consulting Limited as the firm's joint administrators. With the creditors meeting yet to be held and other details yet to be divulged, it is worth noting that with the firm under administration, and consequently under moratorium, the firm's debt servicing burden has been alleviated, as the administrators craft the turnaround strategy.

Section III: Our View

The insolvency Act has had two major impacts:

1. First it has afforded struggling businesses a second chance to reorganize themselves and come out stronger and viable businesses, and,
2. Secondly, it will encourage 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. Research has shown that the availability of reorganization frameworks encourages entrepreneurship.

In conclusion, we note that under the new Insolvency Act 2015, companies under financial distress have been using the legislation to ensure they remain a going concern as opposed to an outright

liquidation. With the companies under administration and under moratorium after invoking the Act, they are not subject to debt repayment obligations, as the administrators focus purely on the best possible resolution strategy to the creditors, and possibly to the shareholders. This will possibly encourage entrepreneurship, as business owners will be accorded time to restructure, and possibly regain their financial stability. This then consequently ensures that creditors and possibly shareholders recoup their lent amounts, and invested capital. The previous resolution mechanism under the Companies Act mean that stakeholders faced the possibility of a wipeout of a significant amount, especially in the event the company's assets failed to cover the liabilities. Thus given that these are the first instances of private sector insolvency restructuring in Kenya under the new Act, it is important that they are done professionally and with due care since they set a precedent for future cases.

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