Fundamentals

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The next regime's poisoned chalice

IN BRIEF

- The next regime will undoubtedly face a challenging task navigating the fiscal landscape, as it assumes office after the August general elections.
- The international bonds market remains inaccessible, albeit temporarily, and the expected alternative syndicated loan issue did not materialize in FY2022 (FY2021/2022). The lower budget execution at the tail end of FY2022, supplementary budgets notwithstanding, gave some fiscal wiggle room.
- But the harsh reality is that syndicated loan issuance, though a stop-gap measure, is not the ultimate panacea. Rate normalising implies further lift-off in the benchmark SOFR (Secured Overnight Facility Rate), which means relatively higher service costs as payments come due.
- Our assessments of the two leading Presidential contenders' manifestos leaves us with a sense that expenditures will have further upward tilt.
- Deputy President Dr. William Ruto's Kenya *Kwanza* manifesto has a costing to the various funds intended to be implemented and run until FY2027 budget. That said, we are sceptical on the realisation of the target financing. On the other hand, Rt Hon. Raila Odinga's *Azimio la Umoja* manifesto is broadly vague on financing of the coalition's pet projects.
- If we think of presidential manifestos as butterflies that cause storms in the future, the elephant in the room presently is the fuel subsidy. The can has been kicked far down the road and it will be the next regime's greatest headache.
- The manifestos are salient with 'widening of the tax base' but light on the how-to. This is compounded by the policy inertia as seen in the delay in the rollout of the Medium-Term Revenue Strategy and the launch of the National Tax Policy and pose tail risks to achieving FY2023 revenue targets.

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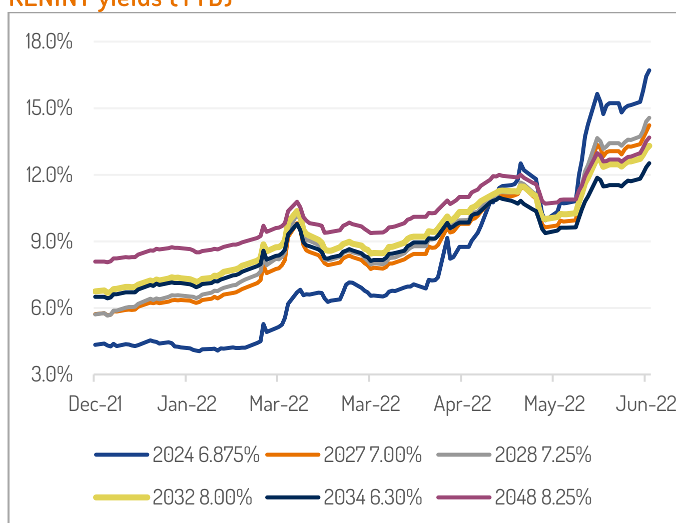
FY2022 laxity belies FY2023 challenges

The FY2023 (FY2022/2023) budget implementation comes at a challenging time when the international bond market has tightened materially. Yields on Kenya's Eurobonds galloped an average of 800bp in 1H2022, with KENINT 2024 increasing the widest by 12.38pp reflecting the near-term challenges of refinancing the outsized USD 2.0bn paper in FY2024 (FY2023/2024). Circling back and into the nascent FY2023, we see significant risks on the fiscal.

Not surprisingly, the Eurobond issuance (c. USD 1.0bn) in FY2022 (FY2021/2022) was off the cards with the authorities opting for a short-term syndicated loan to plug the budget hole. That said, the syndicated loan issuance did not materialize with the silver lining being the slow budget execution towards the tail end of FY2022. To be sure, development spending and equitable disbursements to county governments between 11M2021/2022 (July 2021 and May 2022) underwhelmed, resulting in unspent cash of KES 51.0bn (USD 436.7mn). This gave the authorities some laxity in its syndicated loan negotiations, despite the second supplementary budget that revised the budget higher by KES 70.9bn (USD 603.2bn) late last month.

KENINT yields (YTD)

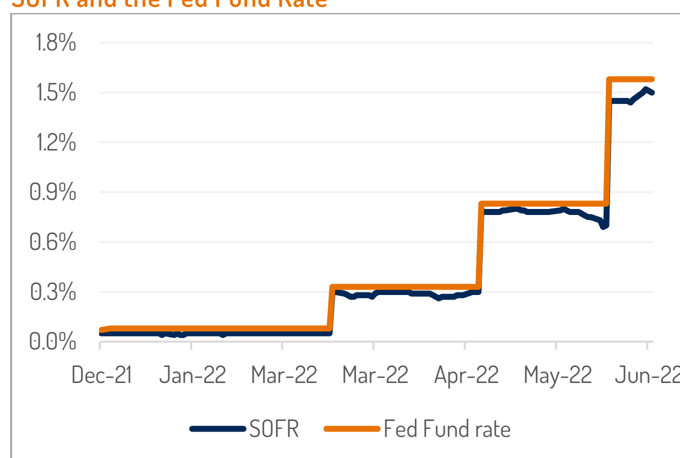


Source: Bloomberg

Rearranging deck chairs on the Titanic

However, the current FY2023 budget does not provide room for complacency. Commercial external financing is at KES 105.6bn which we think will be financed via short-term syndicated loan(s). That said, the syndicated loan financing, acknowledged as a stop-gap measure, is not the ultimate panacea to circumvent the higher service costs from a Eurobond issuance in the current environment. For one, syndicated loans have variable interest rates, SOFR (Secured Overnight Facility Rate, the potential successor to USD LIBOR) plus some premium. Nonetheless, with SOFR tracing the path of US Federal Fed fund rate, this portends further SOFR benchmark rate as the US Federal Reserve pursues its tightening. To be sure, the current Fed plot suggests some further 200bp in the second half of this year. The current tightening global financial conditions implies further premium demanded by the syndicated bankers, to run the course of the financing tenor. Thus, the external financing shift from Eurobonds to syndicated loan may not necessarily tip the apple cart of runaway debt service cost concerns. We see the authorities will be caught between a rock and a hard place as the only realistic option is to raise a loan at the short end of the curve. Nonetheless, this is at odds with the preferred lengthening of the debt maturity profile in the Medium-Term Debt Management Strategy.

SOFR and the Fed Fund Rate



Source: Bloomberg

As per its manifesto, Azimio coalition intends to restructure the debt in the event it emerges victorious in the upcoming polls. Recent comments by Raila Odinga suggests that the Chinese debt (USD 6.8bn) will be on the restructuring's chopping table. The initial market wisdom reflected concern that the Eurobonds stock will be restructured, which led to the immediate massive sell-off on KENINTs following the manifesto launch. We also think that execution risks are high for implementing a broader KENINTs' restructuring, going by the wide berth of the common framework under the DSSI (Debt Service Suspension Initiative). That said, public debt at KES 8.4tn (67.4% of GDP) has seen debt service (both interest and amortizations) cost at KES 1.4tn and posing a pressure on the overall budget. Interest costs in FY2023 stands at KES 690.6bn and on an unsustainable upward glide to FY2026 (KES 790.4bn) will continue posing a challenge for the incoming regime's first term in office.

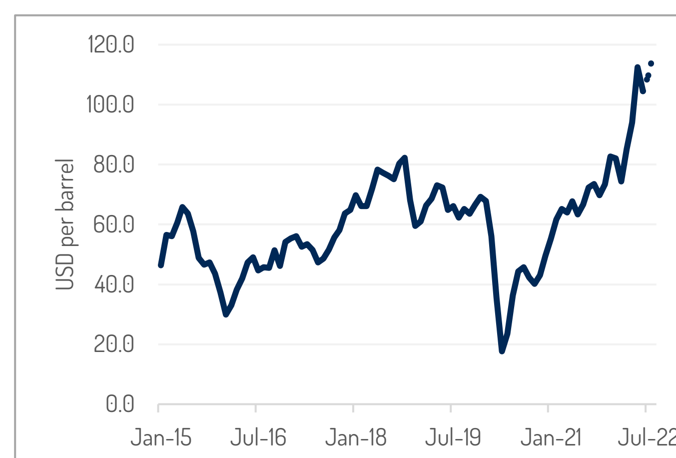
Upward tilt to FY23 budget expenditure

Kenya *Kwanza* manifesto has put a price on its pet projects at KES 250.0bn between FY2023-FY2027. The coalition identified a number of funds to implement, such as the Hustler Fund (KES 50.0bn) for affordable financing for the MSME and debt capital for start-ups, and leverage on the Universal Service Fund (KES 40.0bn) for implementation of wider ICT strategy. That said, we remain sceptical with the funding of the KES 250.0bn, as 80.0% of the financing is expected to issue from pensions' AUM (2021: KES 1.5tn). Unless there's moral suasion, we don't see pension assets deployed to government-run funds with no clear investable return. We cast doubt around the proposed securitization of verifiable domestic arrears, total stock stands at KES 434.5bn (March 2022) and comprising 20.7% of FY23 budgetary allocation to the central government

On the other hand, *Azimio la Umoja* manifesto is broadly vague on the financing of its campaign projects. Top of the list is enhanced social protection targeting the two million most poor households with a KES 6,000 monthly disbursement. This works to KES 144.0bn a year, with the how-to-fund question not properly articulated. Azimio also commits to an economic stimulus and recovery plan within the first 100 days, but the details are threadbare. The coalition further commits to a Universal Health Care program dubbed '*Baba Care*' but the plans are obscure. From our understanding, *Baba Care* seems to suggest unlimited health access which we think will balloon further the health budget (FY23: KES 122.5bn). Finally, the proposed plan of increasing equitable revenue share to 35.0% of ordinary revenue (FY23: 26.2%) will pose some upward tilt on expenditure on upcoming budgets.

If the manifestos are the butterflies that raise storms in the future, we would like to think that the fuel subsidy is the elephant in the room. Fuel subsidy amounted to KES 81.0bn in FY2022, occasioned with the steep rise in the global oil prices that had a knock-on effect on fuel pump prices. Mid-June, the National Treasury indicated plans to wean off the fuel subsidy starting in FY2023. The two leading candidates have proposed legislative tweaks to cushion against elevated fuel prices. The price stabilization fund framework, not followed through within the context of Petroleum Development Levy Order (2020), is set to be implemented by Kenya Kwanza. On the other hand, Azimio coalition intends to review the numerous taxes and levies (c. 37.2% of total fuel pump price) to bring down the fuel price. In the context that the fuel subsidy is to be completely eliminated, Kenya Kwanza's proposal may no longer be feasible. *Azimio*'s proposal for a lowering of the taxes and levies seems a more tangible proposal though risks pushback from the IMF.

ADNOC Murban[1] official selling price



[1]Abu Dhabi National Oil Company (ADNOC) Murban is Kenya's oil import benchmark

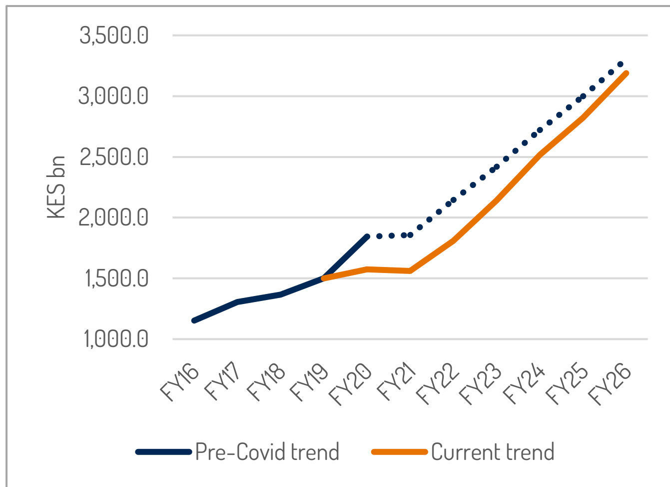
Source: Bloomberg

We also see restructuring Kenya Airways posing a big headache to the next regime. Kenya Airways was amongst the largest 18 SOEs posing the greatest fiscal risk. To be sure, the airline is to receive budgetary support totaling KES 109.0bn though FY2023-FY2026. There have been false starts in restructuring this specific SOE, with the two leading coalitions weighing with their proposals. Whereas Kenya Kwanza has committed to a time-bound (2-year) restructuring plan for the airline, *Azimio's* timeline seems to be open-ended. Nonetheless, the airline's equity position of KES 64.2bn implies continued further government support in FY2023.

Tail risks on FY2023 revenue estimates

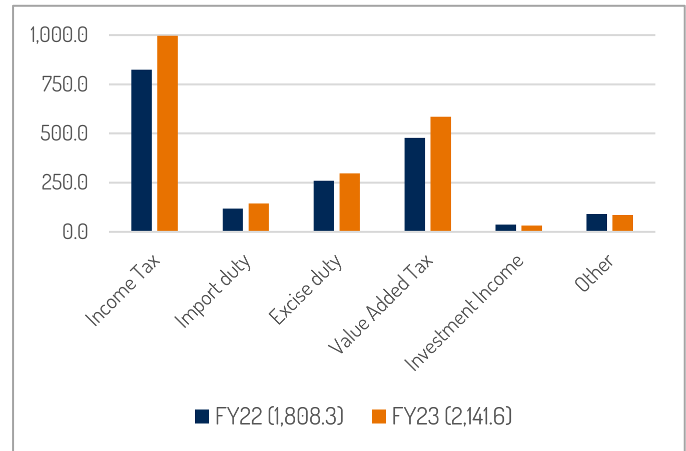
FY2023 revenue estimates are aggressive and the bar raised a tad too high. Certainly, FY2023 revenue still trail the projections before the COVID-19 shock but the estimates nonetheless have baked in an increase of KES 333.4bn (18.4% y/y) from FY2022 levels. We see the IMF's invisible hand as the current Fund's program has been pro-revenue raising measures. However, the necessary levers to ensure a realisation of the revenue targets remain unpulled. For one, the rollout of the Medium-Term Revenue Strategy, aimed at raising 0.85% of GDP in additional revenue, is past its FY2022 deadline.

Ordinary revenue



Source: The National Treasury

Ordinary revenue breakdown, KES bn's



Source: The National Treasury

The imminent launch of an updated National Tax Policy has featured in recent budgets and now comes across as hollow platitude. Rubbing salt to the injury is the ongoing campaign rhetoric that leaves us with the sense that enhanced revenue mobilisation remains a pipe dream. The manifestos of the two leading presidential camps are salient with 'widening the tax base' but the lingering how-to and attendant timelines remain light. Azimio manifesto has gone a notch further with tax sweeteners to MSMEs; lower tax burden in general and tax holiday for startups.

Conclusion: Negative surprise to the fiscal deficit

The upward recalibration of the public debt limit to KES 10.0tn (from KES 9.0tn) gives some wiggle room for implementation of FY2023 budget. To be specific, with public debt estimated at KES 8.6tn in FY2022, the borrowing space was narrow with a ceiling of KES 400.0bn under the previous debt limit. The increase ceiling gives the much-needed wiggle room to accommodate the KES 862.5bn financing throughout the FY2023 budget cycle. That as it may be, we see this fiscal deficit as the base case with odds tilted to the downside. A combination of higher expenditure needs for the incoming regime coupled with less credible revenue raising strategies implies negative surprise on the baseline fiscal deficit (FY2023: -6.2%). In as much as Kenya Kwanza's revenue and expenditure rule - revenue capped at previous three years' average growth while expenditure growth capped at 75.0% of the revenue growth – is applauded, the competing expenditure demands lowers its credibility.

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