Moody's downgrades Kenya's rating from B3 to Caa1

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On 08 July 2024, Moody's downgraded Kenya's long-term foreign currency and local currency issuer ratings and senior unsecured debt ratings from B3 to Caa1 (with a negative outlook). This was the second Moody's downgrade in fourteen months following the downgrade from B2 to B3 in May 2023. On a comparable basis, Moody's credit rating is two notches lower than Fitch Ratings and S&P (both B- rated), with the next scheduled rating action penciled for 02 August and 23 August, respectively. Although Kenya's rating now stands at par with Egypt and Nigeria (Moody's rating scale), the retention of negative outlook amplifies the fiscal strains that the sovereign faces in the near-term, against the momentum in reforms being implemented by the two comparable countries that underpin the positive outlooks of their Caa1 rating.

Highlights Moody's rating downgrade

- Moody's flagged the diminished capacity in implementing revenue-based fiscal consolidation following the fallout from the recent street protests that led to the shelving of the Finance Bill 2024 that targeted to raise KES 346.7bn.
- The ratings agency also raised concerns on implementing an expenditure-driven fiscal consolidation. The proposed spending cut in FY25 budget has been pegged at KES 177.0bn (1.0% of GDP), with President Ruto leaning towards discretionary-based budget cuts.
- The negative outlook underpinned by larger financing needs, which increases liquidity risk for the Treasury. Moody's expects the FY25 fiscal deficit to overshoot the authorities' FY25 budget target of 3.3% to settle at 4.6% with the authorities increasing borrowings to offset the revenue shortfall arising from shelving the Finance Bill 2024.

Our views:

Did Moody's front run the downgrade? We also expect Fitch Ratings and S&P to downgrade in August 2024

- From a FY25 budget perspective, recent fiscal developments cast doubt on the FY25 budget targets and eventual outturn. As such, the anticipated approval of the prolonged IMF's seventh review of the current programme remains in limbo, largely on account of the fuzzy fiscal targets for the outlier eighth and ninth reviews, scheduled for November 2024 and March 2025, respectively. This delayed IMF approval, and the lack of clarity of the fiscal targets for the subsequent reviews, has been the canary in the coal mine but the markets, in our view, have been patient for the white smoke from the IMF. This has raised market perception of a 'premature' downgrade by Moody's.
- This notwithstanding, Moody's seems to have taken the cue from the authorities' latest guidance in penciling the revised FY25 budget targets. President Ruto announced the offsetting mechanism following the shelving of the Finance Bill 2024 that targeted to raise KES 346.7bn (1.9% of GDP), including a spending cut to the tune of KES 177.0bn and an increase in borrowing of KES 169.7bn (1.0% of GDP). Moody's views a much-constrained wiggle room to introduce tax proposals in outer years following the youth revolt, derailing the fiscal consolidation that is revenue-raising biased as outlined in the current IMF programme.
- Nevertheless, FY24 revenue outturn sways our conviction of a much deteriorated fiscal. Tax revenue in the first eleven months of FY24 came in at KES 1,928.8bn, way below the target of KES 2,495.8bn, necessitating the FY24 Supplementary Budget II that lowered the target by KES 250.0bn. Although the Kenya Revenue Authority (KRA) reported an 11.1% y/y growth in Exchequer revenue of KES 2,223.0tn in FY25, terminology differences make it harder to reconcile the FY24 tax revenue outturn for now with the usual monthly National Treasury fiscal updates in the Kenya Gazette. The lower FY24 revenue base makes the targets in FY26-FY28 ambitious but the publication of KRA's 9th corporate plan will give us a glimpse of how the authorities would square this circle.
- We expect downgrade decisions from Fitch Ratings and S&P in their next scheduled ratings on 02 August and 23 August, respectively, in tandem with Moody's latest decision and to maintain the one-notch differential. The two rating agencies will have a better sight of the revised FY25 budget as Parliament will have resumed from recess, although the revised fiscal targets under the IMF programme remain highly uncertain.

Revision of FY25 budget takes shape amidst conflicting guidance by the authorities with a race against time to pass the necessary revised budget laws

- President Ruto's press briefing last Friday leaned heavily on discretionary cuts, underpinning the resolve towards implementing further austerity to the tune of KES 177.0bn in FY25 budget. Nevertheless, a National Treasury circular suggested a spending cut of KES 155.8bn to the national government and implying that the county governments will bear downward adjustment in the order of KES 21.2bn. Notably, the spending cut to be borne by the national government is heavily biased towards development spending at KES 124.0bn and in sharp contrast to the President's broad contours of the austerity plans. Cuts on development expenditure have been the path of least resistance in the recent past and magnifies the lack of political will to thrash out public finance wastage that plagues recurrent expenditure.
- As to the timelines of effecting the revision of FY25 budget, we are of the view that this will be finalized in late August, at the very earliest. The National Assembly will return from recess on 23 July 2024 and the first order will be regularizing the President's memorandum that shelved off the Finance Bill 2024. We also expect the tabling of the FY25 Supplementary Budget Estimates I, which once approved, will allow the passage of the required Supplementary Appropriations Bill. The National Assembly will also make amendments on the Division of Revenue Act (DoRA) 2024 that had initially provided for equitable division of ordinary revenue of KES 2,948.1bn between the national government and county governments but is expected to be revised lower to KES 2,570.5bn following the shelving of Finance Bill 2024. The referral of the County Allocation Bill (CARB) 2024 implies that the county allocation of KES 400.1bn will also be revised lower. The passage of these necessary laws should end in late August, in our estimates, with amendments to DoRA 2024 and CARB 2024 requiring input from the Senate. If the fast tracking of the third reading stage of the Finance Bill 2024 is anything to go by, the necessary legislative adjustments should end by mid-August in the best case.

Moody's is concerned with elevated domestic borrowing rates even as we see near-term impact of the downgrade derailing potential USD-denominated KENINT issuance

- In line with Moody's, we see that the expected increased borrowing will be borne in the domestic market. We see less capacity to adjust the net external borrowing in FY25 budget that has been penciled in at KES 333.8bn or USD 2.6bn at the current exchange rate. Barring the IMF programme going offtrack, loans from the World Bank Development Policy Operation (DPO) and the disbursements from the IMF for the remaining seventh to ninth reviews were pegged at a cumulative USD 2.1bn. As we do not see scope for an increase in these multilateral and bilateral financing, we thus expect increased borrowing to filter into the domestic market.
- Although the net domestic borrowing is expected to decline from a target of KES 723.9bn in FY24 on the back of the Supplementary Budget II Estimates to a revised KES 447.3bn in FY25, the optics of upward mid-year budget adjustments are a drag to fiscal consolidation efforts and likely to see domestic rates elevated longer. That said, with inflation and KES performing better in 1H2024, we expect that Kenya's monetary easing cycle will start in August 2024 in our best case and October 2024 in our base case. A lower domestic rate environment will act as the pressure valve to curb interest service costs that comprises a quarter of the FY25 budget expenditure.
- KENINT 7.25% 2028 traded with 578.8bps Z-spread against 488.6bps and 543.7bps Z-spread in EGYPT 6.588% 2028 and NGERIA 6.125% 2028, respectively, in yesterday's trading session. Although these three Sovereigns are Caa1 rated, the ongoing reforms in Egypt and Nigeria underpins their positive outlooks. Egypt has pivoted to non-USD hard-currency issuances since February 2023 while Nigeria plans to tap the international market later this year from media reports. Kenya's FY25 budget has not explicitly baked in Eurobond under the planned external commercial debt issuance size of USD 1.3bn, but we think they may rely on syndicated loan issuance and/or a debut Samurai bond issuance to refinance the USD 814.0mn external commercial debt amortization.

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