

# DEBT FINANCING STRUCTURE WITHIN THE STATE-OWNED CORPORATIONS IN KENYA

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## Abstract

The current public sector financial management reforms agenda within the state-owned corporations in Kenya aimed at integrating and aligning their performance to vision 2030, has not yet achieved the traction required. This study, therefore, examined the different types of debt financing strategies applied by the various state-owned corporations in Kenya, in comparison to those applied by state-owned corporations from developed and developing economies. The study specifically revealed that private debt financing, through bank loans and payables is commonly used amongst Kenyan state-owned corporations. While, most state-owned corporations from developed and developing economies, such as in America, Europe, Asia and South Africa, use public debt financing, through financial securities, traded in both domestic and international capital markets.

**Keywords:** Debt Financing, Debt Financing Theories, Public Debt, Private Debt, Capital Markets

**JEL classification:** G32

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## 1. Introduction

Kenya's recently developed public sector performance contracting system is supposed to improve efficiency and accountability within the state-owned corporations. The first medium-term 2008 – 2012 of vision 2030, which articulates government's commitment to facilitating public sector growth through enhanced good governance, makes the study of debt financing within the state corporations in Kenya important. The adoption of performance standards within the state-owned corporations in Kenya, aimed at integrating and aligning their performance to vision 2030, has not yet achieved the traction required (Republic of Kenya (2013: xii-xiv). Therefore, there should be a clear developed and enforceable strategic plans, such as debt financing strategies, and performance plans for the state-owned corporations in Kenya. The debt financing strategic plans would facilitate alignment of corporate mandates of state-owned corporations in Kenya with national development projects, which are linked to the Kenyan vision 2030.

Further, the first phase of the reform agenda of state corporations, under the umbrella of public sector reforms' programme in Kenya, has witnessed five state-owned corporations being privatised, and

several more, from hotels to banks, have been scheduled to be privatised (Seymour 2011: 45). However, many of Kenya's state-owned corporations are in considerable debt, which reduces their value in the process of privatisation. Phase two of the reforms, which was launched in 2006 and still in progress, witnessed a series of ministerial and segmental initiatives that led to the introduction of governance reforms, especially on public sector financial management, including debt financing policies and performance based management (Marwa and Zairi 2009: 36).

The Kenyan presidential report (Republic of Kenya (2013: xii-xiv) further noted that, in 2011/12, eleven income generating state owned corporations made losses, compared to twelve in 2010/11 and sixteen in 2009/10. This represents 21%, 23% and 31%, respectively of all income generating state-owned corporations. Highlighting the debt financing patterns, the report observed that the pattern of accumulation of publicly guaranteed debt financing to state-owned corporations in Kenya shows a decline in 2007 from 2006, but has been on an upward trend since then. This indicates that financial performance of state-owned corporations in Kenya has been increasing while their debt financing levels have been on the rise since 2007. Consequently, this study

attempted to analyse the different types and extent of debt financing used by the various income generating state-owned corporations in Kenya for five year period 2007-2011.

The main aim of the study was to investigate the debt financing strategies within the state-owned corporations in Kenya. Particularly, the study attempted to answer two main questions under the debt financing strategies within the state-owned corporations in Kenya. Firstly, what are the different types of debt financing used by state-owned corporations in Kenya and how do they compare with those used from developed and developing economies? Secondly, what is the extent of use of debt financing within the state-owned corporations in Kenya?

## **2. Financing within State-Owned Corporations**

State-owned corporations are believed to be less efficient than their private counterparts (Ramstetter and Ngoc 2013: 28). The managers of state-owned corporations are constantly tempted to base decisions, including debt financing, on political rather than market criteria, and strategic state investment may be misdirected because of simple miscalculation ((Fukuyama 1995: 96); (MacCarthaigh 2011: 215)). The financing decisions of state-owned corporations are unique compared to the private sector corporations. The decisions are made by the Chief Executive Officers (CEO) with technical advice from the finance managers or officers. If the intended borrowing involves a large amount, then the financing strategy must be approved by the Board of Directors or the Cabinet Secretary or Minister in charge of the state owned corporation ((Palcic and Reeves 2013: 121); (OECD 2005: 21)).

Most state-owned corporations get their financial resources from foreign governments, from the private sector, from the revenue generated internally and from their own governments in the form of bona fide loans (Gantt and Dutto 1968: 115). In addition to these sources of finance, some of them also get central government or international grants which they treat as increase in equity. The financing practice of state corporations also varies from one country to another and from one corporation to another. In addition, Adamolekum (1999: 40) argued that financing within state-owned corporations has also been a critical issue in most countries, particularly because of the strong linkage between finance and autonomy. It is, therefore, important to analyse the types of debt financing used within the state-owned corporations.

### ***Debt-financing sources within the state-owned corporations***

Debt financing is the main element of external financing for corporations raising extra funds after creation (Baltacı and Ayaydın 2014: 53). Huyghebaert, Qj and Lijian (2014: 31) argued that given the decision to access external financial markets and institutions, state-owned corporations, like any other corporation, would have preference for debt financing over equity financing. This makes debt financing through bank loans and stock market debt securities or instruments, such as bonds and notes, a common practice within state-owned corporations. The decision to finance either through bank loans or stock market debt instruments is influenced by the state of the national security markets and the cash deficit or requirement within an individual state-owned corporation (Huyghebaert, Qj and Lijian 2014: 31).

In general, for debt financing, lenders and the board frequently assume that there is an implicit government guarantee on debts of state-owned corporations (OECD 2005: 21). The OECD guidelines argued that this situation has, in many instances, led to excessive indebtedness, wasted resources and market distortion, to the detriment of both lenders and the taxpayers. Therefore, state-owned corporations should face competitive conditions regarding access to finance and their relations with state-owned banks, state-owned financial institutions and other state-owned companies should be based on purely commercial grounds (OECD 2005: 21). In other words, as a general principle, the government should not give an automatic guarantee in respect of debt financing of state owned corporations (OECD 2005: 21).

## **3. State-owned corporations in Kenya**

State-owned corporations in Kenya, as in most African countries, are organisations that are set up as corporate bodies and as part of the government agencies for commercial or commercial-like purpose (Dresang and Sharkansky 1975: 163; Adamolekum 1999: 28). They are commonly referred to as state corporations or parastatal, and have remained an important part of the Kenyan public sector since colonial period (Dresang and Sharkansky 1975: 166). Kenyan presidential report, Republic of Kenya (2013: xii-xiv), data shows that the output of state-owned corporations to GDP, in nominal terms, has been increasing from 9.54% in 2008/2009 to 11.64% in 2010/2011, based on internally generated income.

## **4. Methodology**

The study used a combination of the descriptive and explanatory research design. It applied a hybrid of cross sectional and longitudinal quantitative surveys. Rindfleisch, Malter, Ganesan and Moorman (2008: 276), in their study of cross-sectional versus longitudinal, argued that both the designs have

limitations and a combination will give a strong output. Therefore, the combination of the techniques allowed the researcher to investigate types and extent of debt financing across state corporations and also get the trend over a period of five years from 2007 to 2011.

The population of this study was defined in terms of the number of state-owned corporations established by the Acts of Parliament in Kenya as at June 30, 2011. The population frame data was from the office of the Inspector General in charge of state corporations under the Ministry of Public Service in the office of the Prime Minister of Kenya. According to this data, there are 206 established state-owned corporations in Kenya, out of which 50 are income-generating corporations. Hence, the target population for this study was made up of the 50 income generating state owned corporations in Kenya as at 31<sup>st</sup> December 2011.

The sample size for the study is made up of all the 50 income generating corporations, selected from the general population using stratified non-probability sampling technique. The non-income generating corporations are excluded from the study, since their financial performance is not profit based and may not be influenced by market oriented decisions, such as debt financing strategies. Struwig and Stead (2013: 116), argued that the non-probability sampling technique should be used in special cases, usually when the population has much in common, like in this case income generating state-owned corporations.

The study used two measuring instruments to make the results valid and reliable as per the content and predictability of the research. The questionnaire together with the information from the financial statements was used to measure the variables across the state-owned corporations. In addition, ratio analysis was used to measure the variables from the financial statements over the five year period. Most

of the study variable measures were extracted from the financial statements of the state-owned corporations for the five-year period 2007-2011. The information from questionnaires and the state owned corporations' official websites were used to give clarity, especially on the different types of debt financing, where the financial statements were not specific.

## 5. Results

The study analysed the different types of debt financing used by the various state-owned corporations using the data from state-owned corporations presented in Kenya and from developed and developing economies. The convenience sampling technique was used to select data for the income-generating state-owned corporations from different developed and developing economies. The convenience sampling technique was applied since the data was extracted from the financial statements of income-generating state-owned corporations, subject to availability on their official websites (Altinay and Paraskevas 2008: 95).

### **Types of debt financing: Kenyan perspective**

The results illustrate that debt financing is a common practice within state-owned corporations in Kenya. Table 5.1 illustrates the types of debt financing used by the income-generating state-owned corporations in Kenya, showing the number of corporations using each type and the percentage usage. The data used in these analyses was extracted from the financial statements of the state-owned corporations. The table show that trade payables and bank loans are the most common types of debt financing used by state-owned corporations in Kenya.

**Table 5.1.** Types of debts usage-Kenyan perspective

Type of debt financing	Number of corporations using	Percentage of corporations using (%)
Trade payables	40	100.0
Other payables	40	100.0
Bank overdrafts	26	65.0
Loans from local financial institutions	24	60.0
Provisions	21	52.5
Loans from the government	16	40.0
Deferred tax liability	13	32.5
Loans from international financial institutions	12	30.0
Dividend payable	10	25.0
Bonds	2	5.0
Finance lease	2	5.0

The tables also demonstrate that over 60% of the state-owned corporations use loans which are either from the local financial institutions, international

institutions or from the government. This finding confirms the argument of Frank and Goyal (2009: 156) that debt neither vanishes from corporate

accounts nor explodes to overwhelm equity. It is also an indication that low performing state-owned corporations may be using more of loans either from government or any governmental agencies.

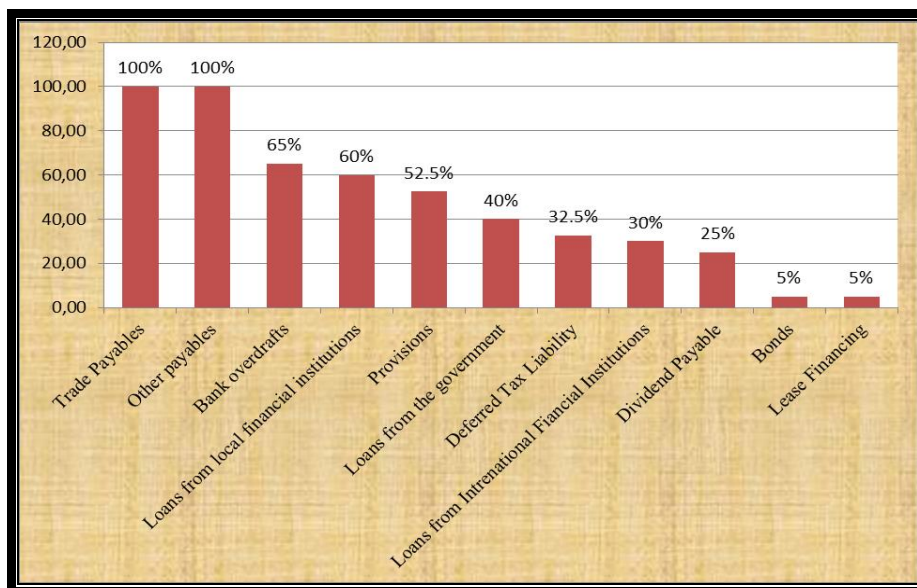
Interestingly, summary descriptive statistics shows that the mean of the ratio of loans from international financial institutions (0.3526) is greater than the mean of loans from either the government (0.2309) or from the local financial institutions (0.0785). This result indicates that large amounts of loans are obtained by the state-owned corporations in Kenya from foreign financial institutions on the basis of political connections and the government as guarantor. In addition, the results demonstrates that state-owned corporations prefer short-term credits, through trade and other payables, more than long-term loans from the local banks. The mean ratio of trade and other payables of 0.2797 are much higher than that of loans from the local financial institutions of 0.0785. This may be an indication that state-owned corporations, which cannot access the government guaranteed loans, would rather use trade and other payables rather than expose the investment activities of the corporations for monitoring by the local financial institutions. It is a sign of state-owned corporations in Kenya perusing the agency cost theory of debt financing.

Table 5.1 observes that all the state-owned corporations in Kenya use trade and other payables as a form of short-term credits. It also highlights that, though the loans from international financial institutions are of large amounts, few state-corporations are privy to this kind of source. Only 30% of the state-owned corporations used the source during the period of study. On the other hand, 65% used loans from local financial institutions, and 40% percent used direct loans from the government.

The other types of debt financing, used by Kenyan state-owned corporations, apart from loans and payables, include bonds, lease financing, provisions, deferred tax liability and dividend payable. Table 5.1 shows that the bond type of debt financing is being used by only 5% of state-owned corporations. This result indicates that stock market debt instruments (public debt) are not common types of debt financing amongst the state-owned corporations in Kenya. This may be because of the under-developed capital market in Kenya and the fear of the politically appointed managers to expose their investments for monitoring by the debt investors (Frank and Goyal 2005: 154; Randa and Gubbins 2013: 15). These results are further presented graphically in Figure 5.1, which presents the percentage of the number of state-owned corporations using the various types of debt financing in Kenya.

Figure 5.1, shows that private debt, from both local and international financial institutions, is the common types of debt financing used by the state-owned corporations in Kenya. In addition, Figure 5.1 and Table 5.1 show loans from the government at 40%, with 16 state-owned corporations using this type of debt financing strategy. Hence, it implies that the agency theory may be the best explanation of debt financing strategies applied by most state-owned corporations in Kenya (Jiraporn *et al.* 2012: 210; Chen *et al.* 2013: 755). Further, unlike most of sub-Saharan Africa banks, Kenyan banks have been experiencing low liquid assets reserve requirements over the last decade, allowing them to expand credit facilities to organisations such as state-owned corporations (Nketcha Nana and Samson 2014: 33 & 36).

Figure 5.1. Percentage usage of types of debt financing in Kenya



The scenario is confirmed by the results of the data from the study questionnaires presented in Table 5.2. Table 5.2 presents the frequency and percentage response to the questionnaire question on how the state-owned corporations' investments are financed.

The table confirms further that, apart from loans and debt instruments in the stock market, the state-owned corporations also prefer to use internally-generated funds and grants from the government or international organisations.

**Table 5.2.** Ways of financing investments of state-owned corporations in Kenya

	Frequency	Percent	Valid Percent
Internally generated funds	14	56	56
Borrowings from the banks	13	52	52
Borrowings from international organisations	6	24	24
Grants form government or international organisations	6	24	24
Government (budget) allocations	5	20	20
Borrowing from the government	3	12	12
Debt instruments in the stock exchange	2	8	8

This is an indication of the pecking order theory. However, Table 5.2 shows that state-owned corporations prefer using internally-generated funds, followed by debt, in terms local and international loans, and equity, in terms of grants and government allocations. The debt instruments in the stock exchange, which should also follow after internally-generated funds, with other debt forms, like loans, ranks last, which contradicts the pecking order theory. This indicates a sign of the agency costs theory, since more use of debt from the stock exchange exposes the investments of the state-owned corporations to the debt providers (Frank and Goyal 2005: 154; Randa and Gubbins 2013: 15). The agency cost theory was further confirmed by the response on the question of the banks from which the managers prefer to borrow. From the results, 62.5% of the state-owned corporations prefer borrowing from the government-owned banks, while 37.5% preferred non-government owned banks. This result indicates that even when the state-owned corporations use loans, they would not like to expose their investments to non-government institutions.

The response to the question of whether the state-owned corporations are allowed to issue debt instruments in any capital market indicates why the stock markets' debt instruments are not types of debt within the corporations. The result shows that 26% of the respondents agree that they are allowed to issue debt instruments in the stock markets. In contrast, 43% showed that they are not allowed and 31% were not sure. The results indicate that the managers of 76% of the state-owned corporations are not aware of the fact that the Public Financial Management Act number 18 of 2012 allows them to access stock market debt financing (Republic of Kenya 2012: 930).

**Types of debt financing: perspective of developed and developing economies**

There are common problems associated with international comparisons of corporate sector

strategies, such as the valuation of assets, the treatment of reserves and classification of liabilities (Mayer 1990: 308). Consequently, this study, in an attempt to analyse the types of debt financing used by state-owned corporations from developed and developing economies, focused only on the types of liabilities shown on the financial statements of some state-owned corporations across the continent of America, Europe, Asia and Africa. The analysed results were presented in Table 5.3 across the continents as follows.

**America**

American state-owned corporations have a diversified debt financing base of domestic and international investors (United States Securities and Exchange Commission 2013: 111). According to the report, purchasers of state-owned corporations' debt securities are geographically diversified and include fund managers, commercial banks, pension funds, insurance companies, foreign central banks, corporations, state and local governments, and other municipal authorities. In both the USA and Canada, types of debt financing within state-owned corporations, as shown in Table 3, include long-term and short-term debts.

According to the financial statements of these state-owned corporations, the long-term debts include both local and international bonds, which are either referred to as debt securities, notes or debentures. They also include derivative financial instruments and preferred stocks, which are traded in both the local and international capital markets. Other long-term liabilities like finance lease, provisions, pension liabilities and deferred tax liability are also common, especially under Canadian state-owned corporations. The short-term debts, on the other hand, include trade and other payables, local discount notes and foreign exchange discount notes. Therefore, a common general type of debt financing in America is public debt financing, with very rear bank loans, since their

capital markets are more developed (Chen *et al.* 2013: 755).

**Table 5.3.** Types of debt financing: developed and developing economies’ perspective

Type of debt financing	America	Europe	Asia	Africa
Short-term debt				
Trade and other payables	√	√	√	√
Bank overdrafts		√		√
Commercial papers		√	√	√
Local discount notes	√			
Foreign exchange discount notes	√			
Long-term debt				
Loans from local financial institutions		√	√	√
Loans from International financial institutions			√	√
Loans from the government			√	√
Domestic debt securities (bonds, notes or debentures)	√	√	√	√
International debt securities (bonds, notes or debentures)	√	√	√	
Derivative financial instruments (swaps, options and forward contracts)	√	√	√	√
Finance lease	√	√	√	√
Provisions	√	√	√	√
Pension liabilities	√	√	√	√
Deferred tax liability	√	√	√	√

### Europe

Unlike in America, as shown in Table 3, European state-owned corporations have bank loans featuring in most of their financial statements. It is believed that private debt, such as bank loans in a developed economy, with advanced capital markets, improves the country’s economic growth (Choong *et al.* 2010: 108; Agbloyor *et al.* 2014: 138 & 151). The may be the reason why private debt, like bank loans, is still common amongst European state-owned corporations although these economies have efficient and active capital markets. The common public debts used amongst the European state-owned corporations are derivative financial instruments, which mostly consist of swaps and forward foreign exchange contracts. In addition, they also use debt securities (either loan notes or medium-term loan notes), finance lease, provisions and pension and deferred tax liabilities. The other unique type of debt financing used, under short-term debts, is the commercial papers, which are traded both in the local and international capital markets. The other short-term debts used by state-owned corporations in Europe include bank overdrafts and trade and other payables.

### Asia

Table 5.3 also shows that Asian state-owned corporations use different types of debt financing under long-term debts and short-term debts. The various financial statements from these state-owned corporations indicate that bank loans, from local

financial institutions, international financial institutions and governments, are common types of long-term debts being used. In addition, public debts, such as bonds and derivate financial instruments, and commercial papers, are also types of debts used in Asia, particularly in Japan and India. The other types of long-term debt include finance lease, provisions, and pension and deferred tax liabilities. However, trade and other payables also appear under Asian state-owned corporations, as a common type of short-term debt. It is noted that public debt, such as bonds, derivative financial instruments and commercial papers, appear to be common types of debt used by Asian countries, such as Japan, whose capital markets are more developed (Choong *et al.* 2010: 108). Nevertheless, developing Asian countries, such as India and Indonesia, also use local bonds (convertible and non-convertible), but not as much as private debt.

### Africa

South Africa is classified under developing economies and its capital market is slightly better than the Kenyan capital market. Table 5.3 shows that most state-owned corporations in a developing economy in Africa (South Africa) also use types of public debt, such as bonds, commercial papers and derivate financial instruments, like swaps, options and forward foreign exchange contracts. However, since most African countries are categorised as underdeveloped economies, the long-term debts of state-owned corporations are dominated by bank loans, either from local financial institutions,

international financial institutions or from the government (Nielsen 2011: 41-44). Other long-term debts, such as provisions and pension and deferred tax liabilities are also common amongst African state-owned corporations. All the same, as it is a common practice world over, all African state-owned corporations also use bank overdrafts and trade and other payables as part of their short-term debt financing. In Kenya, 20% of the state-owned corporations used only the bank overdrafts and trade and other payables as the type of debt financing strategy.

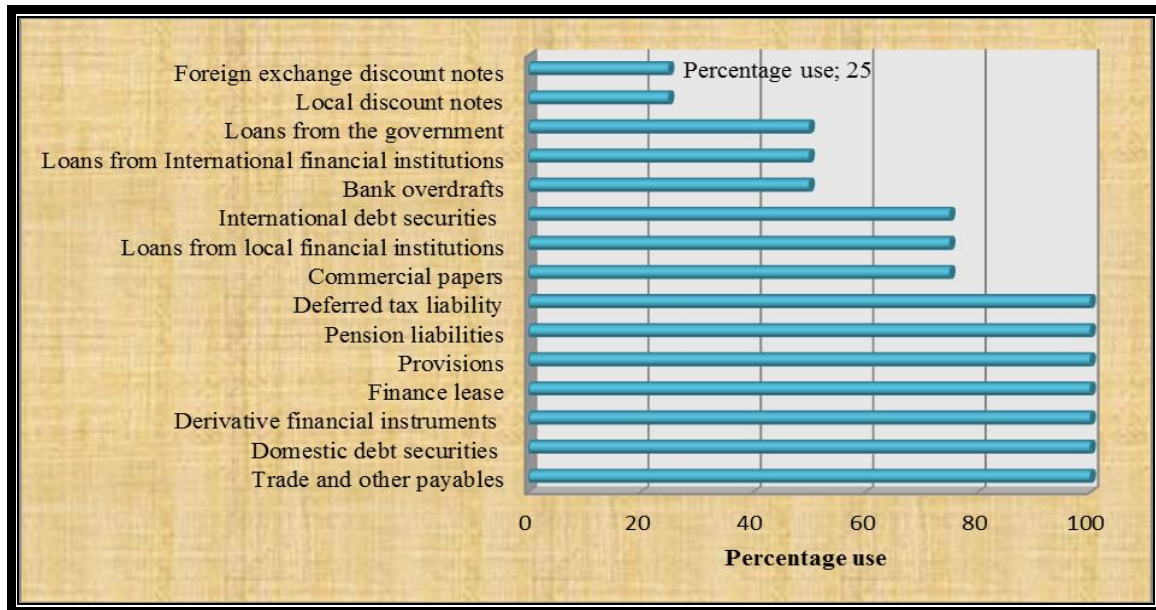
**Extent of debt financing within the state-owned corporations**

Figure 5.2 shows the overall percentage usage of common different types of debt financing across the five continents (America, Europe, Asia and Africa). Generally, trade and other payables are the common type of short-term debt used by all the state-owned corporations across the five continents, indicating 100% continental usage. On the other hand, the other types of short-term debt, such as commercial papers, bank overdrafts and discount

notes, are not common across all the continents. Only 75 % of the continents show the usage of commercial papers and bank overdrafts amongst their state-owned corporations, while, both the local and foreign discount notes are used within 25% of the continents.

Figure 5.2, further, shows that the types of long-term debt commonly used by state-owned corporations amongst the five continents include domestic debt securities, derivative financial instruments, finance lease, provisions, and pension and deferred tax liabilities. All types of loans, either from both local and international financial institutions or from the governments, are not used commonly in all the five continents. The usage of loans from local financial institutions within the state-owned corporations is at 75% of the continents. Loans from both international financial institutions and governments only appear as a type of state-owned corporations' debt financing within 50% of the continents. In general, Figure 5.2 shows that the types of debt financing used by state-owned corporations from developed and developing economies are almost similar, with very few variations, especially on extent of usage.

**Figure 5.2.** Percentage usage of types of debt financing across the continents



In order to further understand the debt-financing levels within the state-owned corporations in Kenya, the aggregate levels of individual types of debt financing during the five-year period from 2007 to 2011, are illustrated in Figure 5.3. The figure

represents the levels of average figures for different types of debt used by the state-owned corporations in Kenya as a fraction of total assets for the five-year period from 2007 to 2011.



Figure 5.3. Aggregate levels of individual types of debt financing

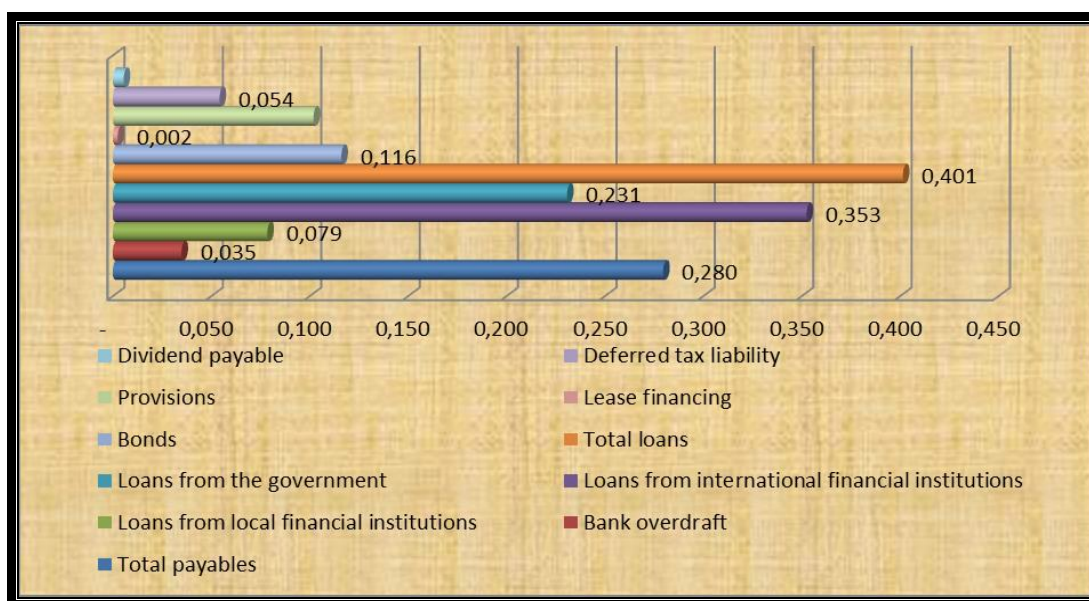


Figure 5.3 shows that the average levels of bank loans, in total, were higher than all the other types of debt, such as bonds and total payables, during the five-year period from 2007 to 2011. It is further observed that loans from international financial institutions were higher (0.353) than the loans from the government (0.231) and loans from local institutions (0.079). These results indicate that the state-owned corporations in Kenya prefer borrowing from financial institutions, since the local commercial banks' interest rates in Kenya have been higher than most of the international banking rates during this period. Further, the state-owned corporations in Kenya may be using more of loans from international financial institutions as a foreign exchange rate risk hedging strategy

Figure 5.3 also shows that the levels of trade and other payables (0.280) were equally high during this period, second to loans from international financial institutions. On the other hand, the levels of bonds (0.054) and lease finance (0.002) are on the lower levels, though the level of bonds is, to some extent, higher than lease finance. This may be an indication that state-owned corporations in Kenya are starting to appreciate financing through debt securities, such as bonds. Aggregate bank overdraft level (0.035) was not very high, but Figure 5.3 indicates that it is also a type of debt financing used by some state-owned corporations in Kenya.

## Conclusion

It can be concluded that the results suggest that state-owned corporations in Kenya prefer to use more bank loans than capital market instruments in financing their investments. Further, they borrow huge sums from the international financial institutions and the

government, which are greater than the sums borrowed from the local financial institutions. The Kenyan bond market is believed to be underdeveloped and inefficient making it unpopular as a borrowing place for the state-owned corporations in Kenya. The result also revealed that very few managers (26%) are aware that the corporations are allowed by the Public Financial Management Act, number 18 of 2012, to access the bond markets (Republic of Kenya 2012: 930).

In contrast, it can be concluded that the capital markets of the developed economies in America, Europe and part of Asia are more efficient and active (Choong *et al.* 2010: 108). Public debt (capital market debt securities), such as bonds, notes and debentures, and derivative financial instruments, such as swaps, options and forward contracts, are commonly used as debt financing strategies within these economies. These types of debt financing have become common amongst the corporations of these economies, including their state-owned corporations. Therefore, the results from the developed and developing economies indicated many similarities with the common types of debt financing used by private-sector corporations highlighted under literature findings. This may imply that the desired public-sector financial-management reforms, under the state-owned corporations, have been embraced positively by the governments from these economies. The management of their state-owned corporations have been left to compete effectively with the private-sector counterparts in the area of debt financing.

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