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Kenya: Law & Practice and Trends & Developments

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KENYA

Law and Practice

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Cliffe Dekker Hofmeyr incorporating Kieti Law LLP ("CDH Kenya") is a leading Kenyan law firm that provides quality, specialised and personalised legal services in key specialist areas of practice. The firm's lawyers are recognised for their depth of expertise and extensive experience in all prominent sectors attractive to private equity investors in Africa. The firm's services include fund formation, portfolio acquisitions and exits, legal and tax due diligence, follow-on acquisitions, debt and equity restructuring or refinancing and business restructuring processes. The firm handles a wide range of cross-border transactions spanning Eastern Africa and other countries such as Mauritius, Nigeria, Ghana, the UK, and Norway, among others.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Trends in Private Equity Transactions

According to the East Africa Financial Review published by I&M Burbidge Capital in July 2022 ("2022 IMB Review"), traditional private equity sectors saw a decrease in the number of deals completed, with only 26 recorded deals in 2022 compared to 38 in 2021 and 41 in 2020. The total disclosed deal value also decreased by 4%, amounting to USD417.7 million. However, it is noteworthy that median deal values increased by 14% to USD26.1 million.

Overall, there has been a steady decline in traditional private equity transactions as private equity funds struggle to fund-raise for the continent. According to the Africa Venture Capital Association ("AVCA"), despite Kenya benefitting from a sizeable share of deals in the period, Africa-focused private equity funds raised only USD5.5 billion in 2020 and 2021, a significant decrease from the USD6.7 billion raised in the previous two years. In addition, high inflation, rising interest rates, and geopolitical uncertainty coupled with subdued economic prospects in developed markets, have discouraged many foreign investors from making long-term commitments to private equity on the continent.

That notwithstanding, the first six (6) months of 2023 were a remarkable period for private equity firms based on the I&M Burbidge Capital Half Year Financial Review 2023 ("2023 IMB Review"). According to the 2023 IMB Review, there have been 34 recorded deals, a notable increase from the 20 deals recorded during the same period last year. These deals have amounted to a total disclosed value of USD1.3 billion, representing an impressive 126% growth compared to the same period in 2022. This is a positive signal for private equity investors.

Trends in M&A Deals

2022 was a particularly strong year for M&A activity in Kenya. According to the 2022 IMB Review, M&A activity in East Africa, including Kenya, has shown remarkable strength, surpassing pre-pandemic levels. The region recorded a total of 129 M&A transactions in 2022, a significant leap from 99 in 2021, with a disclosed deal value of approximately USD1.7 billion, up from USD900.8 million in the previous year. Kenya accounted for 97 M&A transactions with a disclosed deal value of USD1.35 billion.

The driving force behind this growth, as noted in the 2022 IMB Review, has been the dominant presence of venture capital investments. Venture capital investments accounted for 51% of all M&A transactions and 40% of the total disclosed deal value.

1.2 Market Activity and Impact of Macro-Economic Factors

Active Sectors

Transaction investment activity in Kenya spans various industries, with agriculture and healthcare standing out as the busiest sectors. The 2022 IMB Review provided a breakdown of deals in other sectors in 2022, being:

- agribusiness: ten deals;
- healthcare: nine deals;
- energy: eight deals;
- manufacturing: seven deals;
- fast moving consumer goods: four deals;
- hospitality: three deals;
- education and publishing: two deals; and
- real estate: two deals.

Impact of Rising Interest Rates and Other Current Macro-Economic Factors On Private Equity Deal Activity

The influence of rising interest rates and other prevailing macroeconomic factors on private equity transactional operations has been substantial. This is evident in Africa, including Kenya, where foreign currency scarcities and fluctuations in exchange rates consistently present a formidable challenge for debt and equity investments. Notably, the depreciation of the Kenyan shilling has directly affected the profits of private equity funds throughout the investment and distribution phases. This predicament is exacerbated by recent tax hikes as the government aims to secure funding.

The AVCA 2023 Mid-year Report on Private Capital Activity in Africa (Q1-Q2 2023) ("AVCA 2023 Mid-year Report") underscores the significant impact of high interest rates on private equity deal activities in Kenya. These elevated interest rates have led to inflated valuation metrics and heightened return expectations. As the cost of borrowing rises, investors may demand greater returns to offset the escalated risks and the increased opportunity cost of their capital. The augmented risk profile might also result in decreased valuations for portfolio companies during exit procedures such as initial public offers or trade sales. Given these circumstances, private equity funds might choose to invest within their own jurisdictions to ensure a viable return on their investments.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Legal and Regulatory Developments

Dual merger control

The legal landscape in Kenya continually evolves to adapt to market demands and commercial advancements. One significant development in recent times has been the amendment of merger control laws to eliminate the requirement for dual approval from both the Kenyan and regional competition regulators.

Previously, acquisitions meeting both Kenyan and Common Market for East and Southern Africa (COMESA) merger notification thresholds necessitated the approval of both the Competition Authority of Kenya (CAK) and the COMESA Competition Commission (CCC). However, since 2019, merging parties are now only obligated to seek approval from the CCC if at least two-thirds of the turnover or assets of the merging parties are situated outside Kenya and then notify the CAK within 14 days. This development has simplified the approval requirements needed to complete a transaction, making transactions in the jurisdiction more attractive for private equity funds.

East Africa Community Competition Authority

The East African Community Competition Act of 2006 governs the supervision of merger activities within the East African Community (EAC) Member States (ie, Kenya, Uganda, Tanzania, Rwanda, Burundi, South Sudan and Democratic Republic of Congo). It mandates that any merger or acquisition that has a cross-border effect in the East African Community be notified to the East African Community Competition Authority (EACCA).

Presently, notifications for merger transactions within the EAC are not required, as the EACCA is yet to be operationalised. Despite this, in 2022 the EACCA entered into a bilateral agreement with the CAK to foster harmony in the execution of their respective mandates and to lay a framework for adopting a single merger notification regime in Kenya in respect of the EAC. It remains to be seen whether the EACCA will enter into similar arrangements with other EAC Member States or with the CCC. It is therefore important for private equity funds to take note of the developments of the EACCA so as to ensure that all the regulatory approvals with the jurisdiction are obtained.

Proposed removal of local shareholding for ICT companies

A local 30% shareholding requirement for Kenya companies providing information, communication and technology (ICT) services, is set to be removed off the back of international pressure to make Kenya a more attractive hub for international investors. The proposed amendment, announced by President Ruto in April of this year, is currently undergoing public consultation before it is tabled in front of Parliament. The removal of this shareholding requirement could increase investment in the ICT sector as it may allow 100% foreign ownership of ICT companies, operating in Kenya.

Regulation of private equity

The Capital Markets Authority (CMA) currently regulates venture capital companies incorporated in Kenya under the Capital Markets (Registered Venture Capital Companies) Regulations, 2007. The Kenyan government has taken steps to expand this regulatory oversight to venture capital organisations operating in Kenya. In this regard, the Capital Markets Act was amended in 2020 to enable the CMA to license, approve, and regulate private equity funds with access to "public funds". The term "public funds" remains undefined in the Capital Markets Act. The aim of the amendment is to safeguard funds accessed by private entities from public entities in Kenya, such as public pension schemes. In Kenya, pension schemes can invest up to 10% of their assets under management in private equity or venture capital investments.

There have been no guidelines or regulations issued on how the proposed regulation of private equity funds that access "public funds" in Kenya will be effected or if the regulation will apply to offshore funds. We do not expect that this change will affect a majority of private equity funds with investments in Kenya, as the majority of these funds raise their capital offshore. It is, however, prudent to keep an eye on the developments for regulatory purposes.

Evolution of Kenyan tax regime

Several amendments to the Finance Act, No 4 of 2023 ("Finance Act") have resulted in the following amendments, which affect local private equity investments.

Capital gains tax

The rate of capital gains tax (CGT) on any gains obtained by a shareholder through an indirect sale of shares in a Kenyan company has been increased to 15%. This rule is relevant when the shareholder owned either a direct or indirect stake of at least 20% in the target company's shares at any point within the year prior to the sale. This amendment impacts private equity funds looking to exit an investment in a Kenyan target company.

Notification requirement

Transactions involving the sale of at least 20% of the shares in a Kenyan target company must now be notified to the Commissioner-General of the Kenya Revenue Authority ("Commissioner"). This notification introduces additional obligations on private equity buyers and sellers, and it is expected that the notification will alert the Kenya Revenue Authority of capital gains tax due following a 20% change of ownership.

Employee share ownership plans

The mechanism for computing the market value of shares under an employee share ownership plan (ESOP) will now be based on the price that the shares might reasonably be expected to fetch on a sale in the open market when the option is exercised. Previously, the market value was determined based on the amount agreed with the Commissioner before the grant of the options. This should be a point to note for private equity funds when setting up an ESOP in a target company or when undertaking a due diligence exercise of an ESOP.

Exemptions from income tax on royalties and interest

In the health sector in Kenya, the Finance Act now provides exemptions from income tax on royalties and interest paid by companies involved in the manufacture of human vaccines and lowers corporation tax for such companies to 10% from the standard rate of 30%. Reducing the tax burden in this manner will make these companies highly attractive for private equity funds, encouraging increased investment and fostering growth in the Kenyan health manufacturing sector.

Zero-rating of VAT

The zero-rating of VAT on the supply of electric vehicles in Kenya seeks to encourage the adoption of such vehicles in Kenya and this could result in increased investment in the sector.

Implementation of African Continental Free Trade Area (AfCFTA) Agreement

The AfCFTA agreement came into force in 2019 and created the world's largest trade area (by the number of participating states) with a population of about 1.3 billion people and a combined GDP of USD3.4 trillion. The main objectives of the AfCFTA are to create a single market for the trade of goods and services on the continent, facilitated by the free movement of businesspersons and investments and significantly increase economic growth and development on the continent through an integrated single market for goods and services.

The AfCFTA has the potential to positively impact private equity investment in several ways, as outlined below.

Increased market access

The AfCFTA creates a larger and more integrated market, reducing trade barriers and making it easier for businesses to access new markets across African countries. This expanded market can attract private equity investors who seek opportunities in sectors benefiting from increased intra-African trade.

Diversification of investment opportunities

The agreement can lead to greater diversification of industries and sectors within African economies. Private equity investors can tap into a broader range of investment opportunities, including manufacturing, infrastructure, agriculture, services, and technology, as countries focus on economic diversification.

Requirement to disclose the beneficial ownership details with the registrar of companies

In addition, the Companies (Beneficial Ownership Information) Regulations, 2020 ("BO Regulations") introduced a requirement for companies incorporated in Kenya to file a register of beneficial owners holding. A beneficial owner is a natural person who holds at least 10% of the shares, voting rights, or a right to directly or indirectly appoint or remove directors of a company or exercise significant influence or control over the company. Private equity funds may therefore be required to disclose limited partners with controlling beneficial ownership as set out in the BO Regulations. In August 2023, the Business Registration Service (BRS) put out a notice of its intention to propose amendments to the Companies Act, 2015 ("Companies Act") to impose penalties on companies that have failed to declare beneficial ownership. Further, the BRS will also propose amendments prohibiting access to governmental services. Private equity funds need to be aware of this requirement and the imposition of penalties when deciding to invest in a Kenyan target company.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Key Regulators and Regulatory Issues Relevant to Private Equity Funds and Transactions

Merger control

As highlighted in **2.1 Impact of Legal Developments on Funds and Transactions**, the CAK is responsible for ensuring merger control and antitrust compliance. In this regard, the CAK analyses and approves transactions with respect to the prescribed thresholds involving an acquisition of shares, business or other assets, whether inside or outside Kenya, resulting in the change of control of a business, part of a business or an asset of a business in Kenya.

The CAK has set specific thresholds for merger transactions that are (i) transactions always subject to notification, (ii) transactions potentially excluded from notification, and (iii) transactions excluded from notification.

Transactions always subject to notification

- a minimum combined turnover or assets (whichever is higher) in Kenya of KES1 billion and the turnover or assets (whichever is higher) of the target firm is above KES500 million;
- the turnover or assets (whichever is higher) of the acquiring firm is above KES10 billion and the merging parties are in the same market or can be vertically integrated, unless the transaction meets the CCC merger notification thresholds;
- in the carbon-based mineral sector, if the value of the reserves, the rights and the associated assets to be held as a result of the merger exceeds KES10 billion; or
- where the firms operate in the COMESA, the combined turnover or assets (whichever is higher) does not exceed KES500 million and two-thirds or more of their turnover or assets (whichever is higher) is generated or located in Kenya.

Transactions potentially excluded from notification

- where the combined turnover or assets (whichever is higher) is between KES500 million and KES1 billion; or
- if, irrespective of asset value, the firms are engaged in prospecting in the carbon-based mineral sector.

Transactions excluded from notification

- the combined turnover or assets (whichever is higher) does not exceed KES500,000,000;

- the merger meets the COMESA merger notification thresholds and at least two-thirds of the turnover or assets (whichever is higher) is generated or located outside of Kenya;
- the merger takes place wholly or entirely outside of Kenya and has no local nexus; or
- the merger involves a holding company and its subsidiary wholly owned by undertakings belonging to the same group or amalgamations involving subsidiaries wholly owned by undertakings belonging to the same group.

Transactions that have regional impact may also need approval from various regional authorities. If a transaction involves a party that operates in multiple member states of COMESA, and the merging company's turnover/asset value meets the following thresholds, the transaction may require approval from the CCC:

- the combined annual turnover or value of assets (whichever is higher) in the common market of all parties to a merger equals or exceeds USD50million; and
- the annual turnover or value of assets (whichever is higher) in the common market of each of at least two of the parties to a merger equals or exceeds USD10 million unless each of the parties to a merger achieves at least two-thirds of its aggregate turnover or assets in the common market within one and the same member state.

However, transactions that qualify for notification to the CAK and CCC need not be notified to the CAK if two-thirds of the turnover or assets (whichever is higher) is generated or located outside of Kenya. In this instance, the parties are required to file the merger notification with the CCC and only inform the CAK of the filing at the CCC within 14 days.

Capital markets

As stated in **2.1 Impact of Legal Developments on Funds and Transactions**, the CMA has the power to licence, approve and regulate private equity funds that have access to public funds. In addition, the CMA oversees the capital markets sector in Kenya and its approval is required for the acquisition of companies listed on the Nairobi Securities Exchange (NSE) or entities licensed by it, such as investment banks, stockbrokers, securities exchanges, fund managers, dealers and depositories.

The CMA also regulates venture capital companies incorporated in Kenya and which provide substantial risk capital to small- and medium-sized businesses in Kenya through the Capital Markets (Registered Venture Capital Companies) Regulations, 2007 ("VC Regulations"). Fund managers of venture capital companies registered under the VC Regulations need to be approved by the CMA. The VC Regulations do not apply to venture capital companies or private equity funds registered outside Kenya.

Other regulators

In addition, PE transactions will be subject to additional regulations from other laws specific to different sectors, especially if these laws have provisions regarding ownership and control changes. For example, the purchase of a bank will need approval from the Central Bank of Kenya (CBK), while buying significant rights in an aviation company will require clearance from the Kenya Civil Aviation Authority.

Similarly, transactions in the communication, insurance, and energy sectors would require the approval of the Communications Authority of Kenya (CA), the Insurance Regulatory Authority (IRA) and the Energy and Petroleum Regulatory Authority (EPRA) respectively. It is useful to note that the approvals from the regulators are not exclusive of each other and that acquirers may be required to obtain multiple approvals for a transaction.

With regards to any recent developments or evolution of these regimes in our jurisdiction, see **2.1 Impact of Legal Developments on Funds and Transactions**.

Foreign investment restrictions

Restriction on foreign investment tend to be sector-specific, as outlined below.

ICT Industry

As indicated in **2.1 Impact of Legal Developments on Funds and Transactions**, the restriction in the ICT industry with respect to 30% ownership was proposed to be scrapped by the Ministry of Information, Communications and the Digital Economy. In May 2023, the Cabinet approved a resolution to scrap the 30% local ownership requirement for ICT companies. The proposed amendment is currently undergoing public consultation, before it can be tabled by Parliament for approval. Should the amendment be approved, it will effectively remove all restrictions on foreign investment within the ICT industry.

Banking

In the banking industry, no individual or entity other than licensed financial institutions, the government, foreign governments, state corporations, foreign companies licensed as financial institutions in their respective countries, or non-operating holding companies approved by the CBK, may hold more than 25% of the share capital of a Kenyan bank.

Insurance

In the insurance industry, at least 33.33% of the controlling interest in an insurer must be owned by citizens of a partner state of the EAC, a partnership whose partners are all citizens of an EAC partner state, or a corporation whose shares are wholly owned by citizens of an EAC partner state.

Aviation

In the aviation industry, companies licensed to provide air services must have at least 51% of the voting rights ultimately held by Kenyan citizens, the Government of Kenya or both.

Pensions

In the pensions industry, at least 60% of the paid-up capital of a pension scheme administrator must be owned by Kenyan citizens, unless the administrator is a bank or insurance company registered in Kenya.

Fintech

In the fintech industry, there are no specific restrictions on foreign investment yet. However, the government has been considering local shareholding restrictions in order to promote local participation in the financial services sector, while also attracting foreign investment. The restrictions on foreign investment are designed to strike a balance between these two goals.

National security review

There is no definite rule mandating security reviews for PE transactions. However, it was recently reported that the National Security Council was seeking to be involved in the approval process for the disposal of a 60% stake in a national telecommunications firm to the National Treasury by a private equity investor. The involvement of the National Security Council was predicated on the fact that the telecommunications firm provided crucial services to multiple government departments.

Listed company transactions

In the event that a private equity fund wishes to acquire a stake in a public company listed on the Nairobi Securities Exchange, the acquisition may be subject to the Capital Markets (Takeovers and Mergers) Regulations, 2002 ("Takeover Regulations").

The Takeover Regulations prescribe that the following scenarios may require mandatory reporting to the CMA, for which the acquirer is then required to submit a takeover document as prescribed:

- the direct or indirect acquisition of the effective control of the voting rights of a listed company (ie, control of 25% of shares or voting rights);
- the direct or indirect acquisition of a company that has effective control of a listed company;
- the acquisition of more than 5% of the voting rights by an existing shareholder if the shareholder holds more than 25% of the shares but less than 50% of the voting rights;
- the acquisition of voting rights by an existing shareholder holding at least 50% of the voting shares; and
- the acquisition of at least 25% of a subsidiary that has contributed at least 50% of the overall turnover of the listed company in the previous three fiscal years.

Importantly, changes to the Takeover Regulations have been proposed in the 2023 draft Capital Markets (Takeovers and Mergers) Regulations 2023 ("Draft Regulations") as part of an overhaul of capital markets regulation in Kenya. Key proposed changes in the Draft Regulations include:

- an increase in the threshold for determining effective control from 25% to 30%; and
- an exemption for squeeze-out transactions (ie, holder of 90% of issued shares of a listed company acquiring the remaining 10%) from its application; under the Takeover Regulations, if an acquirer purchases 90% of a company's voting shares, they must make an offer to the remaining shareholders to buy their shares at a price higher than the current market value.

The Draft Regulations provide for exemptions for complying with the subsequent takeover requirements in the following instances subject to any conditions that may be imposed by the CAK:

- an acquisition for the purpose of a strategic investment in a listed company that is tied up with management or any other technical support relevant to the business of such company;
- a management buy-out involving a majority of the employees of the offeree;
- a restructuring of the listed company's share capital including acquisition, amalgamation, compromises, arrangements, reconstructions and any other scheme approved by the CAK;
- an acquisition of a listed company in financial distress;
- an acquisition of effective control arising out of the disposal of pledged securities;
- an indirect acquisition where there is no transfer of shares in the listed entity and no impact on the listed company's operations, governance, assets, market capitalisation, sales or earnings;
- the maintenance of domestic shareholding for strategic reason(s); and
- any other circumstances which in the opinion of the Authority serve the public interest.

The Draft Regulations are yet to be placed before Parliament for its discussion.

Anti-bribery and sanctions

There has been no significant change in law or practice in the approach to anti-bribery and sanctions in the past 12 months.

ESG Compliance

There have been no significant changes in ESG compliance in the past 12 months. However, ESG considerations remain an integral part of private equity transactions as discussed in **4.1 General Information**.

4. Due Diligence

4.1 General Information

Red-flag or selective legal due diligence is the increasingly common form of due diligence undertaken in Kenya. However, it is not uncommon for private equity funds undertaking their first investment in the Kenyan market to undertake full due diligence. The nature of due diligence is usually tailored to meet the private equity fund's interest and risk appetite and the target's business.

Legal due diligence exercises usually cover corporate structure and related issues, material contracts, competition, financial arrangements and indebtedness, employment, litigation, intellectual property, information technology, data protection, real estate, material assets, environmental, licences, insurance and tax.

ESG compliance is now a consideration in the legal due diligence exercise and often includes a review of a target's compliance with business ethics, corporate governance, bribery and corruption laws, compliance with human rights legislation and international treaties, respect for occupational health and safety, supply chain and waste management laws and inspection of environmental practices against environmental licenses, permits and legislation.

4.2 Vendor Due Diligence

Vendor due diligence tends to be used in large private equity transactions or auctions in Kenya and allow private equity firms to address the potential risk areas in the target and prepare for queries that a potential buyer might have. Typically, vendor due diligence tends to be red-flag or selective due diligence.

In addition, it is not unusual for sell-side advisers to rely on vendor due diligence reports by way of reliance letters provided to the relevant sell-side adviser.

5. Structure of Transactions

5.1 Structure of the Acquisition

Private equity acquisitions in Kenya are typically effected by way of a private treaty sale and purchase agreement of shares. It is not uncommon for acquisitions to be undertaken by way of asset purchases or by way of share subscription. The terms of acquisition do not differ materially between privately negotiated transactions and auction sales.

5.2 Structure of the Buyer

In terms of deal structure, it is common in Africa and therefore in Kenya for private equity investments to be made into offshore holding companies of targets with subsidiaries in Kenya, rather than directly into operating entities in Kenya. Such offshore holding companies are usually situated in countries that offer greater tax efficiency to the fund on exit, typically Mauritius or Delaware. Mauritius's placement (and subsequent removal) on the "Grey List" has also opened the door for new offshore jurisdictions such as Rwanda with its financial centre, offering tax incentives for investors. The set-up offshore holding companies mostly invest directly in the target company and are directly involved in the negotiation of the documentation.

5.3 Funding Structure of Private Equity Transactions

Private equity deals are typically financed through either equity or debt or a combination of both.

Securing committed debt funds at the signing stage of the deal is not as prevalent in Kenya as it may be in more developed financial markets. Private equity firms do not rely on funding from third-party lenders such as banks and financial institutions. In specific instances discussed in **5.4 Multiple Investors**, they may opt to invest as a consortium in a bid to spread risk and ensure a return on investment at the point of exit. In this respect, it is not typical for private equity funds to provide contractual certainty of funds in Kenya and therefore equity commitment letters are not commonly used.

5.4 Multiple Investors

Deals involving a consortium of private equity sponsors are not uncommon in Kenya. We have seen private equity firms invest in consortiums in a bid to spread the risk of large transactions and to ensure a return on investment at the point of exit. In 2021, it was reported that a consortium of investors led by a major South African private equity fund manager had invested in a major mobile network in South Africa. This has been the recent trend with private equity firms looking to spread risk.

Co-investment by other investors alongside the lead private equity fund are also relatively common. Co-investors may include limited partners (LPs) of the fund who opt to invest directly in specific deals alongside the lead private equity fund as well as external co-investors, who are not part of the original fund.

Co-investors can take either passive or active roles in the investment. Passive co-investors are more common, especially among LPs of the fund, as they typically have existing relationships with the lead private equity fund and may have access to co-investment opportunities as part of their overall investment strategy. However, external co-investors can also be actively involved if their expertise or resources are critical to the success of the acquisition.

Consortia comprising a private equity fund and a corporate investor are not prevalent in Kenya. This will vary depending on the specific market conditions and investment opportunities. This type of consortium combines the financial expertise and resources of a private equity fund with the strategic advantages and industry knowledge of a corporate investor.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

In Kenya, the type of consideration mechanism used in private equity transactions is dependent on the transaction structure and what the parties negotiate. The consideration structures that are predominantly seen in the market are outlined below.

Consideration Structures

Locked-box mechanisms

This consideration mechanism is generally used by private equity funds in less complex transactions in order to streamline and expedite the payment collection process as there is less risk exposure.

Earn-out mechanisms

This mechanism is used when the private equity fund would like to ensure that the vendor, usually a founder or senior management with interest in the business, is motivated in contributing to the successful performance of the business during the transition.

Closing accounts mechanisms

This mechanism is used by private equity funds if there are a set of complex future factors that may affect the value of the target company and the private equity fund is unwilling to take on the uncertain risk.

Fixed-price consideration

This mechanism is generally used in simple transactions with little to no risk so as to expedite completion of the transaction.

Deferred consideration

This mechanism is used mainly to bridge the valuation gap between the buyer and the seller when there are uncertainties about the target company's future performance or when the parties have different expectations about its future earnings.

Typically, the involvement of private equity funds results in the use of more sophisticated and complex consideration mechanisms. In Kenya, where the parties are not as commercially aware or do not engage counsel, fixed-price consideration structures or the use of deferred consideration through an escrow set-up are the norm.

6.2 Locked-Box Consideration Structures

In Kenya, it is not typical for interest to be charged on the equity price or reverse charge interest on any leakage that occurs during the locked-box period. If this is an element of the purchase price mechanism it is a unique element that is negotiated by the parties.

6.3 Dispute Resolution for Consideration Structures

In Kenya, it is typical to have a dedicated independent expert as an alternative dispute resolution mechanism in case there is a dispute with respect to the consideration structures in a private equity transaction. The use of an independent expert is usually separate from other dispute mechanisms such as arbitration and is limited to specific instances involving the consideration, such as how the consideration should be determined or the review of the financial statements.

If the dispute is with respect to other issues; eg, the period of time within which the consideration was determined, then the dispute will be referred to the other dispute resolution mechanism, such as arbitration, to be resolved.

Ideally, the more complex the consideration mechanism; eg, closing account mechanism, the more likely the dispute will be referred to an expert in conjunction with other dispute resolution mechanisms.

6.4 Conditionality in Acquisition Documentation

In Kenya, it is common for private equity transactions to contain conditions that need to be met before completion. These will mostly include the resolution of issues or red flags picked up during legal due diligence and will therefore vary from one transaction to another. Standard conditions in every deal include the waiver of pre-emption rights by existing shareholders, obtaining appropriate board and/or shareholder approvals and merger approvals.

In addition, certain conditions may be typical depending on certain elements of the transaction, such as:

- whether either of the entities is operating within a regulated industry that requires consent to be obtained or a notification to be lodged before completion as outlined in **3.1 Primary Regulators and Regulatory Issues**;
- whether the target company has any encumbered assets that may require the parties to notify or obtain consent from the financiers; or
- whether any of the material contracts contain change of control provisions that require parties to obtain consent or notify third parties of the proposed transaction.

Lastly, material adverse change provisions are common in Kenya, which permit the private equity fund to terminate the agreement on the occurrence of the material adverse change event. The definition of a material adverse change tends to be heavily negotiated.

6.5 "Hell or High Water" Undertakings

In Kenya, it is not typical for a private equity-backed buyer to accept a hell or high water undertaking. Private equity-backed buyers would typically exclude hell or high water provisions since merger control approval is considered mandatory when the merger meets the thresholds outlined in **3.1 Primary Regulators and Regulatory Issues**.

Further, in Kenya, we do not typically distinguish merger-control provisions from foreign investment conditions similar to other jurisdictions such as South Africa. One can, however, distinguish between the two as merger control provisions cannot be waived, whilst foreign investment conditions, which include but are not limited to obtaining requisite consents, may be waived in the event that they may result in a delay in the closing of the transaction.

6.6 Break Fees

Unlike private transactions, break fees are unusual in private equity transactions in Kenya. Private equity-backed buyers will strongly oppose the payment of a fee if the transaction does not close.

6.7 Termination Rights in Acquisition Documentation

As termination rights reduce deal certainty, private equity sellers and buyers prefer to limit the circumstances that can result in the deal being terminated. Therefore, these are usually reserved for specific circumstances; ie, where the mandatory conditions (conditions precedent) stipulated in the agreement are not or cannot be fulfilled by the long-stop date – usually set three to six months from the signature date, if not extended by mutual agreement.

6.8 Allocation of Risk

Private equity buyers usually demand comprehensive warranties regarding the target's business and operational affairs. Private equity sellers typically take on minimal risk concerning the target company's operations. The warranties they provide are usually limited to affirming their ownership and lack of encumbrances on the securities being sold.

Corporate sellers will typically provide broader warranties compared to private equity sellers, although it is typical for corporates to limit the time and quantum of damages arising from a breach. Corporate buyers will also seek greater indemnification rights as compared to private equity funds to guard against any liability upon making an acquisition.

6.9 Warranty and Indemnity Protection

Please refer to **6.8 Allocation of Risk.** It is not unusual for the private equity-backed seller to provide limited warranties to a buyer on exit so as to minimise its risk exposure. The private equity-backed seller typically provides warranties with respect to:

- the ownership of the shares it is transferring;
- the status of the shares it is transferring; and
- its capacity to enter into the agreement and transfer its interest; the private equity-backed seller will usually decline to provide warranties and indemnities that are related to the commercial operations and tax status of the target company.

As the private equity-backed seller has limited its exposure, the warranties and indemnities that relate to the operations of the target company are provided by the target company or the management of the target company, where applicable. These include but are not limited to warranties and indemnities in relation to corporate, legal and regulatory status, tax, employment, material assets, intellectual property and material contracts of the target company.

The limitations on warranties and indemnities depend on what is negotiated. In Kenya, warranties and indemnities may be limited by:

- limiting the thresholds within which the claim can be made;
- including an overall cap on liability;
- limiting the time within which a breach of warranty or indemnity can be made;
- qualifying the warranty to the knowledge of the seller; and
- qualifying the warranties with information that has been disclosed to the seller.

This is undertaken by way of a disclosure letter. It is not common to have a general disclosure of the contents and documentation shared in the data room; usually specific disclosures are required.

6.10 Other Protections in Acquisition Documentation

Further to the approach taken by private equity-backed buyers as discussed in **6.8 Allocation of Risk** and **6.9 Warranty and Indemnity Protection,** other protections in acquisition documents are outlined below.

Clawback Provisions

Acquisition documentation typically includes clawback provisions that enable private equity-backed buyers to reclaim funds by adjusting the purchase price or financial arrangements after the acquisition has completed. In the event that the equity-backed buyer is unable to receive financial compensation for the loss suffered, we have seen clawback clauses that further enable the private equity-backed buyer to acquire additional equity. This could be structured in the post-completion accounts mechanism or in the form of an option providing the private equity-backed buyer with the right to purchase the founder's shares, in the event of a breach of a warranty or indemnity, based on the loss suffered. Ideally, the put option is only exercisable for a set duration.

Warranty and Indemnity Insurance

Warranty and indemnity insurance is not common in our jurisdiction. However, in cross-border deals this is now being considered as an option where parties have utilised the warranty and indemnity insurance from international-based insurance companies.

Escrow or Retention

Private equity-backed sellers are looking to limit their risk and return their investment to their investors on exit. In this respect, their obligations are highly unlikely to be backed by an escrow or retention.

6.11 Commonly Litigated Provisions

Litigation in courts due to breach of contract and warranties is not common in private equity transactions. Parties are more willing to settle matters out of court or through alternative dispute resolution, especially since private equity-backed buyers are looking to maintain the relationship with the target company and promote growth.

7. Takeovers

7.1 Public-to-Private

Public-to-private transactions by private equity-backed bidders are not common in Kenya or if they are, they are kept confidential and not reported. However, there are a few transactions, such as the investment by Helios Investment Partners in Telkom Kenya – which may act as a reference point.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

The Capital Markets (Licensing Requirements) (General) Regulations, 2002 ("Licensing Regulations") specify that any person (including a private equity-backed bidder) who acquires a "notifiable interest" (ie, 3% or more) in shares in a public company or who ceases to be interested in such shares, must notify the public company of the acquisition or cessation of interest in the shares. The Licensing Regulations also require that public companies report to the NSE on a monthly basis:

- all persons who acquire or cease to have a notifiable interest in its shares;
- all directors holding 1% or more in the relevant share capital; and
- cumulative holding of the relevant share capital by directors.

Private equity-backed bidders need to be aware that this requirement under the Licensing Regulations solely applies to public companies in public transactions. However, a similar obligation is applicable to private companies with respect to beneficial ownership, as discussed in **2.1 Impact of Legal Developments on Funds and Transactions**.

Further, the Capital Markets (Securities) (Public Offers, Listing, and Disclosures) Regulations, 2002 require several types of disclosures, including:

- a quarterly disclosure to the NSE of every person who holds or acquires 3% or more of the listed company's ordinary shares;
- publication by a listed company, in its annual report, of (i) distribution of shareholders and (ii) names of the 10 largest shareholders and the number of shares in which they have an interest as shown in the issuer's register of members;
- immediate disclosure by an issuer of any information likely to have a material effect on market activity; and

- disclosure, in the annual report, of any substantial sale of assets involving 25% or more of the total assets.

7.3 Mandatory Offer Thresholds

The Takeover Regulations, as described in detail in **3.1 Primary Regulators and Regulatory Issues**, prescribe that an entity is presumed to have a firm intention to take over a public company if the entity acquires a company that holds "effective control" in a public company or, together with the shares already held by associated persons or related companies or persons acting in concert, will result in "acquiring effective control" of the listed company. The threshold of "effective control" is control of 25% of the shares in a public company.

The Takeover Regulations also prescribe circumstances under which a person is presumed to have a firm intention to make a takeover bid. These are:

- the acquirer holds more than 25% of the shares, but less than 50% of the voting rights, and acquires more than 5% of the voting rights in the company;
- the acquirer holds at least 50% of the voting shares and acquires additional voting shares; directly or indirectly acquires a company with effective control of a listed company; and
- the acquirer obtains at least 25% of a subsidiary that has contributed at least 50% of the general turnover of the company in the previous three financial years.

7.4 Consideration

Both payment in cash and by way of shares is acceptable in Kenya. With respect to public companies, the Takeover Regulations provide that the mode of payment would need to be set out in the takeover offer document.

7.5 Conditions in Takeovers

Use of Conditions

The Takeover Regulations and the CMA do not limit the use of offer conditions in takeovers. It is common for conditions to be imposed in a takeover with respect to the minimum number of issued voting shares of the listed company, the mode of payment, regulatory approvals, and the maintenance of a minimum percentage of shareholding by the general public to satisfy the continuing eligibility requirements for listing. However, the Takeover Regulations do require the conditions to be clearly indicated in the takeover offer document and the notice of intention.

Under the Takeover Regulations, an acquirer is not allowed to announce an intention to make an offer if there are no reasonable grounds to believe that the acquirer will be able to fulfil their obligations once the offer is accepted. The acquirer is also required to demonstrate to their financial adviser that they have enough funds to ensure the takeover offer will not fail. Additionally, when presenting the offer document, the acquirer must include a statement that assures all shareholders who wish to accept the offer that the acquirer has sufficient funds to complete the takeover and that they will be paid in full; therefore, a tender offer cannot be conditional on a bidder obtaining financing.

Security Measures

With respect to listed companies, the Takeover Regulations do not forbid the implementation of measures to ensure the safety of a deal. However, it is a requirement for such measures to be revealed in both the takeover offer document and the notice of intention. Common deal security measures include exclusivity, break fees, and non-solicitation provisions. These deal security measures are also employable by private companies.

7.6 Acquiring Less Than 100%

Additional Governance Rights

If a bidder does not seek 100% ownership of the Target, the bidder may seek additional governance rights, which are typically included in the shareholder agreements or a similar agreement governing shareholder relationships, related to certain transactions, such as private equity. In cases where the buyer does not want full ownership, the buyers usually request governance rights, such as the right to have representation on the target company's board and the power to veto certain decisions.

When it comes to public M&A transactions, the CMA's Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015 (the "CMA Governance Code"), requires companies to treat all shareholders fairly, including minority and foreign shareholders. Companies are also required to fully disclose any non-compliance, and while satisfactory explanations may be considered, the mandatory provisions of the Disclosures Regulations must be followed in the CMA Governance Code.

Squeeze-Out Mechanism

The Business Laws (Amendment) Act 2020 amended the Takeover Regulations to allow the purchaser to squeeze out dissenting shareholders where the purchaser acquires 90% of the share capital of the target.

Under the Takeover Regulations, if an acquirer purchases 90% of a target company's voting shares, they must make an offer to the remaining shareholders to buy their shares at a price higher than the current market value. Although the acquirer has the right to acquire the remaining shares, minority shareholders can challenge this process by appealing to the court. In addition, notices must be given for three months starting from the day after the offer period ends or six months from the date of the offer.

7.7 Irrevocable Commitments

Usually, it is standard practice to obtain a firm agreement from both major shareholders and all shareholders in general before revealing any plans to make an offer. However, if there are any agreements related to voting, they must be disclosed in the takeover documents. For instance, after a target company's initial public offering, the target company may require current shareholders to promise not to sell their shares for a period of 24 months.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentive plans are commonly used in private equity investments in Kenya. Share option plans are most frequently implemented for management and/or the founders. The option pool is typically around between 5% and 10% of the share capital of the target company.

8.2 Management Participation

Management participation is typically structured as ESOPs allowing management the right to exercise their right to acquire shares at a fixed price, which is typically lower than the market value of the shares. ESOPs are typically structured as trusts and set out the vesting criteria for the shares in the plan.

8.3 Vesting/Leaver Provisions

Vesting Provisions

Equity incentive schemes such as ESOPS as outlined in **8.2 Management Participation**, provide managers with vesting provisions and therefore payment on exit.

Leaver Provisions

These provisions are stipulated for shareholders who hold managerial positions within the target company. The typical leaver provisions include: (i) good leaver provisions – where the manager is permitted to maintain their equity within the target company if they leave the target company in "good" circumstances; eg, retirement; and (ii) bad leaver provisions – where the manager is obligated to sell their shares to the shareholders at a price below market value if they leave the company in "bad" circumstances; eg, gross misconduct.

8.4 Restrictions on Manager Shareholders

Restrictive Covenants

In Kenya, there is no restrictive covenants provided to management shareholders. The restrictions agreed to by management shareholders are usually set out in the shareholder's agreement and the employment contract. The typical restrictive covenants are outlined below.

Non-compete clause

This clause limits the business activity that the manager can undertake after leaving the target company. The limitation is limited to a particular jurisdiction and period. It is important to note that the limitation needs to be fair so as not to impede the manager's ability to earn a living. If the clause is extensive there is a risk that the courts in Kenya may deem the clause unenforceable. Parties can negotiate for compensation to be provided on exit, in order for this clause to be binding and adhered to by the manager.

Non-solicitation

This clause prohibits the manager from soliciting the target company's employees and clients for a certain period. There are no limits to enforceability.

Confidentiality

The manager will be bound not to disclose confidential information. Usually, the clause is extensively drafted, clearly highlighting what is deemed confidential information.

Non disparagement clause

The manager is bound not to disclose or say anything negative about the target company either in private or public that may damage the target company's reputation.

8.5 Minority Protection for Manager Shareholders

Management shareholders do not typically benefit from strong minority protection of any form. They do however, like other shareholders, enjoy some limited protection under the Companies Act, which mandates majority (50%) and special (75%) shareholder approval requirements, as well as derivative actions in the event of oppressive behaviour against the target company.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Private Equity funds aim to ensure that their investment is protected and that the target company performs so as to make the most out of their investment. In this respect, private equity funds aim to ensure that they are aware or in control of the day-to-day management of the target company by instituting the following in shareholder agreements.

Board Appointment Rights

Private equity funds usually aim to have control of the board by acquiring the rights to appoint board members depending on their shareholding and usually with veto rights. They will usually negotiate board observer seats at the minimum.

Reserved Matters

Reserved matters are mostly highly negotiated. The shareholder's agreement clearly outlines what is a board-reserved matter and what is a shareholders-reserved matter. The voting threshold on reserved matters is also a point of negotiation as the private equity fund will aim to ensure that they are included in all decision-making.

Information Rights

Private equity funds usually require certain documents such as financial statements and director reports to be submitted at set intervals. This ensures that the private equity fund is aware of the performance of the target company.

9.2 Shareholder Liability

In Kenya, as a target company has a separate legal personality from its shareholders, shareholders are generally not liable for the actions of a limited liability company (in this case the target company). However, there is an exception, where the "corporate veil" can be pierced, and the shareholders are held liable for the actions of the Kenyan target company. This is when the shareholders have used the Kenyan target company to perpetuate fraud or circumvent statute fraudulently.

10. Exits

10.1 Types of Exit

In Kenya, the common types of exits are sales to other private equity funds or corporates. We have also seen sales to the Kenya government with respect to equity stakes in publicly listed companies. We have not seen other forms of private equity exits, such as IPOs, auctions, dual track or triple track, in the last 12 months.

10.2 Drag and Tag Rights

It is common for private equity transactions in Kenya to have drag and tag rights. In practice, drag and tag rights are not typically enforced as minority shareholders are usually willing to collaborate with the private equity funds in the event of a proposed exit from a Kenyan investment.

10.3 IPO

We are not aware of equity funds exiting by way of an IPO in the jurisdiction. Exits are mainly undertaken through trade sales and through transactions with other financial buyers, unlike the Johannesburg Stock Exchange which has had the most PE-backed IPOs in Africa. Nevertheless, exit by way of an IPO is an option.

With respect to lock-in arrangements in the jurisdiction, the Capital Markets (Securities) (Public Offers Listing and Disclosures) Regulations, 2002 provide for a two (2) year lock-up period from the date of listing of the shares.

Trends and Developments

Contributed by:
Sammy Ndolo, Njeri Wagacha and Martha Mbugua
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Cliffe Dekker Hofmeyr incorporating Kieti Law LLP ("CDH Kenya") is a leading Kenyan law firm that provides quality, specialised and personalised legal services in key specialist areas of practice. The firm's lawyers are recognised for their depth of expertise and extensive experience in all prominent sectors attractive to private equity investors in Africa. The firm's services include fund formation, portfolio acquisitions and exits, legal and tax due diligence, follow-on acquisitions, debt and equity restructuring or refinancing and business restructuring processes. The firm handles a wide range of cross-border transactions spanning Eastern Africa and other countries such as Mauritius, Nigeria, Ghana, the UK, and Norway, among others.

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KENYA TRENDS AND DEVELOPMENTS

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Kenyan Economic Outlook

In 2022, the Kenyan economy experienced a decline in its GDP growth rate, with the figure dropping from 7.6% to 4.8%. While there are varied opinions on the possible reasons for this, the Kenya National Bureau of Statistics Economic Survey 2023 attributed the decline to:

- the drought in most parts of the country, which affected food production; and
- a surge in commodity prices (ie, food and energy) caused by supply chain disruption due to the war in Ukraine.

2023, however, has seen the Kenyan economy rebound with GDP growing to 5.3% in the first quarter of 2023. A strong performance in the agricultural sector due to favourable weather conditions has spearheaded this growth along with positive developments in the services sector. The Central Bank of Kenya (CBK) has projected a strengthening of the economy throughout 2023, supported by the aforementioned sectors and the implementation of measures by the government to boost economic activity in priority sectors, such as manufacturing, tourism and information technology. In addition, the Central Bank notes that a reduction of the government budget deficit from 6.2% to 5.3% should also stimulate the economy by reducing government borrowing and exert downward pressure on domestic interest rates.

2022 Deal Activity in Kenya

Investment activity in Kenya spans various industries, including technology, financial services, energy, healthcare, consumer goods, industrials and materials, real estate, and utilities. Among these sectors, technology and financial services stand out as the busiest, accounting for approximately 55% of reported transactions in 2022.

In 2022, traditional private equity investments in East Africa experienced a decline for the third consecutive year, therefore affecting deal activity in Kenya, East Africa's largest economy.

According to the East Africa Financial Review published by I&M Burbidge Capital in July 2022 ("2022 IMB Review"), traditional private equity sectors saw a decrease in the number of deals completed, with only 26 recorded in 2022 compared to 38 in 2021 and 41 in 2020. Total disclosed deal value also decreased by 4%, amounting to USD417.7 million. However, it is noteworthy that median deal values increased by 14% to USD26.1 million.

Overall, there has been a steady decline in traditional private equity investment in Africa as private equity funds struggle to fund-raise for the continent.

According to the Africa Venture Capital Association (AVCA), despite Kenya benefitting from a sizeable share of deals in the period, Africa-focused private equity funds raised only USD5.5 billion in 2020 and 2021, a significant decrease from the USD6.7 billion raised in the previous two years. In addition, high inflation, rising interest rates, and geopolitical uncertainty coupled with subdued economic prospects in developed markets, have discouraged many foreign investors from making long-term commitments to private equity on the continent.

Furthermore, foreign currency shortages and exchange rate fluctuations pose a constant challenge to debt and equity investing in Africa, and Kenya is no exception. The devaluation of the Kenya shilling has affected returns for private equity funds during investment and distribution periods and this has not been helped by the recent increases in taxes as the government itself seeks to fund-raise.

2023 Deal Activity So Far

Based on the I&M Burbidge Capital Half Year Financial Review 2023 ("2023 IMB Review"), there have been 34 recorded deals, a notable increase from the 20 deals recorded during the same period last year. These deals have amounted to a total disclosed value of USD1.3 billion, representing an impressive 126% growth compared to the same period in 2022. This is a positive signal for private equity investors.

According to the 2023 IMB Review, there has also been a consistent trend among private equity firms to gravitate towards larger ticket sizes, indicating their increasing appetite for bigger investment opportunities.

Predictions for 2023

Venture capital (VC) transactions in Kenya seem to be continually on the rise and we predict that this trend is likely to continue. VC transactions constituted 51% of all private transactions and 40% of the disclosed deal value in 2022, indicating the growing significance of VC activity in the region. This growth in VC transactions aligns with the broader trend across Africa, which experienced a 35% increase in VC funding in 2022, as reported by the 2022 IMB Review. Expectations are that VC transactions will continue to drive M&A activity in 2023.

The 2023 IMB Review also notes that the total number of exits in 1H 2023 has kept pace with that of last year, with three exits so far, although it is expected that the number will rapidly accelerate in the second half of 2023 based on anecdotal evidence from the market.

Legal and Regulatory Developments

Dual merger control

The legal landscape in Kenya continually evolves to adapt to market demands and commercial advancements. One significant development in recent times has been the amendment of merger control laws to eliminate the requirement for dual approval from both the Kenyan and regional competition regulators.

Previously, acquisitions meeting both Kenyan and Common Market for East and Southern Africa ("COMESA") merger notification thresholds necessitated the approval of both the Competition Authority of Kenya ("CAK") and the COMESA Competition Commission ("CCC"). However, since 2019, merging parties are now only obligated to seek approval from the CCC if at least 66% of the turnover or assets of the merging parties are situated outside Kenya and then notify the CAK within fourteen (14) days.

East Africa Community Competition Authority

The East African Community Competition Act of 2006 governs the supervision of merger activities within the East African Community (EAC) Member States (ie, Kenya, Uganda, Tanzania, Rwanda, Burundi, South Sudan and Democratic Republic of Congo). It mandates that any merger or acquisition that has a cross-border effect in the East African Community be notified to the East African Community Competition Authority (EACCA).

Presently, notifications for merger transactions within the EAC are not required, as the EACCA is yet to be operationalised. Despite this, in 2022 the EACCA entered into a bilateral agreement with the CAK to foster harmony in the execution of their respective mandates and to lay a framework for adopting a single merger notification regime in Kenya in respect of the EAC. It remains to be seen whether the EACCA will enter into similar arrangements with other EAC Member States or with the CCC.

Proposed removal of local shareholding for ICT companies

A local 30% shareholding requirement for Kenya companies providing information, communication and technology (ICT) services, is set to be removed off the back of international pressure to make Kenya a more attractive hub for international investors. The proposed amendment, announced by President Ruto in April of this year, is currently undergoing public consultation before it is tabled in front of Parliament. The removal of this shareholding requirement could increase investment in the ICT sector as it may allow 100% foreign ownership of ICT companies, operating in Kenya.

Regulation of private equity

The Capital Markets Authority (CMA) currently regulates venture capital companies incorporated in Kenya under the Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

The Kenyan government has taken steps to expand this regulatory oversight to venture capital organisations operating in Kenya. In this regard, the Capital Markets Act was amended in 2020 to enable the CMA to license, approve, and regulate private equity funds with access to "public funds". The term "public funds" remains undefined in the Capital Markets Act. The aim of the amendment is to safeguard funds accessed by private entities from public entities in Kenya, such as public pension schemes. In Kenya, pension schemes can invest up to 10% of their assets under management in private equity or venture capital investments.

There have been no guidelines or regulations issued on how the proposed regulation of private equity funds that access "public funds" in Kenya will be effected or if the regulation will apply to offshore funds. We do not expect that this change will affect a majority of private equity funds with investments in Kenya, as the majority of these funds raise their capital offshore.

Evolution of Kenyan tax regime

Several amendments to the Finance Act, No 4 of 2023 ("Finance Act") have resulted in the following amendments, which affect local private equity investments.

Capital gains tax

The rate of capital gains tax (CGT) on any gains obtained by a shareholder through an indirect sale of shares in a Kenyan company has been increased to 15%. This rule is relevant when the shareholder owned either a direct or indirect stake of at least 20% in the target company's shares at any point within the year prior to the sale. This amendment impacts private equity funds looking to exit an investment in a Kenyan target company.

Notification requirement

Transactions involving the sale of at least 20% of the shares in a Kenyan target company must now be notified to the Commissioner-General of the Kenya Revenue Authority ("Commissioner"). This notification introduces additional obligations on private equity buyers and sellers, and it is expected that the notification will alert the Kenya Revenue Authority of capital gains tax due following a 20% change of ownership.

Employee share ownership plans

The mechanism for computing the market value of shares under an employee share ownership plan (ESOP) will now be based on the price that the shares might reasonably be expected to fetch on a sale in the open market when the option is exercised. Previously, the market value was determined based on the amount agreed with the Commissioner before the grant of the options. This should be a point to note for private equity funds when setting up an ESOP in a target company or when undertaking a due diligence exercise of an ESOP.

Exemptions from income tax on royalties and interest

In the health sector in Kenya, the Finance Act now provides exemptions from income tax on royalties and interest paid by companies involved in the manufacture of human vaccines and lowers corporation tax for such companies to 10% from the standard rate of 30%. Reducing the tax burden in this manner will make these companies highly attractive for private equity funds, encouraging increased investment and fostering growth in the Kenyan health manufacturing sector.

Zero-rating of VAT

The zero-rating of VAT on the supply of electric vehicles in Kenya seeks to encourage the adoption of such vehicles in Kenya and this could result in increased investment in the sector.

Upcoming Privatisation Bill

The Kenyan government, though a Cabinet Dispatch in March 2023, has expressed its desire to privatise several state-owned entities to divest the state of certain sectors and to reduce the demand of these entities for public funds. To facilitate this process, a new Privatisation Bill has been proposed.

The aim of the Privatisation Bill is to revise the regulatory framework for the privatisation of public entities in Kenya with a view to improving the efficiency and competitiveness of Kenya's productive resources. This should allow privatisation transactions to navigate bureaucratic hurdles more smoothly and minimise delays in such transactions.

Implementation of the African Continental Free Trade Area ("AfCFTA") Agreement

The AfCFTA agreement came into force in 2019 and created the world's largest trade area (by the number of participating states) with a population of about 1.3 billion people and a combined GDP of USD3.4 trillion. The main objectives of the AfCFTA are to:

- create a single market for the trade of goods and services on the continent, facilitated by the free movement of businesspersons and investments; and
- significantly increase economic growth and development on the continent through an integrated single market for goods and services.

The AfCFTA has the potential to positively impact private equity investment in several ways, as outlined below.

Increased market access

The AfCFTA creates a larger and more integrated market, reducing trade barriers and making it easier for businesses to access new markets across African countries. This expanded market can attract private equity investors who seek opportunities in sectors benefiting from increased intra-African trade.

Diversification of investment opportunities

The agreement can lead to greater diversification of industries and sectors within African economies. Private equity investors can tap into a broader range of investment opportunities, including manufacturing, infrastructure, agriculture, services, and technology, as countries focus on economic diversification.

Trends

Investment screening: focus on ESG

Environmental, social, and governance (ESG) considerations have emerged as crucial factors influencing private equity transactions. These considerations have significantly impacted the landscape of M&A in several ways, as outlined below.

Expanded due diligence

The due diligence process has evolved to include comprehensive assessments of ESG aspects as integral components. Companies are now subject to scrutiny in areas such as equal employment opportunities, environmental compliance, anti-corruption and bribery measures, and adherence to governance best practices. These considerations have become fundamental in evaluating the overall sustainability and health of a target company.

Focus on sustainable investments

There has been a notable shift towards prioritizing "green transactions" in the M&A arena. Purchasers are increasingly interested in making investments in sustainable and socially responsible assets or targets. These investments encompass various sectors, including renewable energy, energy efficiency, clean transport, and responsible waste management, aligning with the global drive towards a more sustainable future.

As a result of these developments, ESG and responsible investment considerations are poised to become deeply ingrained and inseparable components of M&A transactions.

Growth of African strategic buyers

African strategic buyers have witnessed significant growth as part of private equity exits in Kenya. The involvement of international buyers in transactions has declined, accounting for only 24% of reported transactions in 2022, down from 49% in 2017. This shift has created opportunities for local and regional investors, who represented 67% of all M&A deals reported in the 2022 IMB Review. The increased appetite of African businesses for inorganic growth is likely to continue with the implementation of the AfCFTA Agreement and the removal of trade barriers across the African continent.

Conclusion

The expected growth in investment activity in Kenya, coupled with the projected positive economic outlook, present a hopeful scenario for the country's economic development and investment landscape in the coming years, especially if the tax incentives set out in the Finance Act, such as exemptions from income tax on royalties and interest paid by companies involved in the manufacture of human vaccines and zero-rating of VAT on the supply of electric vehicles bear fruit. In addition, the removal of barriers to entry in various sectors, such as local shareholding requirements in the telecommunications sector, should foster growth and result in increased private equity investment in Kenya.

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