Republic of Kenya

SPECIAL AUDIT REPORT

OF THE

CONTROLLER AND AUDITOR GENERAL

ON

SAFARICOM LIMITED
INITIAL PUBLIC OFFER

JULY 2009

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1.0 INTRODUCTORY

1.1 BACKGROUND

The transfer of 60% of the Telkom Kenya Limited shareholding in Safaricom Limited to the Permanent Secretary, Treasury was carried out as part of the efforts to raise funds to restructure Telkom Kenya Limited. The restructuring was intended to enable Telkom Kenya Limited clean its balance sheet so as to attract a strategic investor. The Government approved restructuring of Telkom Kenya Limited on 23 February 2006 and subsequently a sale of 9% shareholding in Safaricom Limited to Vodafone PLC of United Kingdom was considered. Vodafone's offer for the 9% shareholding was not however attractive and the Government through the Ministry of Finance declined the offer. Thereafter the Government decided to raise the much needed capital through an Initial Public Offer (IPO) and through the recommendation of the Ministry of Finance, the Government approved sale of 25% of its 60% shareholding in Safaricom Limited.

1.2 AUDIT OBJECTIVES

The audit of the Safaricom Limited IPO was carried out with a view to establishing that;

(a) Financial and Procurement regulations were adhered to,
(b) The Government obtained value for money; and that
(c) Applicable laws were complied with during the process.

The audit proceeded along the following terms of reference;

i. Review of compliance with applicable laws, relevant to the sale of Government shareholding in Safaricom Limited.

ii. Review of compliance with Government Financial Regulations and Procedures.
iii. Examination of the IPO process from commencement to conclusion.
iv. Review of valuation and pricing of the shares.
v. Review of the selection, appointment and remuneration of Transaction Advisors, Receiving Banks, Accountants as well as the Attorneys etc.
vi. Analysis of transaction costs and gain/loss on the sale of shares.
vii. Examination of the criteria for allotment of shares before and after issue to individuals, institutional investors and international investors.
viii. Consideration for any other matter relevant to the sale of the shares.

1.3 AUDIT SCOPE AND COVERAGE

The scope of audit covered the entire period of the IPO process i.e. July 2007 to August 2008. It also included the period after the allotment of shares, cash refunds to both the individuals and institutional investors as well as the reconciliation between the Lead Receiving Bank and the licensed Capital Market Authority Brokers and Agents.

In order to gather the necessary information and evidence for the purpose of the audit, the following procedures were adopted;

i. Interviewing of selected officials from the Ministry of Finance (Department of Government Investments and Public Enterprises-DGIPE), Privatization Commission, Capital Markets Authority, Nairobi Stock Exchange, Safaricom Limited, Transaction Advisors, Legal Advisors, Reporting Accountants, Public Relations Consultants, Advertising Consultants, Receiving Bank and the Registrars who were contracted to prepare and keep the Share Register.

ii. Reviewing and examining various key documents including the Capital Markets Authority Act, Companies Act, Privatization Act, Public Procurement and Disposal 2005 Act, prospectus, criteria for allotment of shares, management accounts, financial statements of Safaricom Limited before and after the sale of shares (2007 & 2008) and the listing of shareholders.

iii. Analysis and assessment of the data collected on the sale of shares.

1.4 LIMITATION OF SCOPE

The audit was limited to examination of locally available records and documentation, interviews and references to capital markets practices and experiences.

1.5 GLOSSARY OF TERMS

PE	- Price Earning Ratio
EBITDA	- Earnings Before Interest Taxes Depreciation and Amortization
DGIPE	- Department of Government Investments and Public Enterprises
MTC	- Ministerial Tender Committee
IPO	- Initial Public Offer
CY08	- Calendar Year 2008
CMA	- Capital Markets Authority
AKS	- Association of Kenya Stockbrokers
DCF	- Discounted Cash Flow
OPPS	- Offer Price Per Share
AV/EBITDA	- Average Earnings Before Interest Taxes Depreciation and Amortization
QII	- Qualified Institutional Investors
IFC	- International Finance Corporation
VAT	- Value Added Tax
E	- Expected Growth

2.0 AUDIT FINDINGS

2.1 UNBUNDLING OF SAFARICOM LIMITED FROM TELKOM KENYA LTD

As indicated above, the transfer of Telkom Kenya Limited shareholding in Safaricom Limited to the Government was as a result of the need to restructure Telkom Kenya Limited, with a view to attracting a strategic investor. In this regard, the Government was to acquire 60% of Telkom Kenya Limited shareholding in Safaricom Limited.

The approval for restructuring of Telkom Kenya Limited and sale of Safaricom Limited shares through IPO was granted by the Government on 23 February 2006. The approval required among other aspects that;

- Telkom Kenya Limited divests from Safaricom Limited by transferring all of its 60% shareholding to the Government.
- The Government sells 25% of its shareholding in Safaricom Limited through IPO.
- The transfer proceeds of the shareholding in Safaricom Limited be applied to meet the cost of retrenchment and staff pension payments in Telkom Kenya Limited.
- The transfer proceeds be also used in offsetting the Paris Club rescheduled loans relating to Telkom Kenya Limited.
- A loan of US$ 33 million (Kshs.2,062,500,000 at an exchange rate of 1 US $ to Kshs. 62.5) and accrued interest, on-lent to Telkom Kenya Limited by the Government to finance the Telkom's share of Safaricom Limited licence cost, be converted to equity.
- Statutory taxes, interest and penalties amounting to Kshs.20.9 billion be waived and tax arrears of Kshs. 9.8 billion be rescheduled as appropriate.

The total cost of restructuring Telkom Kenya Limited borne by the Government amounted to Kshs. 84,401,378,570 against an acquisition of 60% shareholding in Safaricom Limited valued at Kshs.86,956,500,000. The valuation of Kshs. 86,956,000,000 had been determined in April 2006 by the International Finance Corporation (IFC) at the request of the Government.

As may be observed above, the Government gained a value of Kshs.2,555,121,430, representing the difference between the shareholding transfer cost and the valuation by IFC.

2.2 SELECTION, APPOINTMENT AND REMUNERATION OF TRANSACTION ADVISORS

2.2.1 Selection of Transaction Advisors

(a) Expression of Interest

An invitation for Expression of Interest for provision of Professional Advisory Services for the IPO was requested through an open tender method. Pursuant to this, an advertisement was placed in the local media in July 2007. The Expressions of Interest by interested and eligible parties were to be delivered to the Treasury in the same month and required;

i. A consortium consisting of Lead Transaction Advisor, Lead Broker and four (4) Co- sponsoring Brokers
ii. Legal Advisory services
iii. Reporting Accountant services
iv. Public Relations Consultancy services
v. Advertising Consultancy services
vi. Receiving Bank services
vii. Share Registrar services

The submissions for Expressions of Interest received, were evaluated and various short-listed consultancy firms were cleared for the next stage of assessment, on the technical and financial proposals.

However, the criteria used to short-list the consultancy firms could not be confirmed as the relevant records were not availed for audit verification. Further, and for a similar reason, the propriety of the evaluation process of the Expressions of Interest could also not be ascertained.

(b) Procurement of Co-sponsoring Brokers Consultancy Services

Records relating to the Expressions of Interest for Co-sponsoring Brokers Consultancy services were not made available for audit review as apparently, the services had been de-linked from the Consortium. The advertisement on Expression of Interest that appeared in the local media in July 2007 on the other hand required a Consortium of Lead Transaction Advisor, Lead Broker and four (4) Co-sponsoring Brokers. It has not been clarified as to why and at what stage the Co-sponsoring Brokers Consultancy services were de-linked from the Consortium.

Available information indicate that subsequent to the de-linking of the Co-sponsoring Brokers Consultancy services from the consortium as indicated above, the Privatization Commission requested for proposals for the Consultancy services through electronic communication (email). The Public Procurement and Disposal Act, 2005 Section 37(3) stipulates that to the extent allowed under written directions of the Public Procurement Oversight Authority, electronic communications may be used instead of written communications. However, the request and written authority for use of electronic communication by the Authority were not availed for audit review. Further, it has also not been clarified how eligible bidders were sensitized on this mode of communication.

A Technical evaluation report dated October, 2007 shows that the evaluation team assessed the technical proposals on the Co-sponsoring Brokers Consultancy services and came up with the following results;

Bidder	**Score %**	**Rank**
Discount Securities Limited, Sterling Securities Limited, and Ngenye Kariuki & Company	88.67%	**1**
Crossfield Securities Limited, Merrill Lynch and Tsavo Securities Limited	51.08%	**2**

Records available indicate that the Ministerial Tender Committee (MTC) through a meeting held in November 2007, awarded the Co-sponsoring Brokerage services to the consortium of Discount Securities Limited, Sterling Securities Limited, and Ngenye Kariuki & Company, at a bid price of Kshs. 2,204,000.

2.2.2 Appointment of Transaction Advisors

Letters of offer were sent in August 2007 to successful consultancy firms namely, Morgan Stanley and Dyer & Blair Consortium as the Lead Transaction Advisor and Lead Broker respectively; Gina Din Communications as the Public Relations Consultants; Muriu Mungai Consortium as the Legal Services Consultants; Redsky Limited for Advertising; Image Registrars for the company register, Deloitte and Touche as the Reporting Accountants and Citibank Consortium as the Lead Receiving Bank. The Attorney General approved the draft contracts for the consultancies in October 2007 and subsequently both Safaricom Limited and Treasury officials signed in the same month the contract documents on behalf of their respective organisations/institutions. However, it has not been possible to establish whether the draft contract for the Co-sponsoring Brokerage services was cleared by the Attorney General for signature although indications are that a draft had been submitted to his office.

(a) Contract for International Placement

(i) The contract for the International Placement Agent was an extension of Article 8 of Morgan Stanley and Dyer & Blair Consortium contract. The Consortium contract of Morgan Stanley and Dyer & Blair stated inter-alia that in case of an international placement, a separate agreement would be entered into in relation to the distribution of any securities, in accordance with the Capital Markets Authority regulations. Such separate agreement provided for payment of a commission of 1.5% of the value placed by the Authorized International Selling Agent and duly accepted and allotted by the Government

(ii) The extension of Article 8 in the contract introduced in July appeared to give Morgan Stanley exclusive right to be the Authorized International Selling Agent, the Sole Global Co-ordinator and Sole Book-runner for the International Placement.

(iii) In December 2007, the Capital Markets Authority (CMA) raised the matter and observed that Morgan Stanley, as the Global Co-ordinator and a Book runner had been given a wide discretion regarding the final allotment of the International Pool. The Authority sought a clarification on the controls that had been put in place to ensure that the allotment of 2 billion shares was done equitably, considering that the Global Co-ordinator and Book-runner was also to receive and process applications as the Authorized Selling Agent.

(iv) The Association of Kenya Stockbrokers (AKS) in a letter dated November 2007 to the Treasury similarly expressed concern over transparency, equitability and fair distribution of the shares to all interested foreign investors, while at the same time subjecting the placement to a book running process through one Book-runner. The Association suggested that the issue be opened and subjected to a competitive process.

No evidence has been seen explaining how the concerns from CMA and AKS were addressed by the Investment Secretary or IPO Steering Committee. A further review indicated that there were limited controls, rules and regulations governing the foreign pool allotments and as such shares could be allocated to investors whose accounts were being managed by related firms.

(b) Contract alteration

Treasury requested the Attorney General in a letter dated March 2008 to introduce amendments for third party costs in the Citibank Consortium, Gina Din Communications and Redsky contracts. According to the letter, third party costs were to be paid upon submission of invoices, based on an approved budget. The three (3) contracts were therefore altered to include reimbursables. Accordingly, and arising from the alterations, additional expenses totalling Kshs.335,162,202 as shown below were incurred.

Contract name	Original contract sum Kshs	Final Payments on Contract Kshs	Variation sum Kshs	Variation Percentage
Gina Din	5,046,000	13,150,449	8,104,449	160 %
Citibank	94,043,034	221,992,865	127,949,831	136 %
Redsky Ltd.	2,082,200	201,190,122	199,107,922	398%
Total	**101,171,243**	**436,333,436**	**335,162,202**	**331 %**

It has not however been explained why these alterations were not considered during the drafting stage of the original contracts.

2.2.3 Remuneration of Transaction Advisors

The Citibank consortium which included National Bank of Kenya, Equity Bank, and Kenya Post Office Saving Bank was awarded the contract to offer consultancy services as the Receiving Bank at a fee of Kshs 94,043,035 inclusive of Value Added Tax (VAT).

However, a letter of offer made to the consortium and signed by the Financial Secretary appeared to indicate that the offer fee for the services was Kshs.94,043,035 net of VAT. This discrepancy does not appear to have been resolved.

2.3 VALUATION AND PRICING OF SHARES

2.3.1 Valuation Methodology

There are several models for an IPO valuation. These include;

(a) Trading Multiples Analysis
(b) Precedent Transactions Analysis, and
(c) Discounted Cash Flow (DCF) Method

The Lead Transaction Advisor carried out a share price valuation of Safaricom Limited IPO based on Trading Multiples Analysis. The Valuation update of March 2008 indicated that the Advisor valued the IPO using the Average Earnings Before Interest, Taxes, Depreciation and Amortization (AV/EBITDA) multiples of Orascom, MTN and Mobinil as follows:-

Key Comparables- Trading Multiples

	AV/EBITDA	
	2008E	2009E
MTN	7.4	6.4
Orascom	7.4	6.3
Mobinil	7.1	6.4
Mean	**7.3**	**6.4**

The use of AV/EBITDA of comparable companies of 7.3 and EBITDA Calendar Year 2008 (CY08) of Kshs 32,860 million gave an aggregate value of Safaricom Limited of Kshs 239,878 million. This aggregate value was then used to calculate the value per share of Safaricom Limited IPO as indicated below: -

7.3 x CY08 EBITDA of Kshs.32,860 million	=	Kshs.239,878 million
Aggregate Value	=	Kshs.239,878 million
Less: Net Debt	=	Kshs 7,175 million
IPO Equity Value	=	Kshs 232,703 million.
20% discount on IPO Equity Value	=	Kshs 46,541 million.
IPO Equity Value Post 20% discount	=	Kshs 186,162 million
Offer Price Per Share (OPPS)	=	Kshs 186,162 Million/40,000 million
	=	Kshs **4.65 per share**

Based on the above analysis, the Advisor recommended an offer price of Kshs.4.75 per share in the Domestic Pool. The Government through the recommendation of the Investment Secretary however enhanced the price to Kshs. 5.00 per share

2.3.2 International Pool Valuation - Book Building

The prospectus indicated that the vendor in consultation with the Lead Transaction Advisor was to determine the offer price for the International Pool using the Book building method, with the price so determined not being lower than the fixed price in the Domestic Pool. The prospectus further indicated that during the International Pool-Offering Period, orders were to be taken from institutional investors in permitted jurisdictions. The orders were to be placed by Authorised Selling Agents or the Global Co-ordinator at different prices and levels as determined by the investor. Each International Pool participant's order for the International Pool was to be submitted to the Application Processing Agent, together with a bank guarantee from a licensed Authorized Depository Bank, for the full amount of the order in the case of orders made through local brokers and investment banks.

The Application Processing Agents were to forward spreadsheets to the Global Co-ordinator by the end of the business each day, and the Co-ordinator was to subsequently enter each International Pool participant's orders into the Institutional Book of Demand. The Book building process enabled the Co-ordinator to build a picture of international investor interest and demand for the offer, and thereby facilitate the setting by the vendor (in consultation with the Co-ordinator) of the offer price in the International Pool.

Although the prospectus indicated that the Global Co-ordinator was to provide daily updates to the vendor as to the progress of the book, no evidence of such updates was however seen. Further, although indications are that that exercise was carried out through a teleconferencing arrangement, no tangible evidence in this regard was made available for audit verification.

An analysis of the Book building process revealed that ninety four (94) International Investors participated in the Book running process, with an effective demand of 12,338,096,795 shares at prices ranging between

Kshs.5.00 and Kshs.6.00 per share. The Advisor settled for a price of Kshs.5.50.

2.4 ALLOTMENT CRITERIA BEFORE AND AFTER IPO

2.4.1 Allotment procedure and policy

Regulation 10 (2) (b), of the Capital Markets Authority (Securities), (Public Offers, Listing and Disclosures) states that every prospectus shall indicate the allotment procedure to be applied in case of an over-subscription for the securities to be issued pursuant to the prospectus. The Capital Markets (Foreign Investors) Regulations, 2002 require that the issuer be under obligation to reserve a specific percentage of the shares being issued for local investors. Regulation 3 (1) requires that every issuer or listed company to reserve at least forty per centum of its ordinary shares for investment by local investors. Regulation 3 (2) states that in the case where the shares are the subject of a public offering and an application for listing, the shares to be reserved shall be a per centum of the ordinary shares being offered to the public i.e. 40% of the shares being offered to the public.

The Safaricom Limited prospectus provided that there was to be a claw-back (withdraw of shares) of up to15% of offered shares from the International Pool, if the level of over-subscription in the Domestic Pool was more than 200% and that the ceiling of 200% over-subscription be maintained. The allotments of the shares on offer before and after the claw-back were as follows;

Category	On offer	%	After Claw-Back	%
Retail	3,380,000,000	33.8	4,880,000,000	48.8
Employees	260,000,000	2.6	260,000,000	2.6
Authorised Dealers	130,000,000	1.3	130,000,000	1.3
Qualified Inst.Inv.	2,730,000,000	27.3	2,730,000,000	27.3
Foreign Investors	3,500,000,000	35	2,000,000,000	20
Total	**10,000,000,000**	**100**	**10,000,000,000**	**100**

2.4.2 Observations on Allotment

(a) Retail Pool

Allotment Criteria

The prospectus stated that if the Retail category was under-subscribed, all valid applications were to get full allotment, after taking into account the minimum number that was to be applied for each category. The balance of the shares was to be aggregated and re-assigned to other categories, which were over-subscribed pro-rata to excess shares applied for in the other categories. If over-subscribed, all valid applications were to be allocated a minimum of 100 shares, and thereafter in multiples of 100 shares on pro-rata, rounded downwards to the nearest 100 shares, until all available shares including unallocated balances from other categories were exhausted.

Four hundred and fifty eight (458) Retail Investors were allotted shares on a pro rata basis but the rounding was done upwards, contrary to the provision in the prospectus of rounding the allotment downward. The rounding of the allotment upwards resulted in an over-allotment of 46,400 shares in the Retail category.

(b) Qualified Institutional Investors (QII)

Allotment Criteria

The prospectus stated that if the Qualified Institutional Investors (QII) category was under- subscribed, all valid applications were to get full allotment after taking into account the minimum number that were to be applied for each category. The balance of shares was to be aggregated and re-assigned to other categories, which were over-subscribed pro-rata to excess shares applied for in the other categories. If over-subscribed, all valid applications were to be allocated a minimum of 100 shares, thereafter in multiples of 100 shares on pro-rata, rounded downwards to the nearest 100 shares, until all available shares, including unallocated balances from other categories were exhausted.

One hundred and sixty four (164) Qualified Institutional Investors (QII) were alloted shares on a pro rata basis but the rounding was done upwards, contrary to the provision in the prospectus. The rounding upwards resulted in an over-allotment of 42,900 shares in the QII category.

(c) Safaricom Limited Employees

Allotment Criteria

The prospectus stated that if the Employees category was under-subscribed, all valid applications were to get full allotment and the balance of shares re-assigned to the Retail category, after taking into account the minimum number that were to be applied for each category. The balance of shares were to be aggregated and re-assigned to other categories, which were over-subscribed pro-rata to excess shares applied for in the other categories. If over-subscribed, all valid applications were to be allocated up to 40,000 shares, thereafter in multiples of 200 shares on pro-rata, rounded downwards to the nearest 200 shares, up to a maximum value of their gross annual salary at the opening date. The allotment was to be decided by the Allotment Committee of the Company whose decision on allotment was to be final.

An analysis of the employee data availed by Image Registrars on allotment in the Employees category revealed the following;

(i) Fifty six (56) employees applied for shares up to a maximum of 40,000 per employee which according to the allotment criteria, ought to have been allotted. However, the employees were allotted fewer shares than applied for. The under-allotment totalled 88,477 shares.

(ii) One thousand and sixty one (1061) employees applied for more than 40,000 shares and appear to have been allotted more than those prescribed in the allotment criteria. This was due to rounding upwards instead of downwards to the nearest 200 share on a pro rata basis. The over-allotment totalled of 3,898,752 shares.

(iii) Two hundred and seventy eight (278) employees applied for more than 40,000 shares but were under-allotted contrary to the allotment criteria for staff. The under-allotment amounted to of 17,824,429 shares.

As may be observed above, the allotment criteria as spelt out in the prospectus were not strictly adhered to in the allotment of shares in all the Domestic Pool categories. This resulted in over and under allotment of 3,988,052 and 17,912,906 share respectively.

(d) Foreign Investors

Allotment Criteria

The prospectus stated that the Foreign Pool allotment was to be carried out by the Transaction Advisor and the Global Co-ordinator by evaluating all orders by the same criteria as outlined in the prospectus. Thereafter, the Advisor was to draw an allotment recommendation, which was to be presented to the vendor for sign-off before execution.

During the Book building process the demand for the International Pool stood at 16,241,893,348 shares at bid prices ranging between Kshs.5 and Kshs.6 per share. The Advisor decided to offer the International Pool category at Kshs.5.50, with a demand of 12,338,096,795 shares for all investors who bidded at Kshs.5.50 or higher.

Book building allotment in an International Pool does not appear to have specific criteria for allotment of shares after the Book-running period. The Book-runners would therefore under normal circumstances allot a substantial number of shares to those bidders whom the runners provide custody and /or other services. In the case of the Foreign Pool category, information availed for audit review appeared to show that 814,300,000 shares representing approximately 40% of the total International Pool of 2 billion shares were allotted to nominee accounts. Details of these accounts as well as the criteria applied in the allotment of the shares were not however seen.

2.4.3 Un-allotted Shares

As of December, 2008 a total of 22,572,580 shares were yet to be allotted. This was due to the rounding downwards effect in the allotment criteria as earlier discussed. A summary of the un-allotted shares (fractional pool) in different categories is shown below;

Category	Applications	Shares offered	% subscribed	Shares Allotted	Unallotted Shares (Fractional pool)
Foreign	12,338,096,795	2,000,000,000	616%	2,000,000,000	0
Retail	22,643,239,000	4,880,000,000	464%	4,859,666,400	20,333,600
QII.	8,758,740,000	2,730,000,000	321%	2,729,974,300	25,700
SCL.Dealers	422,158,200	130,000,000	325%	129,993,200	6,800
Employees	307,455,600	260,000,000	118%	257,793,520	2,206,480
Totals	**44,496,689,595**	**10,000,000,000**		**9,977,427,420**	**22,572,580**

The un-allotted shares were registered in the name of the Permanent Secretary/Treasury, to be used in sorting out cases of under-allotment.

Further information available however shows that the remaining shares were allocated to the National Social Security Fund (NSSF) in public interest. This arrangement was also meant to enable the vendor meet the 25% listing requirements by the Capital Markets Authority Act.

From the foregoing, it would appear that there was no policy guideline in place during and after the IPO on how to deal with the shares in the fractional pool.

2.5 TRANSACTION COSTS

2.5.1 Total Transaction Cost

The total transaction cost of the IPO process was as follows:-

Expenses met by Treasury	**Kshs**
Contract price (various)	115,851,749
Reimbursable expenses	338,162,202
Staff costs	4,127,438
Listing fees (Capital Markets Authority cost)	150,000,000
Printing of certificate	974,400
Stamp Duty	59,980,000
Sub-Total	**669,095,789**
Expenses Paid From IPO Proceeds	
Interest on IPO Proceeds (invoice of CMA)	1,015,406,335
Agent commission- local	551,928,933
Agent commission-foreign	165,000,000
Incidentals	93,892,179
Sub -Total	**1,826,227,447**
Total	**2,495,323,236**

2.5.2 Listing Fees

Listing fee represents the amount paid in accordance with the Capital Markets Act (Licensing Requirements) (General) and Regulations, 2002 Second Schedule Part III (a) – other fees computed at 0.3% of the value of the issue. In the case of the IPO, the listing fees of 150 million represented 0.3% of Kshs 50 billion worth of shares, based on the Domestic Pool price.

The CMA invoiced the Ministry of Finance in April 2008 for a listing fee of Kshs.150 million. The Ministry had initially indicated that it was the responsibility of Safaricom Limited to pay for the listing fees. Safaricom Limited in a response took the position that it was the Government selling its shares and thus Safaricom Limited was not party to the sale. The Company was not therefore obliged to pay the fees.

The matter does not appear to have been concluded but nevertheless indications were that the Ministry had already factored the expenditure in its budget.

2.5.3 Incidentals costs

Incidentals Costs – Receiving Bank

Included in the total IPO cost were incidental costs of Kshs 93,892,179 incurred by the Receiving Bank, and representing 10% of the total fee of Kshs 938,921,798. The amount of Kshs. 938,921,798 was made up of the Authorized Selling Agents' commission of Kshs 716,928,933 and a charge by the Receiving Bank of Kshs. 221,992,865.

The expenditure of Kshs.93,892,179 in respect of the incidental costs could not however be confirmed due to non-availability of supporting documents.

2.5.4 Reimbursables – Advertisement

Records available indicate that Redsky Limited was awarded the contract for the advertisement of the IPO at a fee of Kshs. 2,082,200 inclusive of taxes. The contract does not however appear to have specified the total cost in respect of reimbursables. Expenditure relating to such costs were reimbursed by the vendor against the proof of payment. Clearly, control of expenditure under this arrangement was considerably weak and susceptible to nugatory costs.

Additional information show that the reimbursable costs included media coverage costs, cost of printing publicity material, projector services, press photographs, production of radio and television commercials.

As of December 2008, Redsky Limited had been paid reimbursables totalling Kshs 199,107,922. However, proper supporting documents in respect of this reimbursement were not made available for audit review, consequent upon which its accuracy could not be ascertained.

The total cost of Kshs.199,107,922 in respect of the reimbursables exceeded the approved budget of Kshs.187,825,443 against the item by Kshs.11,282,479.

2.5.5 Reimbursables- Expenses and commissions

The Receiving Bank's reimbursable expenses and commissions totalling Kshs.127,949,831 could similarly not be ascertained due to lack of supporting documents..

2.5.6 Assets

The Receiving Bank purchased various assets on behalf of the Ministry of Finance, which were used during the IPO process. The assets included computers, chairs, desks and telephone accessories etc. However, no documents such as invoices, receipts and other related records were made available for audit review. Further, the assets do not appear to have been taken over by the Ministry after conclusion of the process.

2.6 GAIN/LOSS IN THE IPO PROCESS

2.6.1 Gain on Share Pricing Issue

As mentioned elsewhere in this report, the valuation of the shares for the Domestic Pool was Kshs.4.75 per unit. The Government however approved the price at Kshs. 5.00 per unit. This increase of the unit price from Kshs. 4.75 to Kshs.5.00 brought about a gain of Ksh.2.5 billion as indicated below;

IPO Proceeds	10 billion shares @ Kshs 5 per share	= Kshs 50 billion
IPO Proceeds	10 billion shares @ Kshs.4.75 per share	=Kshs47.5 billion
Gain		**Kshs.2.5 billion**

2.7 OTHER MATTERS

2.7.1 Leveraged Purchase of Shares

It was observed that there were apparently no institutional guidelines on the permissible level of borrowing for the purpose of purchasing shares in the IPO. Records available indicate that various individual and retail investors accessed from local banks, credit facilities ranging on average between Kshs.10,000 and Kshs.2 million for the purpose of buying shares. Although the terms of agreement for such facilities varied from bank to bank, in many instances, the share certificates served as the guarantee against the loans. Under this arrangement however, it would appear that such investors could not meaningfully access, participate and benefit from the services offered at the Nairobi Stock Exchange until the loans extended to them were fully repaid.

2.0.1 Interest on the IPO Proceeds

The Capital Markets Act Cap 485A part II section 18 (2) (e) states that the compensation fund shall consist of interest deemed to accrue on the proceeds of a public issue or offer for sale of shares of a company listed or to be listed on an approved securities exchange, between the closing date and that of dispatch of shares certificates or refund cheques, to be determined at the rate prescribed by the Authority. The closing date for the IPO was 23 April 2008 while the date of dispatch of share certificates and refund of cheques was 4 June 2008 i.e a period of forty one (41) days. The Capital Markets Authority in a letter dated August 2008 raised an invoice for payment of interest amounting to Kshs. 1,015,406,335 on the IPO proceeds. The interest was based on the amount of Kshs 116,835,892,300 at a rate of 7.737% for 41 days which represented proceeds from sale of shares in respect of retail investors, employees and Safaricom Limited dealers. As of December 2008, however there were no indication of the balance of Kshs.1,015,406,335 having been paid to the Authority.

2.7.3 Reconciliation with Brokerage Firms

The Receiving Bank had not as of December 2008 completed reconciliations with other relevant stakeholders in the IPO and as a result it was not possible to establish the amount of proceeds yet to be remitted to the Treasury over and above the sum of Kshs.49,887,137,100 received as at that date. No reasons were provided for the delay in the completion of the reconciliations. Further and as a result of failure to complete the reconciliations, it has also not been possible to ascertain that the Government obtained full value for money in the IPO.

2.7.4 After-Market Trading

Information provided by the Nairobi Stock Exchange on the trading pattern at the Foreign Investors counter between June and July 2008 appeared to show that the Investors were net sellers and were not therefore in the category of long term investors. This tendency would appear to have been inconsistent with the requirement in the prospectus that the Global Co-ordinator was to seek to build a book of demand consisting of a mix of investors who are likely to be long term holders of the securities.

3.0 CONCLUSION

Subject to the issues raised in this report and on the basis of records and information made available, the financial and procurement regulations in force were adhered to and the applicable laws were complied with during the Safaricom Limited Initial Public Offer.

A.S.M. Gatumbu

CONTROLLER AND AUDITOR GENERAL

Nairobi

7 July 2009

Paper laid by DPM & Minister for Finance on 2/3/2010

Republic of Kenya

SPECIAL AUDIT REPORT

OF THE

CONTROLLER AND AUDITOR GENERAL

ON

SAFARICOM LIMITED INITIAL PUBLIC OFFER

JULY 2009

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1.0 INTRODUCTORY

1.1 BACKGROUND

The transfer of 60% of the Telkom Kenya Limited shareholding in Safaricom Limited to the Permanent Secretary, Treasury was carried out as part of the efforts to raise funds to restructure Telkom Kenya Limited. The restructuring was intended to enable Telkom Kenya Limited clean its balance sheet so as to attract a strategic investor. The Government approved restructuring of Telkom Kenya Limited on 23 February 2006 and subsequently a sale of 9% shareholding in Safaricom Limited to Vodafone PLC of United Kingdom was considered. Vodafone's offer for the 9% shareholding was not however attractive and the Government through the Ministry of Finance declined the offer. Thereafter the Government decided to raise the much needed capital through an Initial Public Offer (IPO) and through the recommendation of the Ministry of Finance, the Government approved sale of 25% of its 60% shareholding in Safaricom Limited.

1.2 AUDIT OBJECTIVES

The audit of the Safaricom Limited IPO was carried out with a view to establishing that;

(a) Financial and Procurement regulations were adhered to,
(b) The Government obtained value for money; and that
(c) Applicable laws were complied with during the process.

The audit proceeded along the following terms of reference;

i. Review of compliance with applicable laws, relevant to the sale of Government shareholding in Safaricom Limited.

ii. Review of compliance with Government Financial Regulations and Procedures.

iii. Examination of the IPO process from commencement to conclusion.

iv. Review of valuation and pricing of the shares.

v. Review of the selection, appointment and remuneration of Transaction Advisors, Receiving Banks, Accountants as well as the Attorneys etc.

vi. Analysis of transaction costs and gain/loss on the sale of shares.

vii. Examination of the criteria for allotment of shares before and after issue to individuals, institutional investors and international investors.

viii. Consideration for any other matter relevant to the sale of the shares.

1.3 AUDIT SCOPE AND COVERAGE

The scope of audit covered the entire period of the IPO process i.e. July 2007 to August 2008. It also included the period after the allotment of shares, cash refunds to both the individuals and institutional investors as well as the reconciliation between the Lead Receiving Bank and the licensed Capital Market Authority Brokers and Agents.

In order to gather the necessary information and evidence for the purpose of the audit, the following procedures were adopted;

i. Interviewing of selected officials from the Ministry of Finance (Department of Government Investments and Public Enterprises-DGIPE), Privatization Commission, Capital Markets Authority, Nairobi Stock Exchange, Safaricom Limited, Transaction Advisors, Legal Advisors, Reporting Accountants, Public Relations Consultants, Advertising Consultants, Receiving Bank and the Registrars who were contracted to prepare and keep the Share Register.

ii. Reviewing and examining various key documents including the Capital Markets Authority Act, Companies Act, Privatization Act, Public Procurement and Disposal 2005 Act, prospectus, criteria for allotment of shares, management accounts, financial statements of Safaricom Limited before and after the sale of shares (2007 & 2008) and the listing of shareholders.

iii. Analysis and assessment of the data collected on the sale of shares.

1.4 LIMITATION OF SCOPE

The audit was limited to examination of locally available records and documentation, interviews and references to capital markets practices and experiences.

1.5 GLOSSARY OF TERMS

PE	- Price Earning Ratio
EBITDA	- Earnings Before Interest Taxes Depreciation and Amortization
DGIPE	- Department of Government Investments and Public Enterprises
MTC	- Ministerial Tender Committee
IPO	- Initial Public Offer
CY08	- Calendar Year 2008
CMA	- Capital Markets Authority
AKS	- Association of Kenya Stockbrokers
DCF	- Discounted Cash Flow
OPPS	- Offer Price Per Share
AV/EBITDA	- Average Earnings Before Interest Taxes Depreciation and Amortization
QII	- Qualified Institutional Investors
IFC	- International Finance Corporation
VAT	- Value Added Tax
E	- Expected Growth

2.0 AUDIT FINDINGS

2.1 UNBUNDLING OF SAFARICOM LIMITED FROM TELKOM KENYA LTD

As indicated above, the transfer of Telkom Kenya Limited shareholding in Safaricom Limited to the Government was as a result of the need to restructure Telkom Kenya Limited, with a view to attracting a strategic investor. In this regard, the Government was to acquire 60% of Telkom Kenya Limited shareholding in Safaricom Limited.

The approval for restructuring of Telkom Kenya Limited and sale of Safaricom Limited shares through IPO was granted by the Government on 23 February 2006. The approval required among other aspects that;

- Telkom Kenya Limited divests from Safaricom Limited by transferring all of its 60% shareholding to the Government.
- The Government sells 25% of its shareholding in Safaricom Limited through IPO.
- The transfer proceeds of the shareholding in Safaricom Limited be applied to meet the cost of retrenchment and staff pension payments in Telkom Kenya Limited.
- The transfer proceeds be also used in offsetting the Paris Club rescheduled loans relating to Telkom Kenya Limited.
- A loan of US$ 33 million (Kshs.2,062,500,000 at an exchange rate of 1 US $ to Kshs. 62.5) and accrued interest, on-lent to Telkom Kenya Limited by the Government to finance the Telkom's share of Safaricom Limited licence cost, be converted to equity.
- Statutory taxes, interest and penalties amounting to Kshs.20.9 billion be waived and tax arrears of Kshs. 9.8 billion be rescheduled as appropriate.

The total cost of restructuring Telkom Kenya Limited borne by the Government amounted to Kshs. 84,401,378,570 against an acquisition of 60% shareholding in Safaricom Limited valued at Kshs.86,956,500,000. The valuation of Kshs. 86,956,000,000 had been determined in April 2006 by the International Finance Corporation (IFC) at the request of the Government.

As may be observed above, the Government gained a value of Kshs.2,555,121,430, representing the difference between the shareholding transfer cost and the valuation by IFC.

2.2 SELECTION, APPOINTMENT AND REMUNERATION OF TRANSACTION ADVISORS

2.2.1 Selection of Transaction Advisors

(a) Expression of Interest

An invitation for Expression of Interest for provision of Professional Advisory Services for the IPO was requested through an open tender method. Pursuant to this, an advertisement was placed in the local media in July 2007. The Expressions of Interest by interested and eligible parties were to be delivered to the Treasury in the same month and required;

i. A consortium consisting of Lead Transaction Advisor, Lead Broker and four (4) Co- sponsoring Brokers
ii. Legal Advisory services
iii. Reporting Accountant services
iv. Public Relations Consultancy services
v. Advertising Consultancy services
vi. Receiving Bank services
vii. Share Registrar services

The submissions for Expressions of Interest received, were evaluated and various short-listed consultancy firms were cleared for the next stage of assessment, on the technical and financial proposals.

However, the criteria used to short-list the consultancy firms could not be confirmed as the relevant records were not availed for audit verification. Further, and for a similar reason, the propriety of the evaluation process of the Expressions of Interest could also not be ascertained.

(b) Procurement of Co-sponsoring Brokers Consultancy Services

Records relating to the Expressions of Interest for Co-sponsoring Brokers Consultancy services were not made available for audit review as apparently, the services had been de-linked from the Consortium. The advertisement on Expression of Interest that appeared in the local media in July 2007 on the other hand required a Consortium of Lead Transaction Advisor, Lead Broker and four (4) Co-sponsoring Brokers. It has not been clarified as to why and at what stage the Co-sponsoring Brokers Consultancy services were de-linked from the Consortium.

Available information indicate that subsequent to the de-linking of the Co-sponsoring Brokers Consultancy services from the consortium as indicated above, the Privatization Commission requested for proposals for the Consultancy services through electronic communication (email). The Public Procurement and Disposal Act, 2005 Section 37(3) stipulates that to the extent allowed under written directions of the Public Procurement Oversight Authority, electronic communications may be used instead of written communications. However, the request and written authority for use of electronic communication by the Authority were not availed for audit review. Further, it has also not been clarified how eligible bidders were sensitized on this mode of communication.

A Technical evaluation report dated October, 2007 shows that the evaluation team assessed the technical proposals on the Co-sponsoring Brokers Consultancy services and came up with the following results;

Bidder	Score %	Rank
Discount Securities Limited, Sterling Securities Limited, and Ngenye Kariuki & Company	88.67%	1
Crossfield Securities Limited, Merrill Lynch and Tsavo Securities Limited	51.08%	2

Records available indicate that the Ministerial Tender Committee (MTC) through a meeting held in November 2007, awarded the Co-sponsoring Brokerage services to the consortium of Discount Securities Limited, Sterling Securities Limited, and Ngenye Kariuki & Company, at a bid price of Kshs. 2,204,000.

2.2.2 Appointment of Transaction Advisors

Letters of offer were sent in August 2007 to successful consultancy firms namely, Morgan Stanley and Dyer & Blair Consortium as the Lead Transaction Advisor and Lead Broker respectively; Gina Din Communications as the Public Relations Consultants; Muriu Mungai Consortium as the Legal Services Consultants; Redsky Limited for Advertising; Image Registrars for the company register, Deloitte and Touche as the Reporting Accountants and Citibank Consortium as the Lead Receiving Bank. The Attorney General approved the draft contracts for the consultancies in October 2007 and subsequently both Safaricom Limited and Treasury officials signed in the same month the contract documents on behalf of their respective organisations/institutions. However, it has not been possible to establish whether the draft contract for the Co-sponsoring Brokerage services was cleared by the Attorney General for signature although indications are that a draft had been submitted to his office.

(a) Contract for International Placement

(i) The contract for the International Placement Agent was an extension of Article 8 of Morgan Stanley and Dyer & Blair Consortium contract. The Consortium contract of Morgan Stanley and Dyer & Blair stated inter-alia that in case of an international placement, a separate agreement would be entered into in relation to the distribution of any securities, in accordance with the Capital Markets Authority regulations. Such separate agreement provided for payment of a commission of 1.5% of the value placed by the Authorized International Selling Agent and duly accepted and allotted by the Government

(ii) The extension of Article 8 in the contract introduced in July appeared to give Morgan Stanley exclusive right to be the Authorized International Selling Agent, the Sole Global Co-ordinator and Sole Book-runner for the International Placement.

(iii) In December 2007, the Capital Markets Authority (CMA) raised the matter and observed that Morgan Stanley, as the Global Co-ordinator and a Book runner had been given a wide discretion regarding the final allotment of the International Pool. The Authority sought a clarification on the controls that had been put in place to ensure that the allotment of 2 billion shares was done equitably, considering that the Global Co-ordinator and Book-runner was also to receive and process applications as the Authorized Selling Agent.

(iv) The Association of Kenya Stockbrokers (AKS) in a letter dated November 2007 to the Treasury similarly expressed concern over transparency, equitability and fair distribution of the shares to all interested foreign investors, while at the same time subjecting the placement to a book running process through one Book-runner. The Association suggested that the issue be opened and subjected to a competitive process.

No evidence has been seen explaining how the concerns from CMA and AKS were addressed by the Investment Secretary or IPO Steering Committee. A further review indicated that there were limited controls, rules and regulations governing the foreign pool allotments and as such shares could be allocated to investors whose accounts were being managed by related firms.

(b) Contract alteration

Treasury requested the Attorney General in a letter dated March 2008 to introduce amendments for third party costs in the Citibank Consortium, Gina Din Communications and Redsky contracts. According to the letter, third party costs were to be paid upon submission of invoices, based on an approved budget. The three (3) contracts were therefore altered to include reimbursables. Accordingly, and arising from the alterations, additional expenses totalling Kshs.335,162,202 as shown below were incurred.

Contract name	Original contract sum Kshs	Final Payments on Contract Kshs	Variation sum Kshs	Variation Percentage
Gina Din	5,046,000	13,150,449	8,104,449	160 %
Citibank	94,043,034	221,992,865	127,949,831	136 %
Redsky Ltd.	2,082,200	201,190,122	199,107,922	398%
Total	**101,171,243**	**436,333,436**	**335,162,202**	**331 %**

It has not however been explained why these alterations were not considered during the drafting stage of the original contracts.

2.2.3 Remuneration of Transaction Advisors

The Citibank consortium which included National Bank of Kenya, Equity Bank, and Kenya Post Office Saving Bank was awarded the contract to offer consultancy services as the Receiving Bank at a fee of Kshs 94,043,035 inclusive of Value Added Tax (VAT).

However, a letter of offer made to the consortium and signed by the Financial Secretary appeared to indicate that the offer fee for the services was Kshs.94,043,035 net of VAT. This discrepancy does not appear to have been resolved.

2.3 VALUATION AND PRICING OF SHARES

2.3.1 Valuation Methodology

There are several models for an IPO valuation. These include;

(a) Trading Multiples Analysis
(b) Precedent Transactions Analysis, and
(c) Discounted Cash Flow (DCF) Method

The Lead Transaction Advisor carried out a share price valuation of Safaricom Limited IPO based on Trading Multiples Analysis. The Valuation update of March 2008 indicated that the Advisor valued the IPO using the Average Earnings Before Interest, Taxes, Depreciation and Amortization (AV/EBITDA) multiples of Orascom, MTN and Mobinil as follows:-

Key Comparables- Trading Multiples

	AV/EBITDA	
	2008E	2009E
MTN	7.4	6.4
Orascom	7.4	6.3
Mobinil	7.1	6.4
Mean	**7.3**	**6.4**

The use of AV/EBITDA of comparable companies of 7.3 and EBITDA Calendar Year 2008 (CY08) of Kshs 32,860 million gave an aggregate value of Safaricom Limited of Kshs 239,878 million. This aggregate value was then used to calculate the value per share of Safaricom Limited IPO as indicated below: -

7.3 x CY08 EBITDA of Kshs.32,860 million	=	Kshs.239,878 million
Aggregate Value	=	Kshs.239,878 million
Less: Net Debt	=	Kshs 7,175 million
IPO Equity Value	=	Kshs 232,703 million.
20% discount on IPO Equity Value	=	Kshs 46,541 million.
IPO Equity Value Post 20% discount	=	Kshs 186,162 million
Offer Price Per Share (OPPS)	=	Kshs 186,162 Million/40,000 million
	=	Kshs **4.65 per share**

Based on the above analysis, the Advisor recommended an offer price of Kshs.4.75 per share in the Domestic Pool. The Government through the recommendation of the Investment Secretary however enhanced the price to Kshs. 5.00 per share

2.3.2 International Pool Valuation - Book Building

The prospectus indicated that the vendor in consultation with the Lead Transaction Advisor was to determine the offer price for the International Pool using the Book building method, with the price so determined not being lower than the fixed price in the Domestic Pool. The prospectus further indicated that during the International Pool-Offering Period, orders were to be taken from institutional investors in permitted jurisdictions. The orders were to be placed by Authorised Selling Agents or the Global Co-ordinator at different prices and levels as determined by the investor. Each International Pool participant's order for the International Pool was to be submitted to the Application Processing Agent, together with a bank guarantee from a licensed Authorized Depository Bank, for the full amount of the order in the case of orders made through local brokers and investment banks.

The Application Processing Agents were to forward spreadsheets to the Global Co-ordinator by the end of the business each day, and the Co-ordinator was to subsequently enter each International Pool participant's orders into the Institutional Book of Demand. The Book building process enabled the Co-ordinator to build a picture of international investor interest and demand for the offer, and thereby facilitate the setting by the vendor (in consultation with the Co-ordinator) of the offer price in the International Pool.

Although the prospectus indicated that the Global Co-ordinator was to provide daily updates to the vendor as to the progress of the book, no evidence of such updates was however seen. Further, although indications are that that exercise was carried out through a teleconferencing arrangement, no tangible evidence in this regard was made available for audit verification.

An analysis of the Book building process revealed that ninety four (94) International Investors participated in the Book running process, with an effective demand of 12,338,096,795 shares at prices ranging between

Kshs.5.00 and Kshs.6.00 per share. The Advisor settled for a price of Kshs.5.50.

2.4 ALLOTMENT CRITERIA BEFORE AND AFTER IPO

2.4.1 Allotment procedure and policy

Regulation 10 (2) (b), of the Capital Markets Authority (Securities), (Public Offers, Listing and Disclosures) states that every prospectus shall indicate the allotment procedure to be applied in case of an over-subscription for the securities to be issued pursuant to the prospectus. The Capital Markets (Foreign Investors) Regulations, 2002 require that the issuer be under obligation to reserve a specific percentage of the shares being issued for local investors. Regulation 3 (1) requires that every issuer or listed company to reserve at least forty per centum of its ordinary shares for investment by local investors. Regulation 3 (2) states that in the case where the shares are the subject of a public offering and an application for listing, the shares to be reserved shall be a per centum of the ordinary shares being offered to the public i.e. 40% of the shares being offered to the public.

The Safaricom Limited prospectus provided that there was to be a claw-back (withdraw of shares) of up to15% of offered shares from the International Pool, if the level of over-subscription in the Domestic Pool was more than 200% and that the ceiling of 200% over-subscription be maintained. The allotments of the shares on offer before and after the claw-back were as follows;

Category	On offer	%	After Claw-Back	%
Retail	3,380,000,000	33.8	4,880,000,000	48.8
Employees	260,000,000	2.6	260,000,000	2.6
Authorised Dealers	130,000,000	1.3	130,000,000	1.3
Qualified Inst.Inv.	2,730,000,000	27.3	2,730,000,000	27.3
Foreign Investors	3,500,000,000	35	2,000,000,000	20
Total	**10,000,000,000**	**100**	**10,000,000,000**	**100**

2.4.2 Observations on Allotment

(a) Retail Pool

Allotment Criteria

The prospectus stated that if the Retail category was under-subscribed, all valid applications were to get full allotment, after taking into account the minimum number that was to be applied for each category. The balance of the shares was to be aggregated and re-assigned to other categories, which were over-subscribed pro-rata to excess shares applied for in the other categories. If over-subscribed, all valid applications were to be allocated a minimum of 100 shares, and thereafter in multiples of 100 shares on pro-rata, rounded downwards to the nearest 100 shares, until all available shares including unallocated balances from other categories were exhausted.

Four hundred and fifty eight (458) Retail Investors were allotted shares on a pro rata basis but the rounding was done upwards, contrary to the provision in the prospectus of rounding the allotment downward. The rounding of the allotment upwards resulted in an over-allotment of 46,400 shares in the Retail category.

(b) Qualified Institutional Investors (QII)

Allotment Criteria

The prospectus stated that if the Qualified Institutional Investors (QII) category was under- subscribed, all valid applications were to get full allotment after taking into account the minimum number that were to be applied for each category. The balance of shares was to be aggregated and re-assigned to other categories, which were over-subscribed pro-rata to excess shares applied for in the other categories. If over-subscribed, all valid applications were to be allocated a minimum of 100 shares, thereafter in multiples of 100 shares on pro-rata, rounded downwards to the nearest 100 shares, until all available shares, including unallocated balances from other categories were exhausted.

One hundred and sixty four (164) Qualified Institutional Investors (QII) were alloted shares on a pro rata basis but the rounding was done upwards, contrary to the provision in the prospectus. The rounding upwards resulted in an over-allotment of 42,900 shares in the QII category.

(c) Safaricom Limited Employees

Allotment Criteria

The prospectus stated that if the Employees category was under-subscribed, all valid applications were to get full allotment and the balance of shares re-assigned to the Retail category, after taking into account the minimum number that were to be applied for each category. The balance of shares were to be aggregated and re-assigned to other categories, which were over-subscribed pro-rata to excess shares applied for in the other categories. If over-subscribed, all valid applications were to be allocated up to 40,000 shares, thereafter in multiples of 200 shares on pro-rata, rounded downwards to the nearest 200 shares, up to a maximum value of their gross annual salary at the opening date. The allotment was to be decided by the Allotment Committee of the Company whose decision on allotment was to be final.

An analysis of the employee data availed by Image Registrars on allotment in the Employees category revealed the following;

(i) Fifty six (56) employees applied for shares up to a maximum of 40,000 per employee which according to the allotment criteria, ought to have been allotted. However, the employees were allotted fewer shares than applied for. The under-allotment totalled 88,477 shares.

(ii) One thousand and sixty one (1061) employees applied for more than 40,000 shares and appear to have been allotted more than those prescribed in the allotment criteria. This was due to rounding upwards instead of downwards to the nearest 200 share on a pro rata basis. The over-allotment totalled of 3,898,752 shares.

(iii) Two hundred and seventy eight (278) employees applied for more than 40,000 shares but were under-allotted contrary to the allotment criteria for staff. The under-allotment amounted to of 17,824,429 shares.

As may be observed above, the allotment criteria as spelt out in the prospectus were not strictly adhered to in the allotment of shares in all the Domestic Pool categories. This resulted in over and under allotment of 3,988,052 and 17,912,906 share respectively.

(d) Foreign Investors

Allotment Criteria

The prospectus stated that the Foreign Pool allotment was to be carried out by the Transaction Advisor and the Global Co-ordinator by evaluating all orders by the same criteria as outlined in the prospectus. Thereafter, the Advisor was to draw an allotment recommendation, which was to be presented to the vendor for sign-off before execution.

During the Book building process the demand for the International Pool stood at 16,241,893,348 shares at bid prices ranging between Kshs.5 and Kshs.6 per share. The Advisor decided to offer the International Pool category at Kshs.5.50, with a demand of 12,338,096,795 shares for all investors who bidded at Kshs.5.50 or higher.

Book building allotment in an International Pool does not appear to have specific criteria for allotment of shares after the Book-running period. The Book-runners would therefore under normal circumstances allot a substantial number of shares to those bidders whom the runners provide custody and /or other services. In the case of the Foreign Pool category, information availed for audit review appeared to show that 814,300,000 shares representing approximately 40% of the total International Pool of 2 billion shares were allotted to nominee accounts. Details of these accounts as well as the criteria applied in the allotment of the shares were not however seen.

2.4.3 Un-allotted Shares

As of December, 2008 a total of 22,572,580 shares were yet to be allotted. This was due to the rounding downwards effect in the allotment criteria as earlier discussed. A summary of the un-allotted shares (fractional pool) in different categories is shown below;

Category	Applications	Shares offered	% subscribed	Shares Allotted	Unallotted Shares (Fractional pool)
Foreign	12,338,096,795	2,000,000,000	616%	2,000,000,000	0
Retail	22,643,239,000	4,880,000,000	464%	4,859,666,400	20,333,600
QII.	8,758,740,000	2,730,000,000	321%	2,729,974,300	25,700
SCL.Dealers	422,158,200	130,000,000	325%	129,993,200	6,800
Employees	307,455,600	260,000,000	118%	257,793,520	2,206,480
Totals	**44,496,689,595**	**10,000,000,000**		**9,977,427,420**	**22,572,580**

The un-allotted shares were registered in the name of the Permanent Secretary/Treasury, to be used in sorting out cases of under-allotment.

Further information available however shows that the remaining shares were allocated to the National Social Security Fund (NSSF) in public interest. This arrangement was also meant to enable the vendor meet the 25% listing requirements by the Capital Markets Authority Act.

From the foregoing, it would appear that there was no policy guideline in place during and after the IPO on how to deal with the shares in the fractional pool.

2.5 TRANSACTION COSTS

2.5.1 Total Transaction Cost

The total transaction cost of the IPO process was as follows:-

Expenses met by Treasury	**Kshs**
Contract price (various)	115,851,749
Reimbursable expenses	338,162,202
Staff costs	4,127,438
Listing fees (Capital Markets Authority cost)	150,000,000
Printing of certificate	974,400
Stamp Duty	59,980,000
Sub-Total	**669,095,789**
Expenses Paid From IPO Proceeds	
Interest on IPO Proceeds (invoice of CMA)	1,015,406,335
Agent commission- local	551,928,933
Agent commission-foreign	165,000,000
Incidentals	93,892,179
Sub -Total	**1,826,227,447**
Total	**2,495,323,236**

2.5.2 Listing Fees

Listing fee represents the amount paid in accordance with the Capital Markets Act (Licensing Requirements) (General) and Regulations, 2002 Second Schedule Part III (a) – other fees computed at 0.3% of the value of the issue. In the case of the IPO, the listing fees of 150 million represented 0.3% of Kshs 50 billion worth of shares, based on the Domestic Pool price.

The CMA invoiced the Ministry of Finance in April 2008 for a listing fee of Kshs.150 million. The Ministry had initially indicated that it was the responsibility of Safaricom Limited to pay for the listing fees. Safaricom Limited in a response took the position that it was the Government selling its shares and thus Safaricom Limited was not party to the sale. The Company was not therefore obliged to pay the fees.

The matter does not appear to have been concluded but nevertheless indications were that the Ministry had already factored the expenditure in its budget.

2.5.3 Incidentals costs

Incidentals Costs – Receiving Bank

Included in the total IPO cost were incidental costs of Kshs 93,892,179 incurred by the Receiving Bank, and representing 10% of the total fee of Kshs 938,921,798. The amount of Kshs. 938,921,798 was made up of the Authorized Selling Agents' commission of Kshs 716,928,933 and a charge by the Receiving Bank of Kshs. 221,992,865.

The expenditure of Kshs.93,892,179 in respect of the incidental costs could not however be confirmed due to non-availability of supporting documents.

2.5.4 Reimbursables – Advertisement

Records available indicate that Redsky Limited was awarded the contract for the advertisement of the IPO at a fee of Kshs. 2,082,200 inclusive of taxes. The contract does not however appear to have specified the total cost in respect of reimbursables. Expenditure relating to such costs were reimbursed by the vendor against the proof of payment. Clearly, control of expenditure under this arrangement was considerably weak and susceptible to nugatory costs.

Additional information show that the reimbursable costs included media coverage costs, cost of printing publicity material, projector services, press photographs, production of radio and television commercials.

As of December 2008, Redsky Limited had been paid reimbursables totalling Kshs 199,107,922. However, proper supporting documents in respect of this reimbursement were not made available for audit review, consequent upon which its accuracy could not be ascertained.

The total cost of Kshs.199,107,922 in respect of the reimbursables exceeded the approved budget of Kshs.187,825,443 against the item by Kshs.11,282,479.

2.5.5 Reimbursables- Expenses and commissions

The Receiving Bank's reimbursable expenses and commissions totalling Kshs.127,949,831 could similarly not be ascertained due to lack of supporting documents..

2.5.6 Assets

The Receiving Bank purchased various assets on behalf of the Ministry of Finance, which were used during the IPO process. The assets included computers, chairs, desks and telephone accessories etc. However, no documents such as invoices, receipts and other related records were made available for audit review. Further, the assets do not appear to have been taken over by the Ministry after conclusion of the process.

2.6 GAIN/LOSS IN THE IPO PROCESS

2.6.1 Gain on Share Pricing Issue

As mentioned elsewhere in this report, the valuation of the shares for the Domestic Pool was Kshs.4.75 per unit. The Government however approved the price at Kshs. 5.00 per unit. This increase of the unit price from Kshs. 4.75 to Kshs.5.00 brought about a gain of Ksh.2.5 billion as indicated below;

IPO Proceeds	10 billion shares @ Kshs 5 per share	= Kshs 50 billion
IPO Proceeds	10 billion shares @ Kshs.4.75 per share	=Kshs47.5 billion
Gain		**Kshs.2.5 billion**

2.7 OTHER MATTERS

2.7.1 Leveraged Purchase of Shares

It was observed that there were apparently no institutional guidelines on the permissible level of borrowing for the purpose of purchasing shares in the IPO. Records available indicate that various individual and retail investors accessed from local banks, credit facilities ranging on average between Kshs.10,000 and Kshs.2 million for the purpose of buying shares. Although the terms of agreement for such facilities varied from bank to bank, in many instances, the share certificates served as the guarantee against the loans. Under this arrangement however, it would appear that such investors could not meaningfully access, participate and benefit from the services offered at the Nairobi Stock Exchange until the loans extended to them were fully repaid.

2.0.1 Interest on the IPO Proceeds

The Capital Markets Act Cap 485A part II section 18 (2) (e) states that the compensation fund shall consist of interest deemed to accrue on the proceeds of a public issue or offer for sale of shares of a company listed or to be listed on an approved securities exchange, between the closing date and that of dispatch of shares certificates or refund cheques, to be determined at the rate prescribed by the Authority. The closing date for the IPO was 23 April 2008 while the date of dispatch of share certificates and refund of cheques was 4 June 2008 i.e a period of forty one (41) days. The Capital Markets Authority in a letter dated August 2008 raised an invoice for payment of interest amounting to Kshs. 1,015,406,335 on the IPO proceeds. The interest was based on the amount of Kshs 116,835,892,300 at a rate of 7.737% for 41 days which represented proceeds from sale of shares in respect of retail investors, employees and Safaricom Limited dealers. As of December 2008, however there were no indication of the balance of Kshs.1,015,406,335 having been paid to the Authority.

2.7.3 Reconciliation with Brokerage Firms

The Receiving Bank had not as of December 2008 completed reconciliations with other relevant stakeholders in the IPO and as a result it was not possible to establish the amount of proceeds yet to be remitted to the Treasury over and above the sum of Kshs.49,887,137,100 received as at that date. No reasons were provided for the delay in the completion of the reconciliations. Further and as a result of failure to complete the reconciliations, it has also not been possible to ascertain that the Government obtained full value for money in the IPO.

2.7.4 After-Market Trading

Information provided by the Nairobi Stock Exchange on the trading pattern at the Foreign Investors counter between June and July 2008 appeared to show that the Investors were net sellers and were not therefore in the category of long term investors. This tendency would appear to have been inconsistent with the requirement in the prospectus that the Global Co-ordinator was to seek to build a book of demand consisting of a mix of investors who are likely to be long term holders of the securities.

3.0 CONCLUSION

Subject to the issues raised in this report and on the basis of records and information made available, the financial and procurement regulations in force were adhered to and the applicable laws were complied with during the Safaricom Limited Initial Public Offer.

A.S.M. Gatumbu

CONTROLLER AND AUDITOR GENERAL

Nairobi

7 July 2009