October 2018

KenGen FY18 Earnings Update
"The Drought is Over"

Bloomberg Ticker	KEGN KN
Reuters Ticker	KEGC.NR

Share Statistics

Price	7.35
Market Cap (KES B)	48.5
Market Cap (USD M)	478.9
Year end	30-Jun
Float	30.0%
Foreign ownership	13.1%
3-month Avg Trading Val (USD)	34,253

KenGen's FY18 PBT rose 2.5% y/y to KES 11.7B (close to our estimates of KES 11.6B) though the **return to normalcy in the effective tax rate (+1,140 bps y/y to 32.8%)** saw the firm's **net earnings ebb 12.4% y/y to KES 7.9B.**
In a move that has caught the entire market off-guard, the firm announced a final **dividend of KES 0.40 with books closure set for 6th December 2018.**

Geothermal sales keep top-line largely unchanged
The drought experienced in 1Q18 saw KenGen's electricity income from hydro decline 3.3% y/y to KES 8.3B. Despite higher units sold from thermal sources as a result of the drought (+1.8% y/y), lower yields on thermal power saw electricity revenue from thermal fall 8.4% y/y to KES 3.4B.
The deficit from hydro power was largely met from geothermal sources, resulting in a 17.8% y/y increase in units sold to 3,867GWhs. This resulted in a 6.3% y/y increase in revenue from geothermal sales to KES 17.1B. The increase in geothermal sales negated the fall in hydro and thermal resulting in a largely unchanged (1.0% y/y) top-line at KES 29.3B.

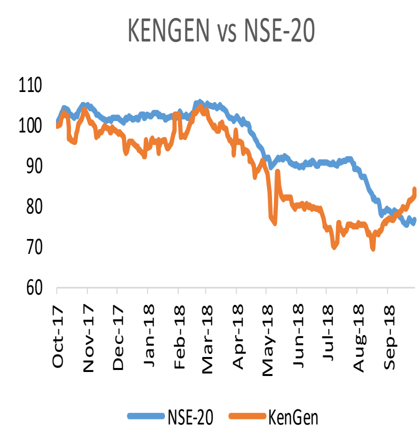
Steam profit grows amidst falling margins: Steam revenue continued the growth witnessed in 1H18, surging 19.9% y/y to KES 6.2B on the completion of new wellheads and the Olkaria-Suswa transmission line. Similar to 1H18, steam costs outpaced the revenues, rising 26.9% y/y to KES 3.5B resulting in a 320bps y/y erosion in steam margin to 43.0%. Nonetheless, steam profit rose 11.7% y/y to KES 2.7B.

Revaluation negates other income: Revaluations undertaken in the year on assets held in foreign currencies resulted in revaluation losses. This saw total other income fall to a loss of KES 399.3M from a KES 1.2B gain in FY17. Consequently, gains made in steam revenue and the marginal jump in electricity revenue were neutralized resulting in a 0.7% y/y marginal decline in net revenue to KES 35.1B.

Enhanced staff remuneration raises operating expenses: Employee costs rose 6.6% y/y to KES 6.1B which the firm attributes to bonuses paid out to staff during the year. Falling other operating expenses (-11.7% y/y to KES 2.2B) partly shielded the firm from the rising employee costs, resulting in a marginal 2.1% y/y growth in operating expenses to KES 9.9B. The uptick in operating expenses coupled with the lower net revenues earned saw the firm's EBITDA margin come off 300bps y/y to 61.5%.

Depreciation and amortization; chickens come home to roost: Historically high capex to enhance generation capacity is being felt in the firm's income statement with depreciation and amortization rallying 9.8% y/y to KES 10.1B. This has resulted in a 570bps y/y deterioration in EBIT margin to 32.6%. The huge 28.9% difference in EBIT and EBITDA margins underscores the impact of depreciation expense.

Price Trend



Source: (NSE)

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Finance income outpaces finance cost: Finance income surged 150.6% y/y to KES 3.3B. This was attributed to additional income from treasury bonds, bank deposits and revaluation gains on foreign currency denominated loans.

The firm's capex of KES 14.6B fell below the KES 40.0B capex outlined for the year, resulting in lower new borrowings undertaken (-58.2% y/y). As such, the firm's finance costs plunged 11.1% y/y to KES 3.0B resulting in a net finance income of KES 304M from a net finance cost of KES 2.1B in FY17.

Any adjustments in the sails?

Capex program still in unchanged, despite threats of sluggish consumption: With the country's projected increase in power generation outpacing the power demand, the sector's increased investment in capacity generation has come into question. Nonetheless, KenGen asserts that the initial expansion program is still in play and intends to add 720MW of new capacity by 2020. Olkaria V, which is 74% complete currently, is set to be commissioned next year July, resulting in an anticipated surge in capacity revenue upon commissioning. In addition, the firm is set to enjoy capital allowances upon commissioning of the plant, easing the tax burden,

Top-line to ride on higher capacity revenue: We forecast capacity revenue to surge at a 4-year CAGR of 12.4% to KES 34.2B on the back of new plant commissioning. Energy revenue is projected to grow in tandem with our estimates on the country's growth in demand of about 6.0%.

To look a gift horse in the mouth: The KES 0.40 dividend announced for FY18 sees the firm honor its promise made during the 2016 rights issue of a pay-out ratio of about 33.3%. Though this is very welcome, questions arise on the sustainability of the policy in the long-term, given the huge capital outlay outlined for the firm.

Long or Short KenGen?: The dividend announcement is a welcome move despite the lingering questions. On the flip side, the firm's 12.4% y/y decline in net earnings throws a spanner in the works for initial market reactions. Though the decline has been attributed to the higher effective tax rate, the firm's operating profit fell 15.5% y/y and the face saving surge in finance income is not sustainable going forward.

Management's intent to sustain the dividend policy is likely to rally the market in the long-run. In addition, the surging capacity revenues coupled with enhanced operating cost optimization strategies are anticipated to drive the bottom-line.

Our fair value currently stands at KES 8.47 translating to an upside of 15.2% based on the firm's current price of KES 7.35. As such we encourage exposure in the counter based on the counter's relatively alluring dividend yield of 5.4% and the potential capital gains.

FY18 Financials

	FY17	ApexAfrica Estimates	FY18	y/y % change	Deviation from estimates
Income statement	**KES M**	**KES M**	**KES M**	**%**	**%**
Electricity revenue	**29,007**	**31,060**	**29,286**	**1.0**	**-5.7**
Steam revenue	5,189	6,425	6,222	19.9	-3.2
Other income	1,153	761	(399)	-134.6	-152.5
Total income	**35,349**	**38,245**	**35,108**	**-0.7**	**-8.2**
Operating expenses	(9,763)	(13,993)	(9,970)	2.1	-28.8
Steam costs	(2,796)	(3,494)	(3,549)	26.9	1.6
EBITDA	**22,790**	**24,252**	**21,590**	**-5.3**	**-11.0**
Depreciation & amortisation	(9,244)	(10,628)	(10,148)	9.8	-4.5
EBIT	**13,546**	**13,624**	**11,442**	**-15.5**	**-16.0**
Finance income	1,333	1,278	3,341	150.6	161.4
Finance costs	(3,417)	(3,342)	(3,038)	-11.1	-9.1
PBT	**11,462**	**11,561**	**11,745**	**2.5**	**1.6**

Tax income/(expense)	(2,455)	(2,747)	(3,855)	57.0	40.3
PAT	**9,007**	**8,814**	**7,890**	**-12.4**	**-10.5**
Other comprehensive income	(528)	-	(623)	18.0	-
Total comprehensive income	8,479	5,320	7,267	-14.3	36.6
Earnings per share KES	**1.37**	**1.34**	**1.20**	**-12.4**	**-10.2**
DPS (KES)	**-**	**-**	**0.40**		

Balance sheet	FY17	ApexAfrica Estimates	FY18	y/y % change	Deviation from estimates
PPE	**323,843**	**353,215**	**328,082**	**1.3**	**-7.1**
Other non-current assets	23,248	24,398	19,858	-14.6	-18.6
Current assets	29,639	26,564	31,412	6.0	18.3
Total assets	**376,730**	**404,177**	**379,353**	**0.7**	**-6.1**
Share capital	16,488	16,488	16,488	0.0	0.0
Share premium	22,151	22,151	22,151	0.0	0.0
Reserves and retained earnings	**144,198**	**155,729**	**151,465**	**5.0**	**-2.7**
Non-current liabilities	173,800	188,938	168,370	-3.1	-10.9
Current liabilities	20,093	20,871	20,879	3.9	0.0
Total equity and liabilities	**376,730**	**404,177**	**379,353**	**0.7**	**-6.1**

Statement of Cashflows	FY17	ApexAfrica Estimates	FY18	y/y % change	Deviation from estimates
Cash generated/ (used) from operating activities	**13,201**	**24,684**	**17,510**	**32.6**	**-29.1**
Cash generated/ (used) from investing activities	(13,074)	(40,000)	(14,843)	13.5	-62.9
Cash generated/ (used) from financing activities	946	14,795	(7,144)	-	-
Net changes in cash and cash equivalents	**1,073**	**(521)**	**(4,476)**	**-**	**-**
Opening balance	6,756	7,831	7,831	15.9	0.0
Effects of exchange rates in cash and cash equivalents	2	-	29		
Closing balance	**7,831**	**7,309**	**3,383**	**-56.8**	**-53.7**

Ratios and margins	FY17	ApexAfrica Estimates	FY18	y/y % change	Deviation from estimates
Steam margin (%)	**46.1**	**45.6**	**43.0**	**-3.2**	**-2.7**
EBITDA margin (%)	**64.5**	**63.4**	**61.5**	**-3.0**	**-1.9**
EBIT margin (%)	**38.3**	**35.6**	**32.6**	**-5.7**	**-3.0**
Net earnings margin (%)	25.5	23.0	22.5	-3.0	-0.6
Effective tax rate	21.4	34.0	32.8	11.4	-1.2
Debt to Equity (%)	**72.1**	**78.1**	**73.0**	**0.8**	**-5.2**
Net Debt to Equity (%)	**67.9**	**74.4**	**71.2**	**3.3**	**-3.2**
ROaE	5.1	4.7	4.2	-0.9	-0.4
ROaA	4.0	2.3	2.1	-1.9	-0.2
Current ratio (x)	**1.5**	**1.3**	**1.5**		
P/E (x)			**6.1**		
P/B (x)			**0.3**		
Dividend Yield (%)			**5.4**		

Source : Company filings & ApexAfrica Research

Appendix

Investment ratings

- **Buy:** A total return is anticipated in excess of the market's long-term historic annual rate (approximately 10%). Total return expectations should be higher for stocks that possess greater risk.

- **Hold:** Hold the shares with neither a materially positive total return nor a materially negative total return anticipated.

- **Sell:** Stock should be sold as materially negative total return is anticipated.

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