Kenya Power Company Update
“Tainted”
Recommendation: BUY

Bloomberg Ticker	KPLL KN
Reuters Ticker	KPLC.NR

Share Statistics	
Recommendation	Buy
Fair Value (KES)	7.70
Current Price (KES)	6.80
Market Cap (KES B)	13.3
Market Cap (USD M)	131.7
Year end	30-Jun
Free Float (%)	49.5
Foreign ownership (%)	9.1
3-month Avg Trading Vol (USD)	51,996

It has been a turbulent time for **Kenya Power** with the firm having to grapple with a number of scandals. The **overcharging of some of its clients** opened the floodgates of hell which, when coupled with issues surrounding **3rd party token vendors** and **fraud around prequalified contractors** have sent the counter’s price on a nose-dive to hit **KES 6.80**. Informed by our **fair value of KES 7.70** representing a **13.9% upside**, we reiterate our **BUY recommendation** on Kenya Power. We note the recent price decline is largely attributed to **market overreaction** to the aforementioned issues. With management anticipated to keep **dividend constant at KES 0.50**, this points to an **alluring dividend yield of 7.4%**.

Price Return	Absolute	Relative
3m	-10.9%	3.2%
6m	-26.6%	-15.7%
12m	-17.7%	-9.3%

The Good

- We project a 4-year CAGR of 7.1% in electricity revenue on the back of growing electricity demand (4-year CAGR of 6.0%) and improving power availability;
- Projected decline in system losses in the long-run to raise gross profit margins;
- High electricity access points to a slowdown in capex. This is anticipated to ease debt requirements and reduce the debt appetite for the firm;
- Cash balances anticipated to close in the green in the long-run driven by rising cashflow from operations and lower cash used in investing activities.

Source: (NSE)

The Bad

- FY18E anticipated to be challenging as suggested by our estimated 21.0% y/y decline in net earnings;
- Previous high capex leads to high future depreciation projected to slow down the recovery in EBIT going forward;

The Ugly

- Corporate image tainted by scandals;
- Possible review of tariffs may lower profit margins. The possible change from foreign currency to local currency in pricing power may see Kenya Power lose forex hedge.

Summary	FY16	FY17	FY18E	FY19F	FY20F	FY21F
Electricity sales (KES B)	**87.1**	**92.0**	**95.8**	**103.5**	**111.8**	**120.9**
y/y change (%)	*11.9*	*5.6*	*4.2*	*8.1*	*8.0*	*8.1*
Gross profit margin (%)	40.9	44.9	44.5	46.2	47.2	48.2
EBITDA margin (%)	27.3	30.5	30.2	31.4	31.7	32.0
Net earnings margin (%)	8.3	7.9	6.0	6.9	7.4	8.2
EPS (KES)	3.69	3.72	2.94	3.66	4.24	5.05
y/y change (%)	*-3.2*	*1.0*	*-21.0*	*24.5*	*15.6*	*19.2*
DPS (KES)	0.50	0.50	0.50	0.50	0.50	0.50
ROE (%)	11.8	10.8	8.3	9.2	9.8	10.6
ROA(%)	2.5	2.3	1.6	2.0	2.2	2.6
P/E (x)	1.8	1.7	2.2	1.8	1.5	1.3
EV/EBITDA (x)	5.1	5.0	4.9	4.5	4.2	3.8

Source: Company Filings, ApexAfrica Estimates

Senior Research Analyst

Harrison Gitau

hgitau@apexafrica.com

+254 (20) 760 2545

The Good

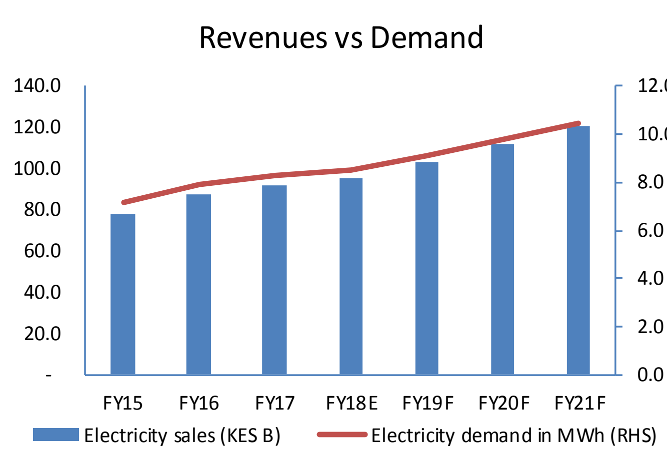
Electricity demand on the rise

With guidance from management, we project a 4-year CAGR of 6.0% in electricity demand to hit 10.5 MWh in FY21. This will be supported by increased electricity connectivity (currently at 73.4%) and increased consumption from both the domestic and commercial customers. Increased disposable income is anticipated to rally demand from the domestic consumers whilst a recovery in economic activity is anticipated to support the growth in power consumption from the commercial customers.

The Head of State intends to leave a legacy not only of heightened electricity access but also cheap power. To this effect, the government plans to lower the cost of power to industrial consumers to c.9.0 US cents per unit which is anticipated to drive power consumption. Management asserts that the uptake of time of use tariff has been positive with about 800 industrial consumers taking advantage of the tariffs.

Anticipated improvement in power availability

The first phase of underground cabling was completed and is meant to serve industrial consumers in the Nairobi region. In addition, the recently commissioned Nairobi City Centre 220/66kV Gas Insulated station (GIS) substation is anticipated to boost the City's Bulk power supply system. The additional capex to be expensed by the utility firm is projected at improving power availability, deviating from the previous objective of raising electricity access. This is anticipated to lower the cases of power outages, supporting the increase in consumption.



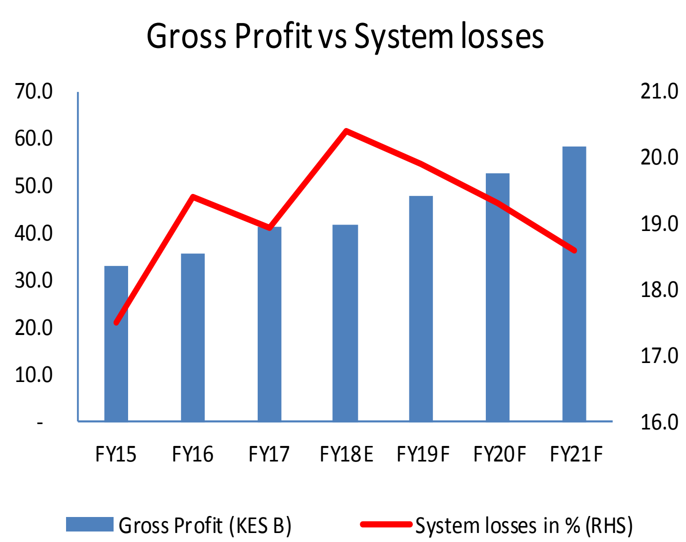
Source: Company filings, ApexAfrica Research

Declining system losses to raise gross profit

We project a gradual decline in system losses from FY19F onwards. In FY18E, we anticipate the 20.4% levels witnessed in 1H18 to hold for the year. According to management, this was anticipated in line with the expanding grid. However, interventions put in place are anticipated to leave the system losses as a one off event for FY18E.

Smart meters and prepaid meters are anticipated to lower commercial losses while the feeder based units coupled with increasing substations are expected to tame the technical losses.

This would result in a 4-year CAGR of 8.9% in gross profit to KES 58.2B in FY21F. With the gross profit outpacing the growth in revenue, we project a rise in gross profit margin to 48.2% in FY21F from 44.9% in FY17.



Source: Company filings, ApexAfrica Research

EBITDA margin on the rise

We forecast EBITDA margin to rise from 30.5% in FY17 to 32.0% in FY21F. This is premised on sales and administration costs growing at a slower rate (4-year CAGR of 7.5%) than the rise in gross profit (4-year CAGR of 8.9%). Management asserts that the introduction of feeder based network management is anticipated to curtail the rising operating costs resulting in an improved EBITDA margin.

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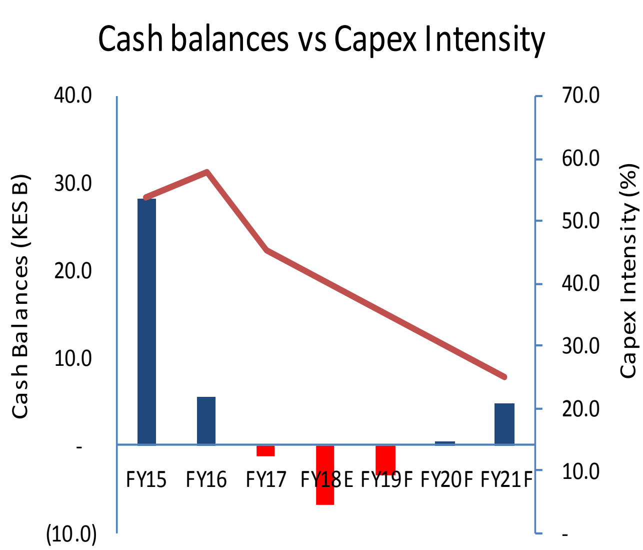
Rising electricity access points to lower capex

With the firm hitting and surpassing its 70.0% access rate target by 2017 (current at 73.4%) and about 20.0% of the access rate to be met by REA (Rural Electricity Authority), Kenya Power is anticipated to record lower capex going forward. We project a decline in capex intensity from 45.1% in FY17 to 25.0% in FY21F. This is anticipated to see capex record a 4-year CAGR of –7.5% to KES 30.4B in FY21F.

Lower capex is projected to ease debt financing. Consequently we project debt to grow at a 4-year CAGR of 3.3%, slower than the 4-year CAGR of 8.5% in equity. This will result in a fall of debt to equity to 143.1% in FY21F from 174.4% in FY17. Given that we project debt levels to grow, albeit marginally, we forecast finance costs to edge up (4-year CAGR of 1.7%).

Cash balances; from red to green, eventually

We expect Kenya Power to turn the tide in its negative cash balances in 1H18 (KES 7.7B) to a positive balance of KES 4.7B in FY21F. The turn-around is to be propelled by rising cash from operating activities (4-year CAGR of 4.1%) and easing cash used in investing activities (4-year CAGR of 7.0%). The rising cash from operations is based on expected rise in EBIT (4-year CAGR of 6.7%) while the lower cash used in investing activities is based on the anticipated cooling in capex.



Source: Company filings, ApexAfrica Research

The Bad

Challenging FY18E

Following the 30.3% y/y decline in 1H18 net earnings, we project FY18E net earnings to fall 21.0% y/y to KES 5.7B. 1H18 was a challenging period for most sectors in the economy which resulted in a subdued growth in electricity consumption (+2.5% y/y) resulting in the dismal performance for the period. 2H18 is anticipated to bring better tidings; however, the damage caused in 1H18 is too big to be corrected by the subsequent half.

Given the impact of 1H18, we forecast a marginal 4.2% y/y increase in electricity sales to KES 95.8B. Fuel recoveries have historically constituted c.99.9% of fuel costs. However, in 1H18, this came down to 95.0%; which we anticipate to hold for the year. Though this is seen as a one-off, it'll impact the firm's gross profit margin in FY18E (-44bps y/y to 44.5%).

System losses rose in 1H18 to 20.3% as a result of the expanded power grid. According to management, the increase was anticipated as the country strives to achieve universal electricity access by FY20F. In FY18E, we project system losses to hit 20.4%, consistent with losses observed in the 9 months to June 2018.

Despite the forecasted dip in FY18E earnings, we expect the firm to raise the dividend pay-out ratio to sustain DPS at KES 0.50.

Given the negative cash balances witnessed in FY17 (KES 1.2B), lower cash from financing activities coupled with flat cash from operating activities is anticipated to worsen the negative balances to KES 6.9B in FY18E. As a result, we project increased reliance on short-term financing facilities (in the short-term) which we expect to pile pressure on the firm's financing costs (+9.5% y/y to KES 6.2B in FY18E). The lower cash balances are anticipated to (nearly) wipeout finance income, further raising the net finance costs.

Depreciation; The chickens come home to roost

The company has in the past invested aggressively in expanding the grid. Though this has raised the electricity access in the country, it has resulted in elevated depreciation costs for the firm. As a result, we project a 4-year CAGR of 10.1% in depreciation outpacing the 4-year CAGR of 9.1% in EBITDA, resulting in a 4-year CAGR of 7.5% in EBIT to KES 21.4B in FY21F.

The Ugly

Tariff review underway

Though the tariff review may be positive or negative for the firm, we opine the latter will carry the day. The Government is determined to deliver on its election promise of cheaper power with this promise pegged on the review of electricity tariffs. The President has further promised manufacturers to lower cost of electricity to US 9.0cents per unit from the current levels of c.US 13 cents. Though this is good for the economy, it might point to compressed profit margins for players in the energy sector.

In the planned tariff review, the ERC plans to stop using US dollars to price electricity in the country. This is aimed at lowering/eliminating forex costs in consumer power bills and encourage local funding of power projects. However, most of the capex financing for Kenya Power is denominated in foreign currency (83.4% as at FY17). Foreign funding is preferred since its cheaper and has longer repayment periods. The hedge against foreign currency risk has been the pricing in foreign currency, with the risk covered in the forex costs component in the billing. The removal of the current method may expose the firm to foreign exchange risk, denting its bottom-line.

Tainted corporate image

The year to date has seen the company's image tainted as a result of a myriad of scandals facing the firm. The company began the year facing a class action suit after allegations emerged that the power company overcharged its clients. According to the allegations, the overcharge came as Kenya Power sought to recover KES 10.2B fuel cost recoveries from consumers which was not charged in FY17. The firm however asserted that the overcharge came from the use of a new billing system. This issue is however proceeding at the High Court of Kenya and is yet to be resolved.

Whilst still looking for a footing, additional claims emerged that the platform owned by Kenya Power for generating tokens was being intentionally sidelined by the firm opting to use third party token vendors. The use of the vendors further resulted in the elevated power costs experienced by consumers.

The final blow was fraud on the part of its staff which has sent the share price at the bourse sprawling. According to an internal audit report, the firm had a number of prequalified firms who served as its contractors. A huge number of the prequalified firms were actually not qualified and were in the prequalified list as a result of collusion with some of its staff.

The aforementioned scandals have taken a toll on the company's share price at the bourse. The current price of KES 6.80 is a far cry from the elevated price levels witnessed mid last year. Management is hell-bent on resolving the company image and has vowed to take action. It states the staff who were involved in the collusion to prequalify unqualified companies have been sent packing. In addition, the firm plans to cancel the services of some two third party token vendors and has started pushing more of its prepaid customers to use its own platform.

It'll take a bit more for the power firm to clean up its act, more so in the public eye. As such, the downward pressure at the bourse is anticipated to hold in the short-term as a result of investor overreaction. We expect the annunciation of an FY18E DPS of KES 0.50 to calm the investors down, though this may be far fetched.

Parting shot based on our crystal ball

We continue seeing value in Kenya Power despite the recent race to the bottom in its share price. The price seems to have bottomed out at current levels but could come under further pressure and slide below the current levels.

Investment into the counter is ideal for the long-term value investor given the alluring dividend yield coupled with potential capital appreciation.

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Peer Comparables

Name	Country	P/E (x)	P/B (x)	EV/EBITDA (x)	Div Yld (%)	ROE (%)
Kenya Power	**KN**	**1.8**	**0.2**	**5.0**	**7.4**	**10.8**
Irbid Lighting	JO	25.8	5.2	9.5	9.0	17.7
Jordanian Electric	JO	-	1.2	11.2	3.3	(3.0)
Umeme	UG	13.3	0.8	6.9	2.6	5.9
Compagnie Ivoirienne	IV	45.4	4.8	-	10.8	8.6
Copperbelt Energy	ZM	5.2	1.3	-	7.5	19.1
Saudi Electric	SR	118.6	1.3	12.0	-	1.1
Mean[a]		**21.1**	**1.1**	**8.9**	**6.8**	**8.4**
Median		**13.3**	**1.3**	**6.9**	**7.4**	**8.6**

a mean is taken without outliers

Source: Company filings, ApexAfrica Research, Bloomberg

Valuation

Assumptions		
Risk free rate (%)	12.5	*5-year T-Bond yield*
Beta	0.9	*ApexAfrica estimates*
Risk premium (%)	5.0	
Cost of Equity (%)	17.0	
WACC (%)	4.8	
Long-term growth rate (%)	10.0	

P/E Method	
Historical average (x)	2.2
FY19F EPS (KES)	3.66
Fair Value (KES)	**7.91**

DDM	FY19F	FY20F	FY21F	Terminal
DPS (KES)	0.50	0.50	0.50	10.53
Discounted DPS (KES)	0.43	0.36	0.31	6.54
Fair value (KES)	**7.64**			

Dividend Yield	
Historical average (%)	6.3
Industry average (%)	6.8
Average Dividend Yield (%)	6.5
FY19F Dividend (KES)	0.50
Fair Value (KES)	**7.68**

Blended Fair Value	
P/E Method (KES)	7.91
DDM Method (KES)	7.68
Dividend Yield Method (KES)	7.64
Blended Fair Value (KES)	**7.70**

1H18 Financials

Income statement	1H17 KES M	1H18 KES M	y/y change %
Electricity sales	**45,795**	**46,931**	**2.5**
Forex adjustment	2,531	4,492	77.5
Fuel cost adjustment	6,183	11,637	88.2
Total income	**54,509**	**63,060**	**15.7**
Non-fuel power purchase costs	(26,109)	(27,429)	5.1
Fuel costs	(6,226)	(12,294)	97.5
Forex costs	(3,156)	(3,793)	20.2
Total power purchase costs	**(35,491)**	**(43,516)**	**22.6**
Gross Profit	**19,018**	**19,544**	**2.8**
Other income	3,961	4,043	2.1
Transmission & distribution costs	(15,058)	(15,814)	5.0
EBIT	7,921	7,773	-1.9
Finance income	-	52	
Finance cost	(2,281)	(3,257)	42.8
Profit before tax	**5,640**	**4,568**	**-19.0**
Income tax expense	(1,439)	(1,641)	14.0
Profit after tax	4,201	2,927	-30.3
EPS (KES)	2.15	1.50	-30.2
DPS (KES)	-	-	

Statement of financial position	1H17	1H18	y/y change
PPE and land	**244,460**	**271,224**	**10.9**
Other non-current assets	11,728	12,563	7.1
Total current assets	43,037	73,280	70.3
Total assets	**299,225**	**357,067**	**19.3**
Total equity	69,231	71,914	3.9
Total non-current liabilities	179,786	196,326	9.2
Total current liabilities	50,208	88,827	76.9
Total equity and liabilities	**299,225**	**357,067**	**19.3**

Statement of cashflows	1H17	1H18	y/y change
Cash generated from operating activities	**12,083**	**9,927**	**-17.8**
Net cash used in investing activities	(13,730)	(14,159)	3.1
Net cash from financing activities	(2,931)	(2,361)	-19.4
Increase/ (decrease) in C&CE	**(4,578)**	**(6,593)**	**44.0**
C&CE at the beginning of the period	5,503	(1,150)	
C&CE at the end of the period	**925**	**(7,743)**	

Ratios and margins	1H17	1H18	y/y change
GP margin (%)	34.9	31.0	-3.9
EBIT margin (%)	14.5	12.3	-2.2
Net earnings margin (%)	7.7	4.6	-3.1
RoAE (%)	12.5	8.3	-0.3
RoAA (%)	2.8	1.7	-0.4
Current ratio (x)	0.9	0.8	-3.8

Source: Company filings, ApexAfrica Research

C&CE– Cash and cash equivalents

Financial Forecasts

Income Statement (KES B)	FY17 KES B	FY18E KES B	FY19F KES B	FY20F KES B	FY21F KES B	y/y change %	4-year CAGR %
Electricity Revenue	**92.0**	**95.8**	**103.5**	**111.8**	**120.9**	**4.2**	**7.1**
Electricity purchase costs	(50.6)	(52.3)	(55.6)	(58.9)	(62.5)	3.4	5.4
Gross profit	**41.3**	**42.0**	**47.7**	**52.6**	**58.2**	**1.5**	**8.9**
Other income	8.1	8.5	9.0	9.5	10.1	5.0	5.5
Operating costs	(22.2)	(22.0)	(24.3)	(26.8)	(29.6)	-0.7	7.5
EBITDA	**27.3**	**28.5**	**32.4**	**35.3**	**38.7**	**4.4**	**9.1**
Depreciation and amortization	(12.0)	(13.4)	(15.3)	(16.3)	(17.2)	11.6	9.6
EBIT	**16.0**	**15.1**	**17.1**	**19.0**	**21.4**	**-5.6**	**7.5**
Net finance cost	(5.1)	(6.2)	(6.0)	(6.1)	(6.1)	20.8	4.3
Profit before tax	**10.9**	**8.9**	**11.1**	**12.9**	**15.4**	**-18.0**	**8.9**
Taxation	(3.6)	(3.2)	(4.0)	(4.6)	(5.5)	-12.2	10.8
Profit after tax	**7.3**	**5.7**	**7.2**	**8.3**	**9.9**	**-21.0**	**7.9**
EPS (KES)	**3.72**	**2.94**	**3.66**	**4.24**	**5.05**	**-21.0**	**7.9**
DPS (KES)	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**-**	**-**

Balance Sheet (KES B)	FY17	FY18E	FY19F	FY20F	FY21F	y/y change	4-year CAGR
Non-current assets	**276.4**	**293.2**	**315.0**	**333.1**	**347.0**	**6.1**	**5.9**
Current assets (excl. cash)	61.7	60.3	48.7	44.9	42.8	-2.3	-8.8
Cash & cash equivalents	3.5	3.3	3.0	2.7	2.2	-6.6	-11.0
Total assets	**341.7**	**356.8**	**366.8**	**380.7**	**392.0**	**4.4**	**3.5**
Shareholders equity	70.0	74.7	80.9	88.2	97.1	6.8	8.5
Non current liabilities	196.4	202.7	213.6	222.0	223.3	3.2	3.3
Current liabilities	75.3	79.3	72.3	70.5	71.6	5.4	-1.2
Total equity and liabilities	**341.7**	**356.8**	**366.8**	**380.7**	**392.0**	**4.4**	**3.5**

Cashflow Statement (KES B)	FY17	FY18E	FY19F	FY20F	FY21F	y/y change	4-year CAGR
Cash flow from operations	**27.4**	**27.7**	**31.1**	**30.7**	**32.1**	**1.1**	**4.1**
Cash flow used in investing	(39.5)	(37.2)	(35.2)	(32.7)	(29.5)	-5.8	-7.0
Cash flow from financing	5.5	3.8	7.5	6.0	1.6	-30.3	-26.0
Cash at the beginning	5.5	(1.2)	(6.9)	(3.5)	0.6	-	-43.5
Net increase for the year	**(6.7)**	**(5.7)**	**3.4**	**4.1**	**4.2**	**-14.2**	**-**
Cash and cash equivalents end	**(1.2)**	**(6.9)**	**(3.5)**	**0.6**	**4.7**	**496.7**	**-**

Ratios and margins	FY17	FY18E	FY19F	FY20F	FY21F
Gross profit margin (%)	44.9	44.5	46.2	47.2	48.2
EBITDA margin (%)	30.5	30.2	31.4	31.7	32.0
EBIT margin (%)	17.4	15.8	16.6	17.0	17.7
Net profit margin (%)	7.9	6.0	6.9	7.4	8.2
Return On assets (%)	2.3	1.6	2.0	2.2	2.6
Return on equity (%)	10.8	8.3	9.2	9.8	10.6
Debt to equity (%)	174.4	161.6	159.8	154.6	143.1
Net debt to equity	176.0	170.8	164.1	153.9	138.2
Current ratio	0.9	0.8	0.7	0.7	0.6

Source: Company filings, ApexAfrica Research

Appendix

Investment ratings

- **Strong Buy:** Issued on counters with strong fundamentals with a fair value above 20.0%. The counter is anticipated to register strong growth with and is currently undervalued.

- **Buy:** Issued on counters with strong fundamentals whose upside lies between 10.0% and 20.0%. The same may be issued for counters with challenged fundamentals whose upside is over 20.0%. Such a scenario is targeted for risk neutral investors.

- **Accumulate:** Issued on counters with an upside of between 5.0% - 10.0%. The counter may be facing contracting avenues for growth with a tepidly growing bottom-line.

- **Hold:** Issued on counters with an upside of between 0% and 5.0% with limited avenues for growth. Contracting bottom-line with an attractive dividend yield of about 5.0%.

- **Lighten:** The company is anticipated to record a moderate downside on its fair value, though it may have strong fundamentals.

- **Sell:** The counter currently has weak fundamentals coupled with significant potential downside.

Disclaimer

ApexAfrica Capital Ltd
A The Riverfront, 1st Floor, Prof. David Wasawo Drive, Off Riverside Drive | P.O. Box 43676-00100 | Nairobi | Kenya |
T: +254-20-2226440 | Fax: +254-20-2319092 | Cell: +254-723-420204| **W** : www.apexafrica.com