Kenya Power 1H17 Earnings Update

Kenya Power's net **earnings** for **1H17 rose 11.4% y/y** to **KES 4.2B**, marginally higher than our **estimates** of **KES 4.0B**. The increase was mainly driven mainly by a **favorable tax rate of 25.5% (-890bps y/y). Profit before tax** ebbed **1.7% y/y** attributed to a **KES 723M** decline in finance income (to **nil**) as a result of **reduced bank balances.**

Wider customer base drives top-line: Kenya Power connected 800,000 new customers in 1H16. The resultant wider customer base saw the firm's electricity sales (excluding fuel recovery and forex surcharge) rise 9.9% y/y to KES 45.8B.

Electricity purchase costs (non-fuel) edged up 4.6% y/y to KES 26.1B attributed to a 5.6% y/y growth in unit purchases to 4,786GWh. Units sold rose faster than the power purchase costs, implying lower capacity charges paid by Kenya Power.

Fuel costs which is a pass through cost declined 22.9% y/y to KES 6.2B attributed to a decline in the unit cost of fuel. Fuel cost recoveries as a percentage of fuel costs increased 690bps y/y to 99.3%, explaining the slower decline in the recoveries (as compared to the costs) of 17.1% y/y to 6.2B.

A faster growth in electricity sales as compared to power purchase costs saw Kenya Power's gross profit margin improve by 220bps y/y to 34.9%. As a result, gross profit rose 8.7% y/y to KES 19.0B.

Operating profit margin largely unchanged not withstanding higher operating costs: As the firm expanded its grid (to serve new customers) and maintained the electricity network (to improve service quality), the firm saw its transmission and distribution costs surge 23.7% y/y to KES 16.2B. The surge wrote-off gains made in the top-line, resulting to a 9.4bps y/y decline in operating profit margin to 13.3%.

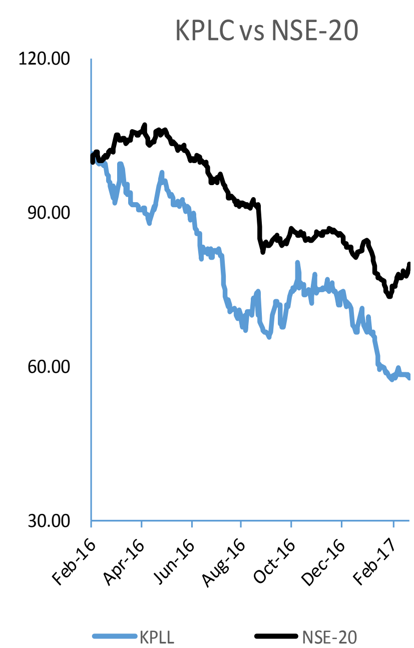
Finance costs decline, but the absence of finance income raises net finance costs: Balance sheet restructuring carried out saw Kenya Power lower its short-term borrowings. The decline in short-term borrowings saw the firm's finance costs decrease 11.6% y/y to KES 2.3B (-29.4% h/h). Cash and cash equivalents at the end of the year plunged 93.2% y/y resulting to a 723M decline in the firm's finance income. This caused a 22.9% y/y surge in net finance costs to KES 2.3B.

Lower tax rate helps Kenya Power to save face: The jump in net finance costs negated gains made in operating profit, resulting in a slight decrease in PBT of 1.7% y/y to KES 5.6B. The effective tax rate slumped 890bps y/y to 25.5%, resulting in a 27.1% y/y fall in income tax expense to KES 1.4B. Consequently, PAT rose 11.4% y/y to KES 4.2B with an EPS of KES 2.15.

Bloomberg Ticker	KPLL KN
Reuters Ticker	KPLC.NR

Share Statistics	
Recommendation	**Buy**
Fair Value (KES)	12.65
Price	7.00
Market Cap (KES B)	13.6
Market Cap (USD M)	130.9
Year end	30-Jun
Float	44.5%
Foreign ownership	15.5%
1 yr Avg Trading Val (USD)	21,325

Price Trend



Source: (NSE)

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Cash and cash equivalents continue facing south: Cash and cash equivalents maintained the declining trend, plummeting 92.3% y/y to KES 925M (-83.2% h/h). Net declines in cash and cash equivalents stood at KES 4.6B from 1H16's KES 14.7B. The apparent improvement was driven by a 44.1% y/y decline in cash used in investing activities to KES 13.7B.

Dividend drought in the energy sector? After KenGen declared no dividend for FY16, Kenya Power decided to withhold interim dividend. There are a myriad of reasons why it could have decided to withhold dividend. One would be the low cash balances and another would be financing its capex programs. Though it remains unclear why there's no interim dividend for the power distributor, investors may grow skeptical of the firm's ability to maintain dividend. As a result, the counter may take a beating on the bourse.

Looking forward

Increased customers to bolster demand: Eyeing 70% access rate by the end of this year and universal access by the end of 2020, Kenya Power plans to connect 1.2M new customers every year. In addition, Kenya Power plans to revamp the grid resulting in a more stable and robust power distribution. Additional customers and a revamped grid are anticipated to rally electricity demand in the country going forward.

System losses anticipated to decline: Kenya Power has set an ambitious target to bring down system losses to single digits in the long-run from 19.1% in FY16. System losses are anticipated to decrease by 50bps y/y in the next 5 years to 16.9% by FY21.

The value of 100bps reduction in system losses in the current situation of surplus generation capacity translates to approximately KES 766M annual power purchase cost savings at present. As there is no significant load shedding, sales increase due to loss reduction may come only from some of the commercial losses translating to additional sales. A 100bps reduction in commercial losses, if translated into additional metered sales, will result in approximately KES 1.3B additional annual revenue.

Capex financing to keep leverage high: Kenya Power has set a debt to equity ratio of 70% to finance its capex programs. The company plans to spend KES 219.6B from FY17 to FY21 as it seeks to attain universal access to electricity as well as revamping the grid. As such, we anticipate the firm to continue drawing loans, keeping its leverage high in the medium term. On the other hand, Kenya Power draws cheap concessionary loans which aid in controlling its finance costs. Thus even though we expect its leverage to rise, the finance costs are anticipated to remain tamed in the long-run.

To buy or not to buy? With Kenya Power deciding to withhold dividend, investor sentiments on the decision may see the counter take a further beat down from its current depressed price of KES 7.00. Nonetheless, we reiterate a BUY recommendation based on the counter's 80.1% potential upside based on Kenya Power's fair value of KES 12.65. We anticipate an 8.1% CAGR in the firm's top-line informed by the increased number of customers. In addition, the gradual decline in the firm's system losses is also anticipated to bolster Kenya Power's bottom-line.

Kenya Power is currently trading at trailing multiples of 1.8 times earnings and 0.2 times book value at its current price of KES 7.00. The attractive tailing multiples make Kenya Power an attractive venture for a long-term value investor.

1H17 Financials

Income statement (KES M)	1H16	2H16	FY16	1H17	y/y % change	h/h % change
Electricity sales	**41,665**	**45,416**	**87,081**	**45,795**	**9.9%**	**0.8%**
Forex adjustment	4,419	4,363	8,782	2,531	-42.7%	-42.0%
Fuel cost adjustment	7,463	5,049	12,512	6,183	-17.1%	22.5%
Other income	3,155	4,315	7,470	5,060	60.4%	17.3%
Total income	**56,702**	**59,143**	**115,845**	**59,569**	**5.1%**	**0.7%**
Non-fuel power purchase costs	**24,951**	**26,449**	**51,400**	**26,109**	**4.6%**	**-1.3%**
Fuel costs	8,072	4,618	12,690	6,226	-22.9%	34.8%
Forex costs	3,021	3,154	6,175	3,156	4.5%	0.1%
Total power purchase costs	**36,044**	**34,221**	**70,265**	**35,491**	**-1.5%**	**3.7%**
Transmission & distribution costs	13,065	15,586	28,651	16,157	23.7%	3.7%
Operating profit	**7,593**	**9,336**	**16,929**	**7,921**	**4.3%**	**-15.2%**
Finance income	723	242	965	-	-	-
Finance cost	**(2,579)**	**(3,232)**	**(5,811)**	**(2,281)**	**-11.6%**	**-29.4%**
Profit before tax	**5,737**	**6,346**	**12,083**	**5,640**	**-1.7%**	**-11.1%**
Income tax expense	(1,974)	(2,552)	(4,526)	(1,439)	-27.1%	-43.6%
Profit after tax	**3,763**	**3,794**	**7,557**	**4,201**	**11.6%**	**10.7%**
EPS	**1.93**	**1.94**	**3.87**	**2.15**	**11.4%**	**10.8%**
DPS	0.20	0.30	0.50	-	-	-

Statement of financial position (KES M)	1H16	2H16	FY16	1H17	y/y % change	h/h % change
Assets						
PPE and Land	**219,314**	**235,599**	**235,599**	**246,762**	**12.5%**	**4.7%**
Recoverable forex adjustment	7,795	6,068	6,068	6,163	-20.9%	1.6%
Net retirement benefit asset	6,414	3,263	3,263	3,263	-49.1%	0.0%
Total non-current assets	**233,523**	**244,930**	**244,930**	**256,188**	**9.7%**	**4.6%**
Total current assets	48,672	50,010	50,010	43,037	-11.6%	-13.9%
Total assets	**282,195**	**294,940**	**294,940**	**299,225**	**6.0%**	**1.5%**
Equity and liabilities						
Total equity	64,626	65,616	65,616	69,231	7.1%	5.5%
Total Non-current liabilities	175,476	181,153	181,153	179,786	2.5%	-0.8%
Total current liabilities	42,093	50,773	50,773	50,208	19.3%	-1.1%
Total equity and liabilities	**282,195**	**297,542**	**297,542**	**299,225**	**6.0%**	**0.6%**

Statement of cash flows (KES M)	1H16	2H16	FY16	1H17	y/y % change	h/h % change
Cash generated from operating activities	12,722	12,955	25,677	12,083	-5.0%	-6.7%
Net cash used in investing activities	(24,571)	(24,272)	(48,843)	(13,730)	-44.1%	-43.4%
Net cash from financing activities	(2,804)	3,242	438	(2,931)	4.5%	-190.4%
Increase/ (decrease) in cash and cash equivalents	**(14,653)**	**(8,075)**	**(22,728)**	**(4,578)**	**-68.8%**	**-43.3%**
Cash and cash equivalents at the beginning of the period	28,231	13,577	28,231	5,503	-80.5%	-59.5%
Cash and cash equivalents at the end of the period	**13,577**	**5,503**	**5,503**	**925**	**-93.2%**	**-83.2%**

Ratios and margins	1H16	2H16	FY16	1H17	y/y % change	h/h % change
GP margin	32.7%	37.6%	35.2%	34.9%	2.2%	-2.7%
Operating profit margin	13.4%	15.8%	14.6%	13.3%	-0.1%	-2.5%
Net earnings margin	6.6%	6.4%	6.5%	7.1%	0.4%	0.6%
Effective tax rate	34.4%	40.2%	37.5%	25.5%	-8.9%	-14.7%
Return on Average Equity	12.8%	12.2%	11.7%	12.5%	-0.3%	0.3%
Return on average assets	3.0%	2.7%	2.6%	2.8%	-0.2%	0.1%
Current ratio	1.45	1.16	0.98	0.86		
P/E (x)				1.8		
Dividend yield				**7.1%**		

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.

Disclaimer

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