ApexAfrica CAPITAL LTD
Part of AXYS Group

February 2018

Kenya Power 1H18 Earnings Update
"The Ghost of Elevated Finance Costs Returns"

In what has caught the industry flat-footed, Kenya Power has announced its **1H18 earnings** reporting a **30.3% y/y plunge in net earnings.** This was largely attributed to the **42.8% y/y surge in finance costs** amidst **a 1.9% y/y marginal ebb in its EBIT**. Further exacerbating the situation, the **effective income tax has normalized to 35.9%** (4-year average of 38.2%) resulting in a **14.0% y/y increase in income tax expense** despite the lower pre-tax earnings. Aiming to protect its weakening liquidity position, Kenya Power stuck to its dividend policy of withholding interim dividend for half year results**.**

Continued slow-down in electricity sales: Electricity sales edged up 2.5% y/y to KES 46.2B attributed to a marginal 2.3% y/y uptick in units sold to 3,893GWh as well as a 2.5% y/y rise in revenue per unit to KES 12.33. The period saw the utility firm connect 16.6% y/y additional customers bringing its customers to 6.5M. This was aided by the 3,408Km additional lines added to the grid. The bulk of the new connections was from domestic consumers seeing that the rise in customers is not commensurate to the marginal uptick in electricity sales. The challenging operating environment witnessed in 1H18 may have attributed to reduced power consumption among the large industrial and commercial power consumers.

Power purchase costs outpace revenue: Power purchase costs (non-fuel) rose 5.1% y/y to KES 27.4B attributed to the double-whammy of rising units purchased (+2.0% y/y to 4,882GWh) and increased power purchase cost per unit (+3.0% y/y to KES 5.62).

Poor hydrology raises use of thermal energy, surging total power purchase costs: The poor hydrology witnessed in 2017 saw the firm take up 47.0% y/y more power from thermal sources (to 1,301GWh). In addition, the period saw higher fuel prices raising the average cost per thermal power purchased up 34.3% y/y to KES 9.45 per unit. Consequently fuel costs galloped 97.5% y/y to 12.3B raising the total power purchase costs 22.6% y/y to 43.5B. With the total purchase costs outpacing total income, 1H18 saw a gross profit margin erosion of 390bps y/y to 31.0%.

Transmission costs edge up in line with increased connectivity: Aiming to serve its growing clientele as well as enhancing customer experience, Kenya Power raised its transmission and operating costs by 5.0% y/y to KES 15.8B. Further adding to the costs, the firm incurred higher depreciation charges attributed to increased capital investment over the period.

Elevated recoverable fuel costs continue to bite: In FY17, Kenya Power reported a 1,165.1% y/y gallop in recoverable fuel costs to KES 10.2B (from KES 0.8B in FY16). These came about as a result of heightened usage of thermal power due to the lower hydrology resulting in elevated fuel recoveries that were to be collected from the consumers at a later date.

Fast forward to 1H18, these sums seem uncollected. We infer that these arm-twisted the firm to take up additional short-term financing facilities which have raised its finance costs 42.8% y/y to KES 3.3B. This saw its PBT contract 19.0% y/y to KES 4.6B.

Higher effective tax rate (+1,040bps y/y to 35.9%) raised its income tax expense by 14.0% y/y to KES 1.6B; despite posting lower pre-tax earnings.

Bloomberg Ticker	KPLL KN
Reuters Ticker	KPLC.NR

Share Statistics

Recommendation	Buy
Fair Value (KES)	11.20
Price	8.20
Market Cap (KES B)	16.0
Market Cap (USD M)	157.1
Year end	30-Jun
Float	49.5%
Foreign ownership	9.0%
3-month Avg Trading Val (USD)	54,442

Price Trend

Source: (NSE)

Senior Research Analyst

Harrison Gitau

hgitau@apexafrica.com

+254 (20) 760 2545

Liquidity challenges continue: Cash generated from operating activities shrunk 17.8% y/y to KES 9.9B attributed to lower profitability as well as apparent working capital challenges. Cash used in financing activities rose 3.1% y/y to KES 14.2B (though eased on a h/h basis) as a result of increased capex investment. Cash used in financing activities reduced by 19.4% y/y to KES 2.4B as a result of the increased uptake of short-term financing activities aforementioned.
The short-term facilities saw the firm's current liabilities gallop 76.9% y/y to KES 88.8B outpacing the relatively slower 19.3% y/y growth in current assets to KES 73.3B. This culminated in a further weakening of the firm's liquidity position as indicated by the current ratio of 0.8x (from 0.9x in FY17).

Is Kenya Power still a gem after all this?

Top-line growth to pick-up in the long-run: The challenging environment has seen power sales grow slower than envisioned as a result of the slow-down in economic activity. We foresee an uptick in economic activity as a result of projected improved hydrology in 2018 as well as an easing of political temperatures in the country. Credit to the private sector remains constrained as a result of the rate cap. We anticipate an easing of the private sector crowding out with the government successfully raising USD 2B from the just concluded Eurobond sale. In addition, the review/repeal of the rate cap got support from Treasury with a section of MPs willing to review the law given a number of preconditions are met. This is anticipated to raise power consumption from the large commercial and industrial consumers, further raising Kenya Power's top-line.
In addition, the firm recently introduced off-peak power tariffs that are anticipated to further raise the demand from the large consumers as they try to cut operating costs.
Increased consumption from the domestic consumers will be driven by increased connectivity (raising the number of customers) as well as increased consumption among domestic customers as a result of rising disposable income.

System losses remain a thorn in the flesh: We estimate a significant increase in system losses to 20.3% in 1H18 from 18.9% recorded in FY17. Though the firm has remained silent on this, it plans to lower its system losses from double-digits in the long-run. This is anticipated to improve the energy balance, reduce energy purchase costs and consequently increase revenues. Despite the numerous investment to bring the losses down in the past, the losses have remained in the late teens to early twenties. We anticipate that the adoption of a feeder based approach to network management as well as a new integrated customer management system will aid in the reduction of system losses. We project system losses to reduce annually by 0.5% - 1.0%.

Transmission and distribution costs to remain elevated: With the firm expanding its grid to ensure universal access by 2020, we anticipate transmission and distribution costs to grow going forward. The return obtained from this sustained investment is however anticipated to outdo the costs resulting in an improving bottom-line.

It all boils down to recoverable fuel costs: Despite the huge gallop in the receivables from recoverable fuel costs in FY17, we remain optimistic that the sums will be collected from the consumers albeit being a staggered collection.
We believe this to have been the major undoing of the firm in 1H18. Collection of the fuel costs is anticipated to ease up the demand for short-term financing activities, deleveraging the firm as well as lowering its finance costs. In addition, it'll result in improved working capital conditions easing pressure on Kenya Power's negative cash flow position as well as improve its liquidity.
On the flip-side, if these sums are not fully collected, it'll result in a write-off which will dent its bottom-line. In addition, heightened leverage as well as finance costs and liquidity challenges may remain for the firm going forward. This is a risk that investors may have to contend with.

Parting shot: To answer the question posed earlier, yes, Kenya Power still remains a gem. It's allure may have dimmed with the recent depressed numbers announced, but we believe the issues facing the company will be resolved making Kenya Power an attractive counter for long-term investors. The counter is anticipated to maintain its KES 0.50 DPS in FY18 which points to an alluring dividend yield of 6.1%.
Largely attributed to the dented earnings, the counter has come under pressure in today's trading with its closing price at KES 7.95. Continued market (over) reaction may push the counter's price even further, which, after bottoming out may prove alluring to value investors.

1H18 Financials

Income statement	1H17	2H17	1H18	y/y change	h/h change
	KES M	KES M	KES M	%	%
Electricity sales	**45,795**	**46,157**	**46,931**	**2.5**	**1.7**
Forex adjustment	2,531	4,151	4,492	77.5	8.2
Fuel cost adjustment	6,183	15,925	11,637	88.2	-26.9
Total income	**54,509**	**66,233**	**63,060**	**15.7**	**-4.8**
Power purchase costs					
Non-fuel power purchase costs	**(26,109)**	**(24,507)**	**(27,429)**	**5.1**	**11.9**
Fuel costs	(6,226)	(15,898)	(12,294)	97.5	-22.7
Forex costs	(3,156)	(3,043)	(3,793)	20.2	24.6
Total power purchase costs	**(35,491)**	**(43,448)**	**(43,516)**	**22.6**	**0.2**
Gross Profit	**19,018**	**22,785**	**19,544**	**2.8**	**-14.2**
Other income	3,961	4,169	4,043	2.1	-3.0
Transmission & distribution costs	(15,058)	(18,358)	(15,814)	5.0	-13.9
EBIT	**7,921**	**8,596**	**7,773**	**-1.9**	**-9.6**
Finance income	-	46	52		13.0
Finance cost	(2,281)	(3,370)	(3,257)	42.8	-3.4
Profit before tax	**5,640**	**5,272**	**4,568**	**-19.0**	**-13.4**
Income tax expense	(1,439)	(2,207)	(1,641)	14.0	-25.6
Profit after tax	**4,201**	**3,065**	**2,927**	**-30.3**	**-4.5**
EPS (KES)	2.15	1.57	1.50	-30.2	-4.5

Statement of financial position	1H17	2H17	1H18	y/y change	h/h change
PPE and land	**244,460**	**264,721**	**271,224**	**10.9**	**2.5**
Other non-current assets	11,728	11,646	12,563	7.1	7.9
Total current assets	43,037	65,286	73,280	70.3	12.2
Total assets	**299,225**	**341,653**	**357,067**	**19.3**	**4.5**
Total equity	69,231	69,962	71,914	3.9	2.8
Total non-current liabilities	179,786	196,433	196,326	9.2	-0.1
Total current liabilities	50,208	75,258	88,827	76.9	18.0
Total equity and liabilities	**299,225**	**341,653**	**357,067**	**19.3**	**4.5**

Statement of cashflows	1H17	2H17	1H18	y/y change	h/h change
Cash generated from operating activities	12,083	15,277	9,927	-17.8	-35.0
Net cash used in investing activities	(13,730)	(25,790)	(14,159)	3.1	-45.1
Net cash from financing activities	(2,931)	8,438	(2,361)	-19.4	-128.0
Increase/ (decrease) in cash and cash equivalents	(4,578)	(2,075)	(6,593)	44.0	217.7
Cash and cash equivalents at the end of the period	**925**	**(1,150)**	**(7,743)**		**573.3**

Ratios and margins	1H17	2H17	1H18	y/y change	h/h change
GP margin (%)	34.9	34.4	31.0	-3.9	-3.4
EBIT margin (%)	14.5	13.0	12.3	-2.2	-0.7
Net earnings margin (%)	7.7	4.6	4.6	-3.1	0.0
Effective tax rate (%)	25.5	41.9	35.9	10.4	-5.9
ROaE (%)	12.5	8.8	8.3	-0.3	-0.1
ROaA (%)	2.8	1.9	1.7	-0.4	-0.1
Current ratio (x)	0.9	0.9	0.8	-3.8	-4.9
NAV/Share (KES)	35.48	35.85	36.85	3.9	2.8
P/E (x)			5.5		
P/B (x)			0.2		
Dividend yield (%)			6.1		

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

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
Part of AXYS Group
W : www.axys-group.com