KenGen 1H17 Earnings Update

KenGen's net earnings for 1H17 plummeted **18.4% y/y** to **KES 4.6B** driven largely by an **11.4% y/y** decline in the generator's **top-line.** Total operating costs (operating costs plus steam costs) declined **2.0% y/y**, while net finance costs waned **27.0% y/y.**

Declines across multiple revenue sources dent the firm's top-line

Electricity revenue decreased marginally by 0.5% y/y to KES 14.7B. Electricity revenue comprises capacity revenue, energy revenue and recoverable forex adjustment, of which only capacity revenue recorded gains.

Capacity revenue edged up 3.9% y/y to KES 10.9B attributed to improved stability of power plants. Capacity revenue from all energy sources recorded improvements with hydro going up 2.0% y/y to KES 3.9B, geothermal rising 3.8% y/y to KES 5.2B and thermal leaping 8.9% y/y to KES 1.7B.

Energy revenue on the other hand declined 7.2% y/y to KES 3.6B as a result of decommissioning of two thermal plants (Garissa and Lamu), the expiry of a PPA for Embakasi gas turbine in November 2016 and scheduled statutory inspections in some power plants. Wind energy revenue remained unchanged at KES 239M while hydro (-10.9% y/y to KES 668M), geothermal (-5.6% y/y to KES 2.5B) and thermal (-15.8% y/y to KES 229M) saw declines.

In 1H16, **steam revenues** of KES 4.1B included arrears on steam revenues of KES 1.6B following the signing of steam resources and maintenance agreement in September 2015. Adjusting for the revenue arrears, steam revenue fell 1.9% y/y to KES 2.5B, pinned on transmission constraints on the dispatch of well-head units.

Decreased revenue from drilling activities and insurance compensation saw KenGen's **other income** plunge 47.6% y/y to KES 598M. Commercial drilling services slumped from KES 617M in 1H16 to nil in 1H17, while insurance compensation waned 37.8% y/y to KES 184M. Carbon credits of KES 57M and net fuel surplus saw miscellaneous income surge 141.1% y/y to KES 205M. Revaluation of bank balances saw the firm record exchange gains resulting in a 46.2% y/y growth to KES 209M.

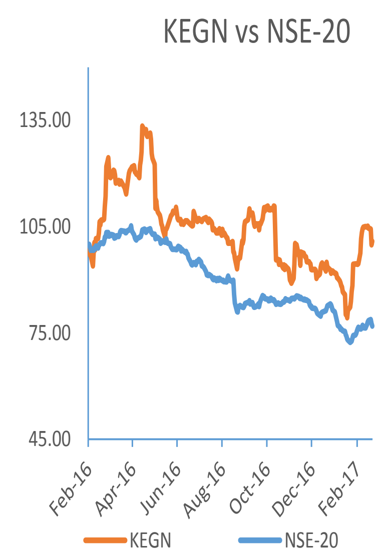
Dwindling steam costs keep total operating costs tamed: Operating expenses rose 6.1% y/y to KES 4.4B attributed to operational factors. Transmission constraints saw the firm dispatch lower wellhead units. The decline in units transmitted saw the firm's steam costs fall 22.4% y/y to KES 1.3B. The huge fall in steam costs saw the firm's total operating costs edge down marginally by 5.7% y/y to KES 5.7B, resulting in a mild 310bps y/y decline in EBITDA margin to 68.0%.

Depreciation and amortization charges grew 0.2% y/y to KES 4.5B resulting in a 22.4% y/y dip in EBIT to KES 7.4B.

Bloomberg Ticker	KEGC KN
Reuters Ticker	KEGN.NR

Share Statistics	
Recommendation	Buy
Fair Value (KES)	11.80
Price	6.30
Market Cap (KES B)	39.3
Market Cap (USD M)	382.0
Year end	30-Jun
Float	25.7%
1 yr Avg Trading Val (USD)	76,563

Price Trend



Source: (NSE)

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Surging finance income brings down net finance costs: Investment of funds raised during the rights issue saw KenGen's finance income gallop 118.7% y/y to KES 632M. The 1.0% y/y marginal decline in the finance cost was attributed to the 12.0% appreciation of the Kenyan shilling against the Japanese Yen. Consequently, net finance costs dropped 27.3% y/y to KES 973M.

Cash position remains healthy: Cash and cash equivalents at the end of the year leapt 155.3% y/y to KES 6.5B (-3.1% h/h), attributed to a 71.0% y/y decline in net changes in cash and cash equivalents to a negative position of KES 211M in 1H17 from a negative position of KES 728M in 1H16. Cash generated from operations came down 35.5% y/y to KES 7.0B while cash used in investing activities fell 51.3% y/y to KES 6.0B, resulting in the improved position of net changes in cash and cash equivalents in 1H17.

What next?

Pipeline of projects to keep capex high: KenGen has a pipeline of projects which are expected to increase its installed capacity by 721MW by 2020. These projects comprise of Olkaria V 140MW, Olkaria VI 140MW, Olkaria VII 140MW, Olkaria I Unit 6 70MW, Wellheads 25MW, Olkaria I Rehabilitation 5.7MW, Olkaria I AU & IV topping plant 60MW, Meru Wind Phase I 80MW, Geothermal Wellheads 50MW and Ngong III project 10MW. Construction of the 140MW Olkaria V is expected to take place in 2H17 after KenGen recently awarded the contract to a group led by Mitsubishi Corp.

The capital intensive projects estimated to cost USD 2.4B are to be financed with a mixture of debt and equity. KenGen recently sold 5.33% of its shareholding to Public Investment Corporation (PIC), a South African Pension fund. The KES 2.3B raised is meant to plug the financing gap that was left after an undersubscription of its 2016 rights issue.

Top-line: Management expects the performance of 2H17 to improve following the completion of the evacuation line for the wellheads and fixing machine breakdowns which affected some power plants. Completion of the evacuation line for the wellheads is anticipated to bolster steam revenue.

Growing electricity demand is anticipated to support the firm's burgeoning top-line going forward.

Operating costs anticipated to remain tamed: KenGen has seen its EBITDA margin improve in the past two years, though, the margin has waned 310 bps y/y in 1H17 to 68.0% attributable to operational factors which we can assume to be non-recurrent. Going forward, we expect KenGen to keep its operational costs in check, safeguarding the improvements made in the top-line.

Steam costs as a percentage of steam revenue declined by 13.7% y/y to 51.9% and we anticipate this to continue declining, albeit at a moderate rate going forward, bolstering the firm's bottom-line in the medium-term.

Debt financing to raise leverage: To finance the USD 2.4B projects, KenGen will need to take up more debt, which will raise its leverage. KenGen has been taking cheap concessionary loans in the past and we expect this to continue with Treasury promising assistance in the arranging and guaranteeing of cheap external loans. As such, KenGen is anticipated to keep its finance costs in check.

In the short-term, cash raised from the rights issue (and possibly from the 5.33% investment by PIC) is anticipated to earn the firm finance income, further keeping its net finance costs low.

Is KenGen still a viable investment venture? KenGen was a household name for listed companies that maintain generous dividends to shareholders. However, withholding of dividend last year caught investors unaware, pushing the share price of the counter to new historic lows. The counter has however recovered, indicating investor confidence.

The Government has maintained that it would like to keep its shareholding at 70%, implying that a further dilution of ownership may not be forthcoming.

We reiterate our **BUY** recommendation on KenGen informed by a fair value of KES 11.80; pointing to an 87.3% potential upside at its current price of KES 6.30.

KenGen is currently trading at 2.1 times trailing earnings and 0.2 times trailing book value (against an industry average of 11.6x and 2.4x respectively), providing an opportune entry point for a long-term value investor.

1H17 Financials

Income statement	1H16 KES M	2H16 KES M	FY16 KES M	1H17 KESM	y/y % change	h/h % change
Revenue						
Electricity Revenue	**14,757**	**14,787**	**29,544**	**14,676**	**-0.5%**	**-0.8%**
Steam Revenue	2,514	4,342	6,856	2,465	-1.9%	-43.2%
Steam Revenue - arrears	1,613	-	-	-	-	-
Other Income	1,141	1,069	2,210	598	-47.6%	-44.1%
Total Income	**20,025**	**20,198**	**38,610**	**17,739**	**-11.4%**	**-12.2%**
Operating Expenses	(4,141)	(4,807)	(8,948)	(4,392)	6.1%	-8.6%
Steam costs	(1,648)	(1,519)	(3,167)	(1,279)	-22.4%	-15.8%
EBITDA	**14,236**	**13,872**	**26,495**	**12,068**	**-15.2%**	**-13.0%**
Depreciation & Amortization	(4,519)	(5,705)	(10,224)	(4,529)	0.2%	-20.6%
EBIT	**9,717**	**8,167**	**16,271**	**7,539**	**-22.4%**	**-7.7%**
Compensating tax	-	-	(2,431)	-	-	-
Interest Income	289	267	556	632	118.7%	136.7%
Finance Costs	(1,622)	(1,510)	(3,132)	(1,605)	-1.0%	6.3%
PBT	**8,384**	**6,924**	**11,264**	**6,566**	**-21.7%**	**-5.2%**
Tax Income/(Expense)	(2,716)	(1,805)	(4,521)	(1,941)	-28.5%	7.5%
PAT	**5,668**	**5,119**	**6,743**	**4,625**	**-18.4%**	**-9.6%**
Other Comprehensive Income	(15)	(281)	(296)	2	-113.3%	-100.7%
Total Comprehensive Income	5,653	4,838	6,447	4,627	-18.1%	-4.4%
Basic EPS(KES)	**2.58**	**0.49**	**3.07**	**2.10**	**-**	**-**
Diluted EPS (KES)	**0.91**	**0.17**	**1.08**	**0.74**	**-**	**-**
Balance sheet						
PPE	312,912	320,933	320,933	322,091	2.9%	2.6%
Other non-current assets	20,206	24,400	24,400	19,162	-5.2%	20.8%
Current assets	21,891	21,916	21,916	22,224	1.5%	0.1%
Total assets	**355,008**	**367,249**	**367,249**	**363,477**	**2.4%**	**3.4%**
Equity and liabilities						
Share capital	5,496	15,610	15,610	15,610	184.0%	-
Share premium	5,040	21,056	21,056	21,056	317.8%	-
Reserves and retained earnings	135,282	136,077	136,077	140,703	4.0%	3.4%
Non-current liabilities	**187,912**	**176,316**	**176,316**	**167,913**	**-10.6%**	**-4.8%**
Current liabilities	21,279	18,190	18,190	18,195	-14.5%	0.0%
Total equity and liabilities	**355,009**	**367,249**	**367,249**	**363,477**	**2.4%**	**-1.0%**
Statement of Cashflows						
Cash generated/ (used) from operating activities	10,836	18,420	29,256	6,994	-35.5%	-62.0%
Cash generated/ (used) from investing activities	(12,238)	(10,452)	(22,690)	(5,954)	-51.3%	-43.0%
Cash generated/ (used) from financing activities	674	(3,776)	(3,102)	(1,251)	-	-66.9%
Net changes in cash and cash equivalents	**(728)**	**4,192**	**3,464**	**(211)**	**-71.0%**	**-105.0%**
Closing balance	**2,564**	**6,756**	**6,756**	**6,545**	**155.3%**	**-3.1%**
Ratios and margins						
EBITDA margin	71.1%	68.7%	68.6%	68.0%	-3.1%	-0.6%
Net earnings margin	28.3%	25.3%	17.5%	26.1%	-2.2%	0.7%
ROaE	7.9%	4.4%	4.3%	5.3%	-2.6%	0.9%
ROaA	3.3%	1.9%	1.9%	2.5%	-0.7%	0.6%
Current ratio	1.0	1.2	1.2	1.2	-	-
P/E (x)			2.1			
P/B (x)			0.2			

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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