ApexAfrica CAPITAL LTD
Part of AXYS Group

October 2017

Kenya Power FY17 Earnings Update

Kenya Power's **FY 17 net earnings edged up 1.0% y/y** largely driven by **a lower effective tax rate** (33.4% down 702bps y/y). **Electricity sales rose 5.6% y/y** while **higher transmission and distribution costs** (+16.6% y/y) and **lower investment income** (-95.2% y/y) eroded the improvement in the top-line.

Kenya Power announced a **KES 0.50 DPS**, holding dividend constant in line with our expectations. Books closure has been slated for **30th November 2017.**

Top-line growth slows down in line with our expectations: Increased connectivity saw electricity access rate rise 800bps y/y to 68% in FY17. This saw the firm record a 4.5% y/y uptick in units consumed to 8,272 GWh in FY17. Arguing that the bulk of the new connections were domestic consumers, the yield earned by Kenya Power rose resulting in a 5.6% y/y increase in electricity sales to KES 92.0B. This is however slower than the 3-year CAGR of 22.0% observed previously which could be attributed to slowed FY17 economic growth.

Lower hydrology raises use of thermal energy, surging power purchase costs: Electricity purchase costs marginally fell 1.5% y/y to KES 50.6B largely attributed to reduced power purchase from hydro-electric plants (HEP). Units purchased from hydro sources dropped 13.2% y/y to 3,341 GWh while units sourced from geothermal sources came down 3.4% y/y to 4,451 GWh. The dent in units purchased from HEPs was as a result of reduced hydrology caused by the drought experienced in the better part of 2017. Resulting from lower units bought from geo and hydro-power sources, units purchased from thermal power sources surged 66.9% y/y to 2,165GWh. A rise in international fuel prices translated to higher fuel costs in FY17. This, when coupled with the surge in units sourced from thermal sources saw fuel costs incurred by the firm gallop 74.3% y/y to KES 22.1B. This resulted in a 12.3% y/y increase in total power purchase costs to KES 78.9B.

With the power purchase costs outpacing the increase in top-line, gross profit margin fell 54bps y/y to 34.6%. Notwithstanding the decrease in efficiency for the firm, gross profit margin rose 9.7% y/y to KES 41.8B.

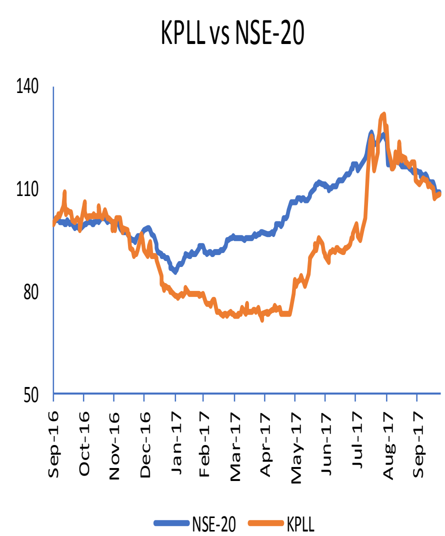
Rising transmission and distribution costs eat into improved top-line: Increased electricity connectivity expanded Kenya Power's grid resulting in higher transmission and distribution costs. Higher depreciation attributed to increased capital investment and a general upsurge in the cost of doing business further exacerbated the costs. This culminated in 16.6% y/y leap in transmission and distribution costs to KES 33.4B, slightly below our KES 33.9B FY17 estimate. This resulted in a 2.4% y/y dent in EBIT to KES 16.5B implying a 194bps y/y dip in EBIT margin to 13.7%.

Lower finance income adds insult to injury: Kenya Power managed to bring down its finance costs though marginally by 2.8% y/y to KES 5.7B. The decrease came despite an increase in borrowings; informed by the KES 5.5B cash from financing (FY16 KES 438.0M from financing activities). Lower cash and cash equivalents for the year (negative cash balance of KES 1.2B in FY17 from positive cash balance of KES 5.5B in FY17) saw the firm almost wipe out its finance income. Interest income plunged 95.2% y/y to KES 46.0M resulting in a 9.7% y/y dip in PBT to KES 10.9B.

Bloomberg Ticker	KPLL KN
Reuters Ticker	KPLC.NR

Share Statistics	
Recommendation	**Buy**
Fair Value (KES)	12.65
Price	9.55
Market Cap (KES B)	18.6
Market Cap (USD M)	179.7
Year end	30-Jun
Float	44.5%
Foreign ownership	15.5%
1 yr Avg Trading Vol (USD)	89,163

Price Trend



Source: (NSE)

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Lower effective tax rate raises net earnings: Kenya Power's effective tax rate tumbled 702bps y/y to 33.4% resulting in a 25.4% y/y decrease in income tax expense to KES 3.6B. This saw the utility firm record a mild 1.0% y/y increase in net earnings to KES 7.3B.

From positive cash balance to servicing an overdraft facility: Cash from operating activities rose 6.6% y/y to KES 27.4B which may be attributed to lower tax paid (borrowing from lower income tax expense) and working capital changes (current liabilities +47.8% y/y outpacing 30.5% y/y increase in current assets). Cash used in investing activities fell 19.1% y/y to KES 39.5B which may be largely attributed to lower capex by the group in FY17. In FY16, the firm incurred KES 50.5B in capex while in FY17, management had estimated its capex at KES 42.0B. Cash generated from financing activities leapt to KES 5.5B from KES 438M which could be attributed to increased borrowing informed by the 7.6% y/y increase in non-current liabilities to KES 196.4B.

It's worth noting that net cash used during the year fell to KES 6.7B from KES 22.7B in FY17. However, lower opening cash balances saw the group record a negative cash position of KES 1.2B indicating an overdraft facility taken up by the firm.

What we envision for the firm

Top-line growth to sustain momentum: We anticipate the group's electricity revenue to grow faster than the 5.6% y/y increase recorded in FY17 seeing that the year has proved to be a difficult one. Going forward, we expect a rebound in economic activity to drive electricity consumption among the industrial and large consumers. In addition, Kenya Power plans to connect these consumers with alternative dedicated lines to eliminate power outages, translating into increased revenue.

For the domestic consumers, Kenya Power plans to reach 70% connectivity rate by the end of the year which will add on to the number its customers; consequently raising revenue. In addition to higher units sold to this segment, the domestic consumers segment offers higher yields to Kenya power which translates to a bulging bottom-line.

System losses anticipated to come down further: In FY16, Kenya Power reported its system losses at 19.1% while KNBS recorded the entire energy losses for Kenya at 18.8%. In FY17, KNBS has recorded system losses at 13.5% implying that the system losses for Kenya Power have come off from FY16 levels.

Going forward, Kenya Power system losses are anticipated to decrease to 16.9% by FY21. This points to increased revenue for the firm as well as an expanding bottom-line.

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. However, in the long-run, seeing that expenditure on the grid will largely evolve around maintenance, we expect these costs to stagnate, protecting the firm's bottom-line.

Capex financing to keep leverage high: Kenya Power had set a debt to equity ratio of 70% to finance its capex programs. The company had planned 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 cheap concessionary loans, keeping its leverage high in the medium term.

However, in the long-run, we expect capex figures to drop as the expenditure will be mainly focused on revamping the grid. This translates to fewer power outages and lower system losses implying a growing bottom-line. In addition, lower capex figures point to lower debt financing implying easing leverage in the long-run.

Cash position to improve? Despite drawing an overdraft facility, Kenya Power plans on paying KES 975.7M in cash dividends to shareholders on 31st January 2018. This may be inferred to mean management expects the utility firm to improve its cash position by the end of FY18F. Improved cash position may see the firm cancel the overdraft facility further taming its finance costs.

Parting shot: We reaffirm our buy recommendation seeing that Kenya Power is a fundamentally sound counter with numerous growth opportunities which point to prospective capital gains. Trading at a P/E of 2.6x and a P/B of 0.3x, Kenya Power appears to trade at a discount given industry multiples of 9.9x earnings and 3.1x book value. Its DPS of KES 0.50 points to a dividend yield of 5.2% which adds to its allure.

In the immediate short-term, we expect Kenya Power to hold its ground given the slight 1.0% y/y increase in net earnings while the market had already factored in the dividend pay-out.

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FY17 Financials

Income statement	FY16 KES M	ApexAfrica Estimates KES M	FY17 KES M	y/y % change %	Deviation from estimates %
Electricity sales	**87,081**	**95,100**	**91,952**	**5.6**	**-3.3**
Forex adjustment	8,782	-	6,682	-23.9	
Fuel cost adjustment	12,512	25,366	22,108	76.7	-12.8
Total income	**108,375**	**120,466**	**120,742**	**11.4**	**0.2**
Non-fuel power purchase costs	**51,400**	**53,403**	**50,616**	**-1.5**	**-5.2**
Fuel costs	12,690	25,614	22,124	74.3	-13.6
Forex costs	6,175	-	6,199	0.4	
Total power purchase costs	**70,265**	**79,017**	**78,939**	**12.3**	**-0.1**
Gross Profit	**38,110**	**41,449**	**41,803**	**9.7**	**0.9**
Other income	7,470	7,704	8,130	8.8	5.5
Transmission & distribution costs	(28,651)	(33,859)	(33,416)	16.6	-1.3
EBIT	**16,929**	**15,294**	**16,517**	**-2.4**	**8.0**
Finance income	965	-	46	-95.2	
Finance cost	(5,811)	(5,157)	(5,651)	-2.8	9.6
Profit before tax	**12,083**	**10,137**	**10,912**	**-9.7**	**7.6**
Income tax expense	(4,886)	(3,041)	(3,646)	-25.4	19.9
Profit after tax	**7,197**	**7,096**	**7,266**	**1.0**	**2.4**
EPS (KES)	3.87	3.63	3.72	-3.9	2.4
DPS (KES)	**0.50**	**0.50**	**0.50**	**0.0**	**0.0**

Statement of financial position	FY16	ApexAfrica Estimates	FY17	y/y change	Deviation from estimates
PPE and land	235,599	267,458	264,721	12.4	-1.0
Other non-current assets	11,933	2,893	11,646	-2.4	-
Total non-current assets	247,532	270,351	276,367	11.6	2.2
Total current assets	50,010	52,441	65,286	30.5	24.5
Total assets	**297,542**	**322,792**	**341,653**	**14.8**	**5.8**
Total equity	64,022	72,785	69,962	9.3	-3.9
Total non-current liabilities	182,605	194,222	196,433	7.6	1.1
Total current liabilities	50,915	55,785	75,258	47.8	34.9
Total equity and liabilities	**297,542**	**322,792**	**341,653**	**14.8**	**5.8**

Statement of cashflows	FY16	ApexAfrica Estimates	FY17	y/y change	Deviation from estimates
Cash generated from operating activities	**25,677**	**23,340**	**27,360**	**6.6**	**17.2**
Net cash used in investing activities	(48,843)	(40,518)	(39,520)	-19.1	-2.5
Net cash from financing activities	438	16,292	5,507		
Increase/ (decrease) in cash and cash equivalents	**(22,728)**	**(885)**	**(6,653)**		
Cash and cash equivalents at the beginning of the period	28,231	5,503	5,503	-80.5	0.0
Cash and cash equivalents at the end of the period	**5,503**	**4,617**	**(1,150)**		

Ratios and margins	FY16	ApexAfrica Estimates	FY17	y/y change	Deviation from estimates
GP margin (%)	35.2	34.4	34.6	-0.5	0.2
EBIT margin (%)	15.6	12.7	13.7	-1.9	1.0
Effective tax rate (%)	40.4	30.0	33.4	-7.0	3.4
ROaE (%)	11.5	11.5	10.8	-0.7	-0.7
ROaA (%)	2.5	2.7	2.3	-0.3	-0.4
Current ratio (x)	0.98	0.94	0.87		
P/E (x)			2.6		
P/B (x)			0.3		
Dividend yield (%)			5.2		

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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