ApexAfrica CAPITAL LTD
Part of AXYS Group

February 2018

KenGen 1H18 Earnings Update
"Undone By High Capex"

Bloomberg Ticker	KEGN KN
Reuters Ticker	KEGC.NR

Share Statistics

Price	8.60
Market Cap (KES B)	56.7
Market Cap (USD M)	557.5
Year end	30-Jun
Float	30.0%
Foreign ownership	13.1%
3-month Avg Trading Val (USD)	67,622

KenGen's **net earnings for 1H18** dipped **11.5% y/y** to **KES 4.1B** driven largely by a **14.7% y/y** surge in the generator's **depreciation and amortization. Total income grew 4.9% y/y while EBITDA** rose marginally by **0.9% y/y** despite a **13.6% y/y** increase in total operating costs.
Largely in-line with our expectations, the firm **did not declare any dividend** for 1H18.

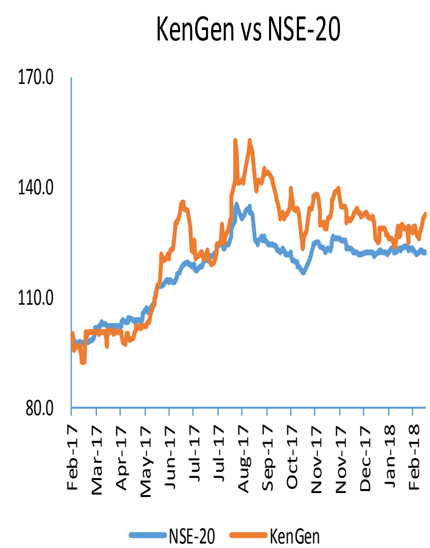
Investment in geothermal pays off
Total income rose 4.9% y/y to KES 18.6B riding on growths in electricity as well as steam revenues. Electricity revenue edged up 1.7% y/y to KES 14.9B on the back of a 15.6% y/y growth in energy revenue but was brought down by the 4.3% y/y ebb in capacity revenue (both are components of electricity revenue) . The impressive performance from energy revenue was attributed to increased revenue from geothermal (19.3% y/y) to KES 3.0B. Capacity revenue came-off due to lower revenues from hydro (-13.1% y/y to KES 3.4B) as a result of the poor hydrology experienced during the period.

Steam profit gains momentum: Deviating from the previously observed declines, steam revenue witnessed a 28.0% y/y surge to KES 3.2B (+15.8% h/h) with the leap being attributed to the completion of new wellheads plants and improved power evacuation following the completion of Olkaria-Suswa transmission line. On the flip side, steam costs outpaced revenue to burgeon 40.2% y/y to KES 1.8B which eroded 500bps y/y of steam margin to 43.2%. The increase in steam costs was attributed to the completion of the Olkaria-Suswa transmission line. Nonetheless, steam profit grew 14.8% y/y to KES 4.9B (12.8% h/h).

Capex raises operating expenses and depreciation & amortization: Over the past few years, KenGen has raised its capex in power generation (mainly geothermal) to raise both its capacity and energy revenue. As a consequence of the same, operating expenses grew 5.8% y/y to KES 4.6B in 1H18 due to costs associated with maintaining new and existing plants.
As a result of the capitalization of the completed wellheads and wells towards the end of FY17, depreciation and amortization expenses galloped 14.7% y/y to KES 5.2B. This negated the marginal 0.9% y/y uptick in EBITDA culminating in a 7.5% y/y squeeze in EBIT to KES 6.9B.

Net finance costs edge lower: Net finance costs closed 7.9% y/y lower to KES 896.0M attributed to rising finance income whilst finance costs increased marginally. Finance income surged 15.8% y/y to KES 732.0M due to investment of surplus funds earmarked for capital projects in 1H18. The marginal 1.4% y/y uptick in finance costs to KES 1.6B was attributed to the completion and capitalization of wellheads commissioned in 1H18.

Elevated effective tax rate adds insult to injury: The effective tax rate for 1H18 edged up 310bps y/y to 32.7% resulting in a 2.3% y/y increment in income tax expense to KES 1.9B; despite the lower pre-tax earnings (-7.4% y/y to KES 6.1B). Consequently, PAT fell 11.5% y/y to KES 4.1B.



Price Trend

Source: (NSE)

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Liquidity improves despite lower cash balances: As indicated by the current ratio, KenGen's liquidity appears to have improved with the current ratio rising to 1.6x from 1.2x in 1H17. The improvement was attributed to the 34.8% y/y surge in current assets coupled with a marginal 1.6% y/y uptick in current liabilities.
Dented profitability coupled with constrained working capital resulted in a negative operating cash flows of KES 341.0M from positive of KES 6.9B in 1H17. This culminated in a huge 89.3% y/y decline in cash balances to KES 701.0M.

What next?
Pipeline of projects to keep capex high: KenGen plans to add 721MW by 2022, which is estimated to cost KES 152B in capex. The firm is on course to complete the 158MW Olkaria V power plant by 2019 which upon commissioning is anticipated to add on to its assets. The higher asset balances are anticipated to further grow the firm's depreciation costs which may eat into their bottom-line.

Top-line: With a bulk of KenGen's revenue being sourced from capacity revenue, increased investment in geothermal production (87.4% of additional capacity is to be soured from geothermal power) is anticipated to augment its top-line. The country is anticipated to record improved power consumption in line with a rebounding economy from 2H18 onwards. As such, energy revenue accruing to the power generator is projected to continue on the upward trajectory.

Operating margin protection: With increased investment in its generative capacity, the firm's operating expenses are anticipated to increase. However, the firm has expressed commitment to keep the growth minimal. Given the additional investment is anticipated to raise the firm's top-line going forward, the revenue is projected to outpace costs, resulting in an improving operating profit margin.

Debt financing to raise leverage: To finance the KES 152B 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.

Sustained dividend drought: Given the large capital outlay, the firm may continue the dividend drought in the medium-term given the firm's plan to partly fund capex internally. Capex is anticipated to ease off from FY20 onwards which may see the firm commence dividend payment.

Is KenGen still a viable investment venture? The counter has negotiated its thorny issue of dividend payment to rise to KES 8.60 levels. Top-line growth is anticipated given the pipeline of plants anticipated to raise its capacity revenue while growth in costs is anticipated to remain reasonably low. As such, KenGen remains a pocket of value for value investors.
After the announcement today the counter has closed trade up to KES 8.95 despite the lower earnings recorded. This may be attributed to the dimmer fortunes of Kenya Power which has seen a significant price compression to KES 7.80 today and is projected to decline further. Investors seeking exposure in the energy sector may be dumping Kenya Power for KenGen which may raise the latter's demand, pushing up its price in the market.

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1H18 Financials

Income Statement	1H17	2H17	1H18	y/y change	h/h change
	KES M	KES M	KES M	%	%
Electricity revenue	**14,676**	**14,693**	**14,924**	**1.7**	**1.6**
Steam revenue	2,465	2,724	3,154	28.0	15.8
Other income	598	284	535	-10.5	88.4
Total income	**17,739**	**17,701**	**18,613**	**4.9**	**5.2**
Operating expenses	(4,392)	(5,299)	(4,648)	5.8	-12.3
Steam costs	(1,279)	(1,517)	(1,793)	40.2	18.2
EBITDA	**12,068**	**10,885**	**12,172**	**0.9**	**11.8**
Depreciation & amortisation	(4,529)	(4,715)	(5,195)	14.7	10.2
EBIT	**7,539**	**6,170**	**6,977**	**-7.5**	**13.1**
Interest income	632	610	732	15.8	20.0
Finance costs	(1,605)	(1,812)	(1,628)	1.4	-10.2
PBT	**6,566**	**4,968**	**6,081**	**-7.4**	**22.4**
Tax income/(expense)	(1,941)	(536)	(1,986)	2.3	270.5
PAT	**4,625**	**4,432**	**4,095**	**-11.5**	**-7.6**
Earnings per share					
Basic (KES)	2.10	2.02	1.86	-11.4	-7.9
Diluted (KES)	0.74	0.63	0.62	-16.2	-1.6

Statement of Financial Position	1H17	2H17	1H18	y/y change	h/h change
PPE	**322,091**	**323,843**	**324,128**	**0.6**	**0.1**
Other non-current assets	19,162	23,715	23,718	23.8	0.0
Current assets	22,224	29,639	29,947	34.8	1.0
Total assets	**363,477**	**377,197**	**377,793**	**3.9**	**0.2**
Equity and Liabilities					
Share capital	15,610	16,488	16,488	5.6	-
Share premium	21,056	22,151	22,151	5.2	0.0
Reserves and retained earnings	140,703	144,524	148,621	5.6	2.8
Non-current liabilities	167,913	173,941	172,045	2.5	-1.1
Current liabilities	18,195	20,093	18,488	1.6	-8.0
Total equity and liabilities	**363,477**	**377,197**	**377,793**	**3.9**	**0.2**

Statement of Cashflows	1H17	2H17	1H18	y/y change	h/h change
Cash generated/ (used) from operating activities	6,994	2,305	(341)	-	-
Cash generated/ (used) from investing activities	(5,954)	(5,147)	(5,416)	-9.0	5.2
Cash generated/ (used) from financing activities	(1,251)	4,128	(1,373)	9.8	-133.3
Net changes in cash and cash equivalents	**(211)**	**1,286**	**(7,130)**	**-**	**-**
Opening balance	6,756	6,545	7,831	15.9	19.6
Closing balance	**6,545**	**7,831**	**701**	**-89.3**	**-91.0**

Ratios and margins	1H17	2H17	1H18	y/y change	h/h change
EBITDA margin	68.0	61.5	65.4	-2.6	3.9
EBIT margin	42.5	34.9	37.5	-5.0	2.6
Net earnings margin	26.1	25.0	22.0	-4.1	-3.0
Effective tax rate	29.6	10.8	32.7	3.1	21.9
ROaE	5.3	4.9	4.4	-0.9	-0.5
ROaA	2.5	2.4	2.2	-0.4	-0.2
NAV/share (KES)	26.89	27.77	28.39	5.6	2.2
Current ratio (x)	1.2	1.5	1.6		
P/E (x)			6.9		
P/B (x)			0.3		

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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