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Part of AXYS Group

October 2017

KenGen FY17 Earnings Update
‘In line with expectations’

KenGen’s **net earnings** for FY17 surged **34.3% y/y** on the back of **lower depreciation** incurred (-15.7% y/y), **higher finance income** (+123.4% y/y) and l**ower income tax expense** (-45.2% y/y)**.** These saw the group offset the **8.2% y/y dip in top-line** in FY17. In line with our expectations, KenGen **withheld dividend** for the second consecutive year.

Topline ebbs 8.2% y/y on lower energy, steam and other revenue
Electricity revenue decreased marginally by 0.6% y/y to KES 29.4B. Electricity revenue comprises capacity revenue, energy revenue and recoverable forex adjustment, of which only capacity revenue recorded gains.
Capacity revenue edged up 2.0% y/y to KES 21.7B attributed to improved availability of the Olkaria 280MW plants. In addition, the group added an additional 10MW of Wellhead Power to the national grid. Early in FY17, the group decommissioned the Lamu and Garissa power plants (9.0 MW). The resultant effect is a benign 1.0MW increase in generation capacity.
Energy revenue on the other hand declined 5.0% y/y to KES 7.3B as a result of hydrology challenges and dispatch issues. Hydrology challenges were caused by the drought facing the country for the better part of 2017 denting the generative capacities of HEP plants. KenGen decommissioned thermal plants (Garissa and Lamu) in 1H17 with the PPA for Embakasi Gas Turbine expiring in November 2016. KenGen incurred KES 475.0M attributed to hydrology challenges and KES 173.0M incurred in dispatch challenges. Forex recovery plunged 41.0% y/y to KES 362.0M on account of the debt to equity conversion during the rights issue.
In FY16, **steam revenues** of KES 6.9B included arrears on steam revenues of KES 1.6B following the signing of steam resources and maintenance agreement in September 2015. Adjusting for revenue arrears, steam revenue eased marginally by 0.5% y/y to KES 5.2B, pinned on transmission constraints on the dispatch of well-head units.
Decreased revenue from contracts and consultancy saw KenGen’s **other income** plunge 60.1% y/y to KES 882.0M. Contracts and consultancy earned the firm KES 1.5B in FY16 while in FY17, the group did not book any revenue from this segment.

Rising operating expenses eat into EBITDA margin: Operating expenses rose 8.3% y/y to KES 9.7B brought about by the generator’s continued preparedness to increase its installed generative capacity. Mirroring steam revenue, steam costs fell 11.7% y/y to KES 2.8B with the steam margin remaining largely unchanged at 46.1% (-7.9bps y/y). With the higher operating expenses and lower top-line, EBITDA declined 13.4% y/y to KES 23.0B as the EBITDA margin took a 390bps y/y hit to 64.8%.

Decommissioned plants a silver lining: KenGen in 1H17 decommissioned two power plants totaling 9.0MW. This in turn saw the group lower its depreciation and amortization costs by 9.6% y/y to KES 9.2B. Despite this, EBIT came down 15.7% y/y to KES 13.7B resulting in a 350bps y/y dip in EBIT margin to 38.7%.

Bloomberg Ticker	KEGN KN
Reuters Ticker	KEGC.NR

Share Statistics	
Recommendation	**Buy**
Fair Value (KES)	9.43
Price	8.75
Market Cap (KES B)	57.7
Market Cap (USD M)	558.1
Year end	30-Jun
Float	25.7%
1 yr Avg Trading Val (USD)	114,826

Price Trend

Source: (NSE)

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Proceeds from rights issue bring down net finance costs: KenGen successfully managed to see a 100% subscription on its rights issue after 351.2M shares were issued to PIC in 2H17. This, in addition to sums collected during the initial offer, was to be used to invest in the pipeline of projects anticipated to add 721MW by 2022. However, the uptake of these projects was slow and as such, the firm invested the funds in short-term deposits. As a result, KenGen's finance income galloped 123.4% y/y to KES 1.2B, in line with our forecasts. Notwithstanding a 9.1% uptick in finance costs, net finance costs decreased 15.6% y/y to KES 2.2B on account of higher interest income.

No compensating tax in FY17 and tax incentives save face: In FY16, KenGen paid KES 2.4B in form of compensating tax which was a one-off event. Consequently, despite a lower EBIT, PBT edged up 2.4% y/y to KES 11.5B. The year saw the firm add 10MW of Wellhead capacity. KenGen leveraged on this to earn investment allowance above the cost of setting up the plant. Therefore, KenGen's income tax plummeted 45.2% y/y to KES 2.5B translating to an effective tax rate of 21.5%. The lower tax incurred saw the firm's net earnings surge 34.3% y/y to KES 9.1B.

Additional borrowing and PIC investment raise cash balances: Cash from operating activities plunged 68.2% y/y to KES 9.3B mainly attributed to working capital changes. This is informed by the 43.9% surge in current assets (excluding cash). Slower implementation of capex programs saw the group use up 51.1% y/y lower cash in operating activities. In the year, KenGen took up KES 11.8B in new debt whilst repaying KES 9.0B in debt. The firm received KES 2.0B from additional shares issued to PIC resulting in KES 2.9B cash generated from financing activities (KES 3.1B cash used in financing activities in FY16). This resulted in a 15.9% y/y leap in cash and cash equivalents to KES 7.8B

What next?

Capex aimed at leveraging on increased consumption: Through demand creation programs, Kenya's electricity demand is projected to lie between 2,600-3,600MW by 2025. Taking the upper side, this translates to an 8-year CAGR of 10.7% from the current levels. This presents opportunities that KenGen can leverage on to increase its energy revenue.

By 2025, KenGen plans to inject an additional 2,500MW of installed power capacity to remain a dominant market player with over 50% market share in installed capacity. By 2022, KenGen plans to add 721MW of installed power capacity with the main focus being geothermal (87.4% of new capacity). Borrowing from past trends, only geothermal, thermal and hydro power earn capacity revenue. As such, the focus on geothermal power is poised to grow KenGen's capacity revenue going forward.

KenGen to remain leveraged: Given the capex program lined up, we expect the firm to remain leveraged. KenGen plans to use up KES 152.0B by 2025 to finance the influx of capacity. This is to be financed through a mixture of debt and internally generated funds. We however expect finance costs to remain largely constrained given KenGen's ability to draw cheap concessionary loans. Management assert that the firm is in talks with the World Bank to restructure some of its loans which may see KenGen lower its effective interest rate from 2.5% .

Dividend pay-out to remain a thorny issue: KenGen has withheld dividend for the past two years with the market anticipating a dividend in FY17. We however didn't expect a dividend in this year but may see a small pay-out going forward. However, this may be unlikely given the large capital outlay planned by the group. It is likely that the firm may resume payment of dividends after FY19F seeing that it's the year they're projected to incur the largest capex (KES 81B).

Should we still buy KenGen?: KenGen is currently trading at KES 8.75 with a P/E of 6.4x and a P/B of 0.3x. The multiples tell differing narratives with the counter proving costly on earnings multiple, but trading at a significant discount on NAV multiple. We however re-affirm our buy recommendation on the counter.

Notwithstanding the dividend drought, we feel KenGen is still a pocket of value for a long-term investor. The top-line is anticipated to surge upon completion of the power projects with the bottom-line benefitting from cost containment measures and tax incentives. The withholding of dividend might see the counter take a beating at the bourse, which may offer an opportune time to buy.

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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 revenue	**29,544**	**30,334**	**29,369**	**-0.6**	**-3.2**
Steam revenue	6,856	5,215	5,189	-24.3	-0.5
Other income	2,210	1,244	882	-60.1	-29.1
Total income	**38,610**	**36,792**	**35,440**	**-8.2**	**-3.7**
Operating expenses	(8,948)	(9,179)	(9,691)	8.3	5.6
Steam costs	(3,167)	(2,706)	(2,796)	-11.7	3.3
EBITDA	**26,495**	**24,907**	**22,953**	**-13.4**	**-7.8**
Depreciation & amortization	(10,224)	(12,088)	(9,244)	-9.6	-23.5
EBIT	**16,271**	**12,819**	**13,709**	**-15.7**	**6.9**
Interest income	556	1,210	1,242	123.4	2.6
Finance costs	(3,132)	(3,093)	(3,417)	9.1	10.5
PBT	**11,264**	**10,936**	**11,534**	**2.4**	**5.5**
Tax income/(expense)	(4,521)	(3,281)	(2,477)	-45.2	-24.5
PAT	**6,743**	**7,655**	**9,057**	**34.3**	**18.3**
Other comprehensive income	(296)	-	(610)	106.1	-
Total comprehensive income	6,447	7,655	8,447	31.0	10.3
Basic EPS (KES)	3.07	3.73	4.12	34.2	10.3
Diluted EPS (KES)	1.08	1.24	1.37	26.9	10.3

Balance sheet	FY16	Apex Estimates	FY17	y/y change	Deviation from estimates
PPE	**320,933**	**331,505**	**323,843**	**0.9**	**-2.3**
Other non-current assets	24,400	24,658	23,715	-2.8	-3.8
Current assets	21,916	23,090	29,639	35.2	28.4
Total assets	**367,249**	**379,253**	**377,197**	**2.7**	**-0.5**
Share capital	15,610	16,488	16,488	5.6	0.0
Share premium	21,056	23,181	22,151	5.2	-4.4
Reserves and retained earnings	136,077	142,885	144,524	6.2	1.1
Non-current liabilities	176,316	174,176	173,941	-1.3	-0.1
Current liabilities	18,190	22,524	20,093	10.5	-10.8
Total equity and liabilities	**367,249**	**379,253**	**377,197**	**2.7**	**-0.5**

Statement of cashflows	FY16	Apex Estimates	FY17	y/y change	Deviation from estimates
Cash generated/ (used) from operating activities	29,256	22,853	9,299	-68.2	-59.3
Cash generated/ (used) from investing activities	(22,690)	(18,205)	(11,101)	-51.1	-39.0
Cash generated/ (used) from financing activities	(3,102)	(3,006)	2,877		
Net changes in cash and cash equivalents	**3,464**	**1,642**	**1,075**	**-69.0**	**-34.5**
Opening balance	3,292	6,756	6,756	105.2	-
Closing balance	**6,756**	**8,399**	**7,831**	**15.9**	**-6.8**

Ratios and margins	FY16	Apex Estimates	FY17	y/y change	Deviation from estimates
Steam margin (%)	46.2	48.1	46.1	-0.1	-2.0
EBITDA margin (%)	68.6	67.7	64.8	-3.9	-2.9
Effective tax rate (%)	40.1	30.0	21.5	-18.7	-8.5
ROaE (%)	4.3	3.9	5.1	0.8	1.2
ROaA (%)	1.9	1.9	4.0	2.1	2.1
NAV/share (KES)	27.67	27.68	27.77	0.4	-0.3
P/E (x)			6.4		
P/B (x)			0.3		

Source : Company filings & ApexAfrica Research

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Appendix

Disclaimer

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