ApexAfrica CAPITAL LTD
Part of AXYS Group

September 2018

KenGen Company Update
"Squeeze Theorem in Effect"
Recommendation: STRONG BUY

KenGen has come under considerable pressure at the bourse in what we feel could be the firm's squeezed position between scandals rocking Kenya Power and Ketraco. As investors impose sell-off pressure on Kenya Power, KenGen has been grazed in the process slumping 23.4% YTD. We however continue to see value on the counter hence our **STRONG BUY recommendation** informed by a **fair value of KES 8.47,** translating to a **31.3% upside** on its **current price of KES 6.40.** The firm stands to leverage on its hefty capex program that's projected to raise its capacity revenue at a 4-year CAGR of 12.4%. With revenue forecasted to outpace costs, the net earnings for the firm are estimated to grow at a 4-year CAGR of 16.8%.

Upsides

- Capex investment to grow capacity revenue (4-year CAGR of 12.4%);
- Leverage on growing demand realizing a 4-year CAGR of 7.0% in energy revenue;
- Steam revenue to rise (4-year CAGR of 8.9%) with growing geothermal capacity;
- Sluggishly growing costs raise EBITDA margins (FY22F at 67.4% from 64.8% in FY17);
- Projected resumption in dividend payment after the heavy capex investment.

Downsides

- Negative investor sentiment on the energy sector may keep the price depressed;
- Elevated capex to raise debt and finance income, denting FY19F net earnings;
- Potential project delays;
- Drive to lower power costs may affect revenue accruing to projects in the pipeline

The Game Changer

- Public Private Partnership (PPP) financing

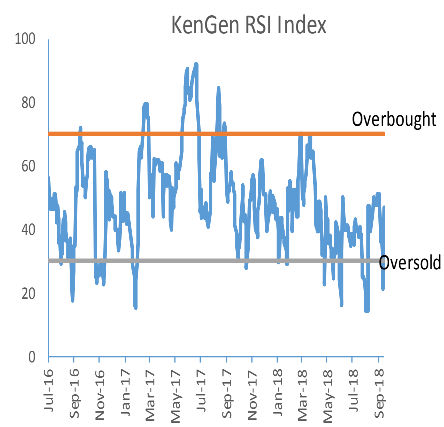
Summary	FY17	FY18E	FY19F	FY20F	FY21F	FY22F
Net earnings margin (%)	25.6	23.0	18.6	25.1	28.6	29.0
y/y change (%)	*8.1*	*-2.5*	*-4.4*	*6.4*	*3.6*	*0.3*
EPS (KES)	1.37	1.34	1.14	1.82	2.30	2.49
y/y change (%)	*27.2*	*-2.7*	*-15.0*	*59.7*	*26.7*	*8.3*
DPS (KES)	-	0.00	0.00	0.27	0.46	0.82
y/y change (%)	-	-	-	-	*68.9*	*78.6*
ROaE (%)	5.1	4.7	3.7	5.6	6.7	6.9
y/y change (%)	*0.8*	*-0.4*	*-0.9*	*1.8*	*1.1*	*0.3*
ROaA (%)	2.4	2.3	1.8	2.6	3.3	3.6
y/y change (%)	*0.5*	*-0.2*	*-0.5*	*0.9*	*0.7*	*0.3*
Debt to equity (%)	75.7	78.1	87.1	75.4	66.1	58.0
y/y change (%)	*-3.5*	*2.4*	*8.9*	*-11.7*	*-9.3*	*-8.1*
EV/EBITDA (x)	7.6	7.7	8.4	6.4	5.4	4.6

Source: Company Filings, ApexAfrica Estimates

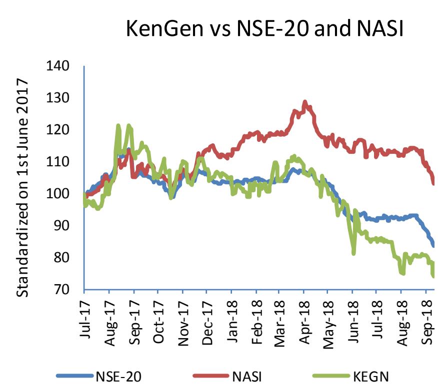
Bloomberg Ticker	KEGC KN
Reuters Ticker	KEGN.NR

Share Statistics	
Current Price (KES)	6.40
Market Cap (USD M)	412.1
Free Float (%)	29.9
Foreign ownership (%)	12.8
3-month Avg Trading Vol (USD)	28,752

Trailing multiples	
EPS (KES)	1.37
P/E (x)	1.6
ROaE (%)	5.1



Overbought suggest shorting the stock
Oversold suggests going long on the stock
Source: Bloomberg & ApexAfrica Research



Source: Bloomberg & ApexAfrica Research

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Upsides

Capex investment to pay-off

With guidance from management, we project a 4-year CAGR of 8.5% in installed capacity to 2,263MW by FY22F with the bulk of this new capacity being sourced from geothermal power production. Given the surging capacity, we forecast capacity revenue to gallop at a 4-year CAGR of 12.9% to 34.8B in FY22F.

Project Pipeline

Project	Capacity (MW)	Status	Comm date
Ngong I Phase 3	10	Optimization Study	2020
Olkaria I Unit 6	70	Procurement of contractors	2019
Olkaria I AU Uprating		Financing	2020
Olkaria IV Uprating	47[a]	Financing	2020
Olkaria I Rehabilitation	46	Financing completed	2020
Wellhead plants	47	Procurement of a Developer	2019
Olkaria V	140	Construction ongoing	2019
Meru Wind Phase I	80	Land acquisition	2020
Olkaria VI	140	Project development	2020
Olkaria VII	140	Project development	2020
Total	**720**		

Source: KenGen 2017 Annual Report

a refers to the capacity for Olkaria I AU Uprating and Olkaria IV Uprating

Leveraging on growing demand

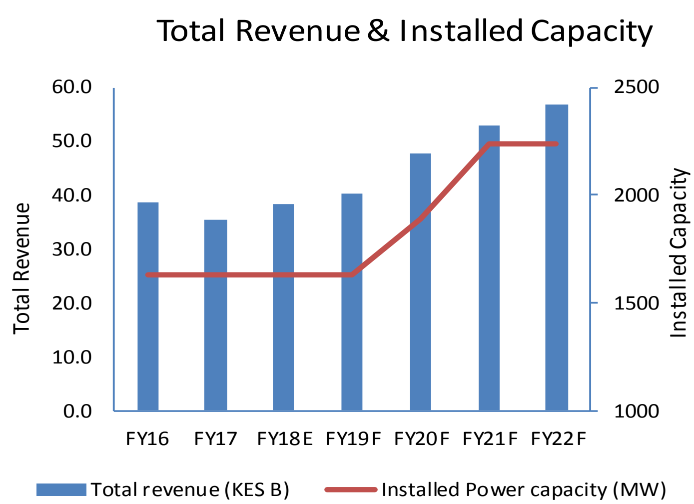
We forecast the country's electricity demand to grow at a 4-year CAGR of 6.0% driven by increased connectivity (raising consumer numbers) as well as rising consumption from both domestic and commercial consumers. Given the anticipated rally in electricity consumption, we forecast the energy revenue to grow at a 4-year CAGR of 7.0% to KES 11.9B in FY22F.

Steam revenue grows in tandem with geothermal capacity

Following a forecasted 4-year CAGR of 21.0% in geothermal capacity to 1,129MW in FY22F, we project steam revenue to increase at a 4-year CAGR of 8.9% to KES 9.1B. The increase in steam revenue is to be supported by more firms setting up shop near the proposed inland port at Naivasha, easing logistics for selling steam to the aforementioned firms. In addition, the firm's plan to set up the Olkaria Industrial Park may increase steam demand, racking up the revenue.

Rebound in commercial drilling

The last two years (FY17 and FY18E) have proved to be challenging given the slow down in commercial drilling. However, going forward, management remains optimistic that its fortunes are bound to turn given the anticipated rebound of the services. The country has 10,000MW geothermal potential which KenGen and other firms are looking to exploit. Given their expertise, the firm is looking at carrying out commercial drilling services for other firms such as Akiira Geothermal. Considering the erratic nature of this revenue, we have not captured it in our forecasted 4-year CAGR of 5.3% in other income to KES 0.9B in FY22F. Occurrence of the said revenue is anticipated to raise other income above our forecasts, raising KenGen's bottom-line.

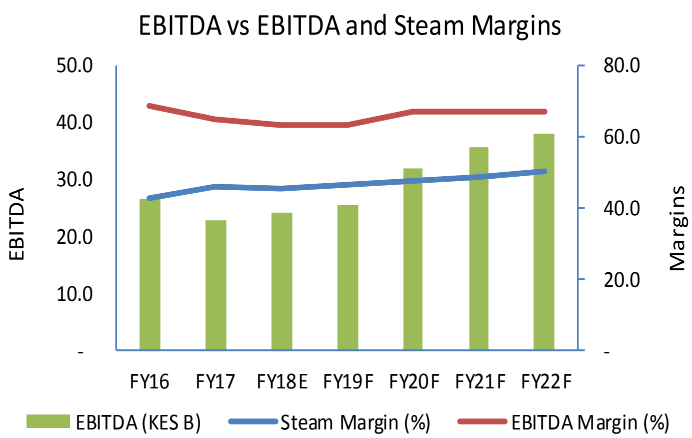


Source: Company filings, ApexAfrica Research

Sluggish costs raise margins

As KenGen's top-line rallies (4-year CAGR of 10.3%) the firm's costs are projected to drag the top-line. Steam costs are projected to grow at a 4-year CAGR of 6.4% given that most of the costs are projected to stagnate despite the rising steam revenue. Some of the wells run by KenGen (59 out of 304) belong to Geothermal Development Company (GDC) with some steam costs comprising payments made to GDC. Going forward, the new wells dug will belong to KenGen, stagnating these costs. Consequently, steam margin is anticipated to grow from 45.6% (FY18E) to 50.6% in FY22F.

The firm has initiated a number of cost optimization strategies that are anticipated to curtail operational costs. Nonetheless, the heavy capex planned out is anticipated to raise the firm's operating costs at a 4-year CAGR of 7.2%. This would see the top-line outpacing the operating expenses resulting in a burgeoning EBITDA margin (67.4% in FY22F from 63.4% in FY18E).

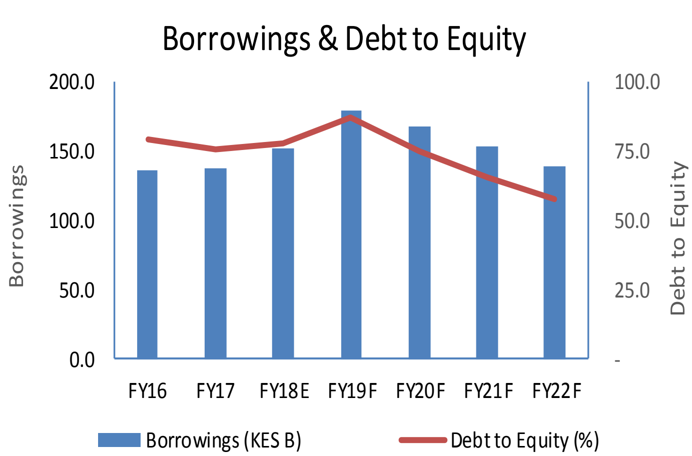


Source: Company filings, ApexAfrica Research

Deleverage in the horizon

Despite continued growth in debt levels in the previous years, we project the firm to eventually ease up on its debt levels. This is informed by lower capex outlined by the firm from FY20F onwards, as well as higher free cashflow used to bring down the debt levels. In addition, KenGen plans to finance Olkaria VI (*explained later)* through PPP financing that's anticipated to reign in on its debt levels. Given the heavy capex outlined for FY19F, the firm's debt level is anticipated to hit its highest level in FY19F, then decline thereafter.

Lower debt levels coupled with the higher profitability point to lower debt to equity (58.0% in FY22F from 78.1% in FY18E). In addition, finance costs are projected to remain tamed realizing a marginal 4-year CAGR of 1.2% to KES 3.5B in FY22F.



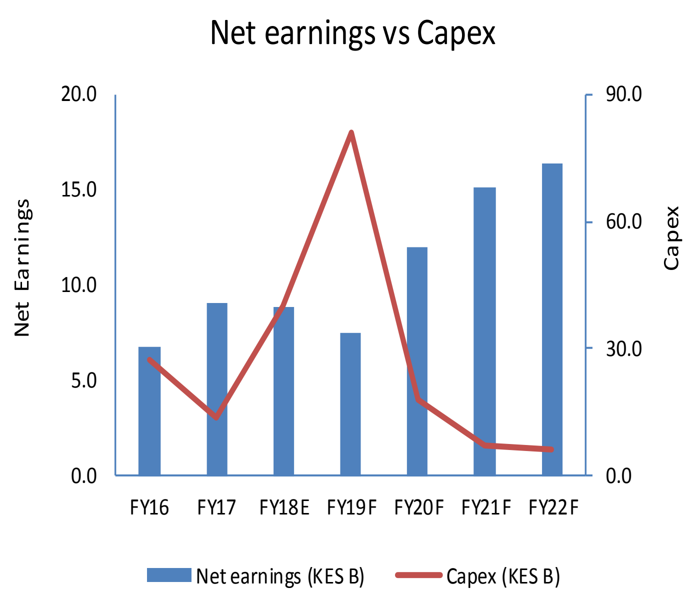
Source: Company filings, ApexAfrica Research

Bottom-line burgeons

A burgeoning top-line coupled with slow growth in operating and financing costs points to a 4-year CAGR of 16.8% on the firm's net earnings to KES 16.4B. The huge growth is to be observed in FY20F and FY21F when the new generation capacity is to be commissioned. In the years when the new plants will be commissioned, the firm is poised to claim capital allowance on the projects which effectively lowers its effective tax rate. Given the contentious computation of capital allowance granted by the tax authority, we have not factored in these allowances. However, when granted, they're projected to raise the bottom-line above our current forecasts.

Higher profit + Lower Capex = Dividend (Maybe)

After the heavy capex projected for FY19F (KES 81B), the capex program is projected to ease off resulting in higher free cashflow. In addition, as outlined, the company is projected to realise a significant growth in its net earnings. As such, we envision a dividend pay-out will be commenced in FY20F. We project a pay-out ratio of 15.0% in FY20F to be raised to about 33.0% in FY22F in line with the target issued by the company during the rights issue.



Source: Company filings, ApexAfrica Research

Downsides

Scandals in the energy sector (Squeeze Theorem)

KenGen seems to be squeezed between Kenya Power and Ketraco such that whenever scandals hit the latter firms, it's inferred (by the market) that the scandals also face KenGen. The situation has seen the counter come under pressure at the bourse and with the storm being far from over, the negative market sentiments may keep the price depressed.

A rocky patch lies ahead

Just before the dawn of leaps in profitability, we project the darkness of falling profitability to hit the firm in FY19F. Despite the higher EBITDA (5.1% y/y to KES 25.5B) as a result of the growing top-line (+5.3% y/y to KES 40.3B) depreciation and amortization costs in FY19F (+12.2% y/y) are projected to wipe out the gains in EBITDA resulting in a 0.4% y/y dip in EBIT to KES 13.6B. The final nail on this coffin would be the double whammy of falling finance income (as a result of higher capex minimizing free cash to invest) and elevated finance costs (+32.2% y/y to KES 4.5B) as a result of heightened debt levels (+18.1% y/y to KES 179.4B) to finance the capex outlined. Consequently, PBT is anticipated to take a beating (-14.6% y/y to KES 9.9B) which may shadow the allure of the firm for short-term investors.

Potential downsides in push to lower power costs

The government is keen on delivering on its promise of cheaper power in the country. On the face value of it, lower tariffs to consumers, with generation costs remaining unchanged, points to lower profit margins. A caveat on this threat is that the price at which it sells power to Kenya Power as well as capacity revenue accruing to KenGen are embodied in the existing PPAs; whose review may prove costly and hence this route is unlikely. However, the new projects in the pipeline, whose PPAs have not been approved, may face the threat of lower capacity and/or energy revenue.

In addition, the ERC had recommended scraping the forex element in power bills. This could expose KenGen to forex risk given 89.4% of its FY17 debt is foreign denominated. Nonetheless, management is ready to employ hedging mechanisms should the development see the light of day.

Project delays

The revenue projections used in coming up with our valuation are highly dependent on the timely completion of the pipeline of projects. Management asserts that some may face delays which are at times inevitable. For instance, there have been issues in land acquisition of the Meru wind farm and as such, the project is prone to delays. To factor in the delays, we have deferred the commissioning dates for the subsequent financial years, other than Olkaria V whose project completion in on track for commissioning in July 2019.

Unattractive on ROE basis

KenGen's ROE stands at 5.1% against a peer mean of 16.1%; with KenGen as the clear outlier. The low ROE is attributed to elevated initial government investment in the hydro plants whose unit costs to the final consumer average about KES 3.00; the lowest among other sources (Geothermal KES 9.00). Management is optimistic that the new plants (with targeted ROE of c.10.0%) will raise the firm's ROE. We project KenGen's ROE to hit 6.9% in FY22F, though, FY18E and FY19F are projected to record lower ROEs (4.7% and 3.7% respectively) as a result of lower profitability.

The Game Changer

PPP Financing

KenGen intends to finance Olkaria VI 140MW through PPP financing. The firm intends to enter into a joint venture (JV) agreement with KenGen controlling 49.0% of the investment vehicle. The estimated total capex of Olkaria VI is c. KES 30B with the SPV bound to be heavily leveraged (70.0%). The model of financing ends up being off-balance sheet financing using the equity method of consolidation. This will leave KenGen accounting for its investment in the SPV as well as any gains/loss accruing to JV. Consequently, debt accruing to the SPV will bypass KenGen's balance sheet, deleveraging the power generator. In addition, since the wells belong to KenGen, the firm is anticipated to earn 100% of the steam revenue accruing to the project. Though still in its formative stages, this model of financing may deleverage KenGen, minimizing the high leverage risk that puts off some investors. The ideal partner, according to management is a seasoned player in geothermal generation which may facilitate transfer of knowledge. However, a pure equity injection partner would see KenGen earn management fees of the SPV.

A change in reporting standards remains a risk should the consolidation procedures for joint ventures change. However, there are currently no plans to change these standards. The success of this model of financing may see the firm employ it in other capex financing resulting in lower debt levels.

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Peer comparables

Name	Country	P/B	P/E	EV/EBITDA	ROE	Div Yld
		x	x	x	%	%
KenGen	**KN**	**0.2**	**1.6**	**7.5**	**5.1**	**-**
Montauk Energy Holdings	SA	6.7	42.3	17.2	16.9	0.7
Sembcorp Salalah Power	2.2	16.5	9.3	15.4	6.0	
SMN POWER	OM	4.2	13.8	9.8	34.9	6.3
Al Suwadi Power	OM	1.0	10.3	8.7	11.2	3.0
ACWA Power Barka	OM	2.2	18.2	7.7	12.8	5.6
Al Batinah Power	OM	1.1	9.8	8.8	11.4	4.7
TAQA Morocco	MO	3.7	19.2	8.6	19.3	4.8
Qatar Electricity & Water	QA	2.2	13.2	14.4	18.3	4.0
Mean		**2.6**	**16.1**	**8.4**	**16.1**	**4.4**
Median		**2.2**	**13.8**	**8.8**	**15.4**	**4.7**

Source: Company filings, ApexAfrica Research, Bloomberg

Valuation

Assumptions		
Risk free rate (%)	11.7	*5-year T-Bond yield*
Beta	1.2	*ApexAfrica Estimates*
Risk premium (%)	5.0	
Cost of Equity (%)	17.8	
WACC (%)	10.7	

P/B Method	
Historical average (x)	0.3
FY19F NAV (KES)	31.24
Fair Value (KES)	**8.43**

EV/EBITDA	
Historical EV/EBITDA (x)	7.3
Industry average EV/EBITDA (x)	8.4
Weighted EV/EBITDA (x)	7.9
FY19F EBITDA (KES B)	25.5
EV (KES B)	200.7
FY17F Net Debt (KES B)	144.6
Market Cap (KES B)	56.1
Fair Value (KES)	**8.51**

Blended fair value	
P/B (KES)	8.43
EV/EBITDA (KES)	8.51
Blended fair value (KES)	**8.47**

1H18 Financials Recap

Income statement	1H17	1H18	y/y change
	KES M	KES M	%
Electricity revenue	**14,676**	**14,924**	**1.7**
Steam revenue	2,465	3,154	28.0
Other income	598	535	-10.5
Total income	**17,739**	**18,613**	**4.9**
Operating expenses	(4,392)	(4,648)	5.8
Steam costs	(1,279)	(1,793)	40.2
Depreciation & amortization	(4,529)	(5,195)	14.7
EBIT	**7,539**	**6,977**	**-7.5**
Interest income	632	732	15.8
Finance costs	(1,605)	(1,628)	1.4
PBT	**6,566**	**6,081**	**-7.4**
Tax income/(expense)	(1,941)	(1,986)	2.3
PAT	**4,625**	**4,095**	**-11.5**
Basic EPS (KES)	**2.10**	**1.86**	**-11.4**
Diluted EPS (KES)	**0.74**	**0.62**	**-16.2**

Statement of Financial Position	1H17	1H18	y/y change
PPE	322,091	324,128	0.6
Other non-current assets	19,162	23,718	23.8
Current assets	22,224	29,947	34.8
Total assets	**363,477**	**377,793**	**3.9**
Share capital	15,610	16,488	5.6
Share premium	21,056	22,151	5.2
Reserves and retained earnings	140,703	148,621	5.6
Non-current liabilities	167,913	172,045	2.5
Current liabilities	18,195	18,488	1.6
Total equity and liabilities	**363,477**	**377,793**	**3.9**

Statement of Cashflows	1H17	1H18	y/y change
Cash from operating activities	**6,994**	**(341)**	**-**
Cash from investing activities	(5,954)	(5,416)	-9.0
Cash from financing activities	(1,251)	(1,373)	9.8
Net changes	**(211)**	**(7,130)**	**-**
Opening balance	6,756	7,831	15.9
Closing balance	**6,545**	**701**	**-89.3**

Ratios and margins	1H17	1H18	y/y change
Steam margin (%)	48.1	43.2	-5.0
EBITDA margin	68.0	65.4	-2.6
EBIT margin	42.5	37.5	-5.0
Net earnings margin	26.1	22.0	-4.1
Effective tax rate	29.6	32.7	3.1
ROaE	5.3	4.4	-0.9
ROaA	2.5	2.2	-0.4
NAV/share (KES)	26.89	28.39	5.6
Current ratio (x)	1.2	1.6	

Source: Company Filings, ApexAfrica Research

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Financial Forecasts

Income statement (KES B)	FY17	FY18E	FY19F	FY20F	FY21F	FY22F	y/y	4-yr CAGR
	KES B	KES B	KES B	KES B	KES B	KES B	%	%
Capacity revenue	21.7	21.4	21.9	27.8	32.3	34.2	(1.3)	12.4
Energy revenue	7.3	9.1	10.1	11.2	11.3	11.9	24.9	7.0
Electricity revenue	**29.4**	**31.1**	**32.4**	**39.5**	**44.1**	**46.7**	**5.8**	**10.7**
Steam revenue	5.2	6.4	7.0	7.5	8.0	9.1	23.8	8.9
Other income	0.9	0.8	0.8	0.8	0.9	0.9	(13.7)	5.3
Total Income	**35.4**	**38.2**	**40.3**	**47.8**	**53.0**	**56.7**	**7.9**	**10.3**
Operating expenses	(12.5)	(14.0)	(14.8)	(15.8)	(17.3)	(18.5)	12.1	7.2
Steam costs	(2.8)	(3.5)	(3.8)	(3.9)	(4.1)	(4.5)	25.0	6.4
EBITDA	**23.0**	**24.3**	**25.5**	**32.0**	**35.6**	**38.2**	**5.7**	**12.0**
Depreciation and amortization	(9.2)	(10.6)	(11.9)	(12.6)	(12.9)	(13.1)	15.0	5.3
EBIT	**13.7**	**13.6**	**13.6**	**19.4**	**22.8**	**25.2**	**(0.6)**	**16.6**
Finance income	1.2	1.3	0.8	0.5	0.6	0.5	2.9	(22.3)
Finance expenses	(3.4)	(3.3)	(4.5)	(4.2)	(3.9)	(3.5)	(2.2)	1.2
Share of joint venture profit	-	-	-	-	1.0	1.0	-	-
PBT	**11.5**	**11.6**	**9.9**	**15.8**	**20.4**	**22.1**	**0.2**	**17.6**
Tax	(2.5)	(2.7)	(2.4)	(3.8)	(5.3)	(5.7)	10.9	20.1
PAT	**9.1**	**8.8**	**7.5**	**12.0**	**15.2**	**16.4**	**(2.7)**	**16.8**
EPS (KES)	**1.37**	**1.34**	**1.14**	**1.82**	**2.30**	**2.49**	**(2.7)**	**16.8**
DPS (KES)	**-**	**-**	**-**	**0.27**	**0.46**	**0.82**	**-**	**-**

Statement of Financial Position (KES B)	FY17F	FY18E	FY19F	FY20F	FY21F	FY22F	y/y	4-yr CAGR (%)
PPE	**323.8**	**353.2**	**396.7**	**402.1**	**396.3**	**389.2**	**9.1**	**2.5**
Investment in joint venture	-	-	-	4.4	5.1	5.8	-	-
Other non-current assets	23.7	24.4	25.2	25.6	25.9	26.2	2.9	1.8
Current assets (excluding cash and cash equivalents)	21.8	19.3	19.8	24.3	25.2	26.9	(11.7)	8.8
Cash and cash equivalents	7.8	7.3	6.6	6.8	5.0	5.5	(6.7)	(7.0)
Total assets	**377.2**	**404.2**	**448.3**	**463.3**	**457.4**	**453.6**	**7.2**	**2.9**
Total equity	183.2	194.4	206.0	223.0	233.1	241.6	6.1	5.6
Non-current liabilities	173.9	188.9	220.4	212.8	196.8	180.5	8.6	(1.1)
Current liabilities	20.1	20.9	21.9	27.5	27.5	31.5	3.9	10.9
Total equity and liabilities	**377.2**	**404.2**	**448.3**	**463.3**	**457.4**	**453.6**	**7.2**	**2.9**

Statement of cashflows (KES B)	FY17F	FY18E	FY19F	FY20F	FY21F	FY22F
Cashflows from operating activities	9.3	24.7	25.5	29.5	35.0	37.5
Cashflows from investing activities	(11.1)	(40.0)	(55.4)	(18.0)	(7.0)	(6.0)
Cashflows from financing activities	2.9	14.8	29.2	(11.3)	(29.8)	(31.1)
Net Changes in cash and cash equivalents	**1.1**	**(0.5)**	**(0.7)**	**0.2**	**(1.8)**	**0.5**
Opening cash and cash equivalents	6.8	7.8	7.3	6.6	6.8	5.0
Closing cash and cash equivalents	**7.8**	**7.3**	**6.6**	**6.8**	**5.0**	**5.5**

Ratios and margins	FY17F	FY18E	FY19F	FY20F	FY21F	FY22F
Steam margin	46.1	45.6	46.6	47.6	48.6	50.6
EBITDA margin	64.8	63.4	63.3	67.0	67.3	67.4
EBIT margin	38.7	35.6	33.7	40.7	43.0	44.4
Net profit margin	25.6	23.0	18.6	25.1	28.6	29.0
ROaA	2.4	2.3	1.8	2.6	3.3	3.6
ROaE	5.1	4.7	3.7	5.6	6.7	6.9
Debt to equity	75.7	78.1	87.1	75.4	66.1	58.0
Current ratio	1.5	1.3	1.2	1.1	1.1	1.0

Source: Company filings, ApexAfrica Research

Appendix

Investment ratings

- **Strong Buy:** Issued on counters with strong fundamentals with a fair value above 20.0%. The counter is anticipated to register strong growth with and is currently undervalued.

- **Buy:** Issued on counters with strong fundamentals whose upside lies between 10.0% and 20.0%. The same may be issued for counters with challenged fundamentals whose upside is over 20.0%. Such a scenario is targeted for risk neutral investors.

- **Accumulate:** Issued on counters with an upside of between 5.0% - 10.0%. The counter may be facing contracting avenues for growth with a tepidly growing bottom-line.

- **Hold:** Issued on counters with an upside of between 0% and 5.0% with limited avenues for growth. Contracting bottom-line with an attractive dividend yield of about 5.0%.

- **Lighten:** The company is anticipated to record a moderate downside on its fair value, though it may have strong fundamentals.

- **Sell:** The counter currently has weak fundamentals coupled with significant potential downside.

Disclaimer

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