



Power Sector: Initiation of Coverage

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Boosting capacity to power more...

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Investment Summary

We initiate coverage on Kenya's Power Sector with a **POSITIVE OUTLOOK**.

An efficient and cost effective power sector is the driving force for growth of any economy. However, in order to achieve this, there needs to be an even mix of investment, cost recovery and affordability.

Kenya's installed effective generation capacity has grown at a CAGR of 7.2% from 1,153MW in FY2007 to 1,637MW in 2012. We estimate this effective capacity in the country to increase by 1,236MW in the next four years to about 2,872MW by FY2016 largely driven by the new projects to be commissioned by KenGen and other independent power producers.

According to KenGen, Kenya has significant natural power potential in the form of;

- ✓ Geothermal (approximately 7,000 MW)
- ✓ Hydro (approximately 1,500MW)
- ✓ Wind (approximately 4,400MW)

The geothermal potential is currently being aggressively exploited by KenGen with a growing demand strengthening the case for such exploitation.

Other power sector growth drivers we have highlighted include:

- ✓ **GDP Per Capita Growth:** As the GDP per capita for the Kenya continues to grow, so will the spending power in the country resulting in a rise in electricity consumption.
- ✓ **Decentralisation:** The upcoming counties will facilitate expansion of electricity into areas that did not have access to power before.
- ✓ **Industrialization and Expansion of large and industrial power consumers:** As industrialization increases, so does the demand for electricity.
- ✓ **Key infrastructure projects:** Kenya Power estimates the key vision 2030 flagship projects to bring in an estimated 876MW of power.

KenGen

We initiate coverage on Kenya Electricity Generating Company (KenGen) with a **BUY recommendation**. Based on our EV/EBITDA valuation we arrive at a price target of KES 21.70 which represents an 35.2% upside from the current share price of KES 16.05 (17.06.2013).

Kenya Power

We initiate coverage on Kenya Power with a **NEUTRAL recommendation**. Based on our EV/EBITDA valuation we arrive at a price target of KES 14.72 which represents an 5.2% downside from the current share price of KES 15.50 (17.06.2013).

Efficient and cost effective power sector is the driving force of an economy

Average tariff in Sub Saharan Africa is USD 0.12 per kWh

Electricity consumption has a direct correlation with GDP per capita

Impending demand from the county level

Vision 2030 projects will necessitate more energy production

BUY KenGen

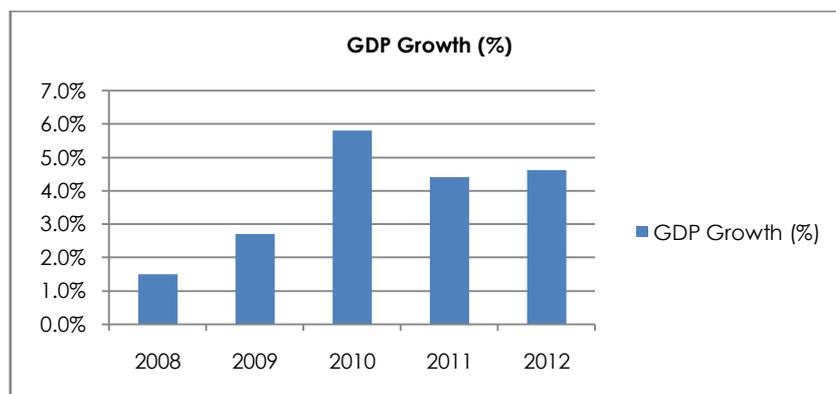
NEUTRAL on Kenya Power

Economic Overview

Kenyan Economy

Real GDP growth rate of 4.6% in 2012

Kenya's Real Gross Domestic Product (GDP) is estimated to have grown 4.6% in 2012 compared to 4.4% in 2011. Though moderate, growth was experienced in all sectors of the economy in a fairly stable macroeconomic environment. Inflation eased to an average of 9.4% in 2012 from an average of 14.0% in 2011 mainly due to tighter monetary policy and favourable economic conditions in the first half of 2012.



Source: World Bank

Agricultural sector recorded a growth of 3.8% in 2012

Agriculture: The sector recorded a growth of 3.8% in 2012 compared to 1.5% in 2011. Performances of individual subsectors varied on account of erratic rainfall across the ecological zones. There was an increase in production in coffee, maize, sugarcane and wheat. A decline was witnessed in the production of horticulture, tea and pyrethrum.

Favourable weather conditions expected in 2013

According to the Kenya Meteorological Department (KMD), there is high likelihood of sufficient rains in 2013 even though the onset of long rains delayed slightly. The Agricultural sector is likely to post better growth due to these favorable weather conditions.

Manufacturing sector to benefit from favourable weather conditions

Manufacturing: The sector recorded a slower growth of 3.1% in 2012 compared to a growth of 3.5% registered in 2011. The decreased growth was on account of high production costs, high costs of credit, competition from imported goods and election-related uncertainties.

The sector recorded slow growth in the run up to the elections with production of cement dropping to 373,337 metric tonnes in March 2013 from 387,527 metric tonnes in January 2013.

Going forward, production of new assembled vehicles and cement are bound to increase in order to meet growing demand. Furthermore, the sector is poised to benefit from the favourable weather with stable electricity and water supply.

Transport and communication: The Transport and Communication sector grew by 4.0% compared to 4.7% growth in 2011. The transport and storage subsector recorded a slower growth of 3.1% in 2012 as compared to 4.9% growth in 2011. An increased growth of 5.3% in 2012 was recorded in the communication subsector as compared to 4.3% growth in 2011.

Growth in the sector is bound to increase citing increased number of vehicles registered (20,023 vehicles in March 2013 from 17,061 in February 2013), lower cost of credit following the cut in the Central Bank Rate to 8.5% and a relatively stable Kenya Shilling.

Tourism sector recorded a slow growth of 2.6%

Tourism: The sector experienced a slow growth of 2.6% in 2012 as compared to 4.9% in 2011. This was due to decreased number of tourist arrivals and earnings. Hotel occupancy decreased significantly due to the Euro crisis and security concerns associated with the 2013 general elections. However, local and international conferences increased by 11.5% and 6.1% respectively in 2012.

Hotels and restaurants likely to benefit from concluded peaceful election process

Uncertainty surrounding the general elections impacted negatively on the transport sector with passengers who landed at Jomo Kenyatta International Airport (JKIA) declining from 178,202 persons in February 2013 to 176,895 persons in March 2013. Hotels and restaurants are now likely to benefit from the concluded peaceful election process and resurgence in the global economy leading to more international visitor arrivals.

CBR rate cut to 8.5% in May 2013

Financial Intermediation: The sector recorded a slower growth of 6.5% in 2012 compared to 7.8% growth in 2011. This was due to a declined growth in credit to 10.8% in 2012 from 30.8% in 2011 resulting from the tighter monetary stance adopted in the first half of 2012.

The Monetary Policy Committee cut the Central Bank Rate to 8.5% in May 2013 in a bid to boost credit uptake and stimulate the economy. Growth in credit is expected following the cut in the indicative rate.

Electricity and water to post better growth

Electricity and water: The sector recorded an overall growth of 10.3% compared to a contraction of 2.6% in 2011. Electricity supply increased by 12.6% in 2012 from a 4.4% decline in 2011 due to an increase in hydro generation by 21.6%. Total demand for electricity recorded a growth of 2.2% to 6,414.4 million KWh in 2012.

Given that the country has experienced better weather conditions in the first quarter of the year 2013 than in 2012, there is a higher possibility that electricity and water supply will post better growth.

Increased development of infrastructure likely to lead to increased cement production and consumption

Construction: A growth of 4.8% in 2012 was recorded compared to 4.3% in 2011. Cement consumption increased by 1.7% to 3,937.3 thousand tonnes in 2012 from 3,870.9 thousand tonnes in 2011. Government expenditure index on roads rose to 447.3 in 2012 from 397.0 in 2011.

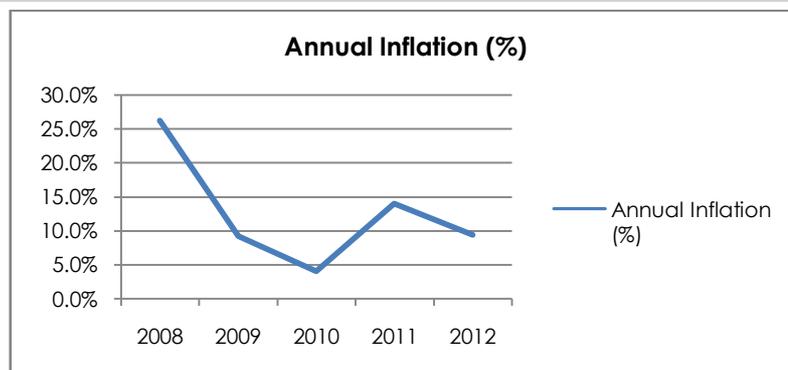
Consumption of cement dropped to 284,794 Metric tonnes in March 2013 from 334,285 metric tonnes in February 2013. This could be attributable to the overall slowdown in the economy due to election-related uncertainties. Going forward, a number of growth drivers such as lowered lending rates, increased development of infrastructure and rising disposable income are likely to lead to increased cement production and consumption.

Annual inflation dropped to 9.4% in 2012 from 14.0% in 2011

Inflation

Annual inflation dropped to 9.4% in 2012 from 14.0% in 2011. The fall in annual inflation is largely attributed to improved weather conditions that led to increased food production. The Food and Non-alcoholic beverages increased by 10.0%.

Overall inflation rate stood at 4.1% in May 2013 from 3.7% in January 2013. Following the favorable weather conditions, cut in the CBR rate and the recent budget proposals, we expect inflation to stand between 4.0% and 4.6% for the remainder of the year.



Source: World Bank

Interest Rates

Year	Month	Deposit	Saving	Lending	Overdraft	Inter-bank	CBR
2012	Dec	6.80	1.60	18.15	17.79	5.89	11.00
2011	Dec	6.99	1.59	20.04	20.20	22.10	18.00
2010	Dec	3.59	1.45	13.87	13.69	1.20	6.00
2009	Dec	4.84	1.73	14.76	14.13	3.00	7.00
2008	Dec	4.89	1.65	14.87	14.40	6.70	8.50

Source: KNBS, CEK

The Central Bank Rate (CBR) was maintained at 18.0% up to June 2012 and gradually reduced to 11.0% in December 2012. Reduction in the CBR rate was implemented after desired results in regards to the high inflation were attained. Commercial banks have been reducing marginally their lending and overdraft interest rates to 18.15% and 17.79% respectively in December 2012 in line with the reduction in the CBR. Interest rate spread declined from 13.05 points in December 2011 to 11.35 points in December 2012.

The Monetary Policy Committee (MPC) recently cut the CBR to 8.5% in May 2013 in order to ease access to credit. Most commercial banks cut their lending rates by 100bps to a range of 16.5% to 17.5%. The lending rates are expected to be maintained at that level should the CBR be kept constant.

Most commercial banks cut their lending rates by 100 bps in response to the cut in the CBR

Exchange Rates

	USD	STG POUND	EURO
Dec-11	86.66	135.1	114.15
Dec-12	85.99	138.78	112.77

Source: Central Bank of Kenya

The Kenya Shilling appreciated against all major currencies except for the Pound Sterling in 2012. The stability of the shilling is attributable to the prudent monetary policy stance adopted by the Central Bank of Kenya. The Kenya Shilling appreciated by 0.8% and 1.2% to trade at an average of KES 85.99 per USD and KES 112.77 per Euro in comparison to December 2011. The Kenya Shilling depreciated by 2.7% against the Sterling Pound to trade at an average of KES 138.78 per Pound in comparison to December 2011.

The Kenya Shilling appreciated by 0.9% to trade at an average of KES 85.35 per USD (13.06.2013) from the beginning of the year average of KES 86.08 per USD (2.06.2013). The Kenya shilling has weakened in recent weeks on the back of high dollar demand from foreigners looking to convert their shilling earnings from the stock market.

Kenya Shilling has weakened in recent weeks

Power Industry Overview

An efficient and cost effective power sector is the driving force for growth of any economy. However, in order to achieve this, there needs to be an even mix of investment, cost recovery and affordability.

Sub Saharan Africa (SSA) faces chronic power problems

According to the International Monetary Fund (IMF), in a report, "Energy Subsidy Reform in Sub Saharan Africa: Experiences and Lessons" Sub Saharan Africa (SSA) faces chronic power problems including insufficient generation capacity, low access, poor reliability as well as high costs and tariffs.

The average tariff in SSA is about twice that of other developing countries

According to the report, the combined power generation capacity of the 48 SSA countries is about 80 gigawatts, and less than 3 in every 10 Africans have access to electricity.

In Kenya, EPP's accounted for 5.0% of total power generated in FY2012

Notwithstanding limited and unreliable supply, power is expensive: the average tariff in SSA is USD 0.12 per kWh, about twice that of other developing countries. This has been attributed to among other factors, the poor infrastructure brought about by under-investment in the sector.

Energy sector to get 4.8% of the Kenya national budget

As a result of this under-investment, in Kenya, Emergency Power Producers (EPP's) accounted for 5.0% (381.0 GWh) of total power generated by the industry in FY2012. This figure stood at 16.4% (1,096 GWh) of total generation in FY2010 due to poor hydrology during the financial year which resulted in the consumer paying a higher cost of electricity due to the fuel cost component.

During the past five financial years, the energy sector in Kenya has been allocated nothing less than 3.5% of the national budget. For the upcoming financial year FY2013/2014, the Government of Kenya has proposed to fund the energy sector with KES 78.5 billion, 4.8% of the national budget.

A table showing the energy sector allocation from the national budget in East Africa and South Africa

	2009/10	2010/11	2011/12	2012/13	2013/14
Energy(Ksh Bn)	31	34.9	65.7	79.9	78.5
% change		12.58%	88.25%	21.61%	-1.75%
5-year average					58.00
Total budget(Ksh Bn)	865.6	998.8	1,154.9	1,459	1,640.9
Kenya: % of national budget	3.58%	3.49%	5.69%	5.48%	4.78%
% change		-0.09%	2.19%	-0.21%	-0.69%
5-year average					4.60%
Tanzania: % of national budget	3.00%	2.82%	3.99%	4.82%	7.82%
Uganda: % of national budget	9.92%	5.26%	13.71%	13.59%	13.77%
South Africa: % of national budget	0.50%	0.70%	0.68%	0.70%	0.63%

Source: Ministry of Finance, Planning and Economic Development – Uganda, Ministry of Finance – Tanzania, Ministry of Finance – Kenya, Ministry of Finance - South Africa

Uganda has the highest allocation to the energy sector

As the table above shows, Uganda has the highest allocation to the energy sector as a percentage of the total budget. We attribute this to the heavy investments being done by the Ugandan government to increase access to electricity and support the constantly growing demand for power. According to the National Environment Management Authority – (NEMA) Uganda, over 90.0% of the country's population is not connected to the national grid.

Uganda's electricity demand has been growing by 10.0% every year, while supply prior to commissioning of Bujagali hydropower plant (250MW) in October 2012 has remained stagnant.

Developments in the Power Sector

In 1994, the Government of Kenya initiated reforms in the electricity supply industry. The key objectives of these reforms included:

- 1) Separating commercial function from policy setting, regulation and coordinating functions.
- 2) Creating more competitive conditions in the electricity supply industry.
- 3) Requiring the sector companies to operate at arm's length on a commercial basis.

Unbundling of KPLC led to Kenya Power and KenGen

This resulted in the unbundling of Kenya Power and Lighting Company (KPLC) into two entities, KPLC (now known as Kenya Power) and Kenya Electricity Generating Company (KenGen).

Kenya Power was tasked with the responsibility of transmission, distribution and supply of electricity while KenGen became responsible for generating in competition with Independent Power Producers (IPPs).

KETRACO incorporated in 2009 to take over the transmission function from Kenya Power

In 2009, a further restructuring took place which saw the incorporation of Kenya Transmission Company (KETRACO) taking over the transmission function from Kenya Power. The key mandate of KETRACO is to design, construct operate and maintain new high voltage electricity transmission lines using exchequer funding while Kenya Power retained ownership of all existing transmission systems at the time.

This has brought about more effective running of the power industry companies as they are now tasked with specific functions i.e. Generation (KenGen), Transmission (KETRACO) and Distribution (Kenya Power).

GDC formed in order to accelerate the development of geothermal resources in the country

Another restructuring took place in the last decade in the Power sector with the formation of Geothermal Development Corporation (GDC). GDC is a 100% state owned company, formed by the Government of Kenya as a Special Purpose Vehicle to accelerate the development of geothermal resources in the country.

Massive potential of an estimated 7,000 MW – 10,000 MW

Since the search for geothermal energy began in 1957, only 209MW had been harnessed before the formation of GDC. This is in spite of a massive potential of an estimated 7,000 MW – 10,000 MW. The GDC's task is mainly to avail steam to power plant developers for electricity generation funded by the government.

The result of this is that the heavy capital investment of drilling together with the risk of unsuccessful drilling has been removed from the investor and borne by the government.

KenGen has invested in 3 drilling rigs and 3 other contracted rigs

Notably, in a move to accelerate the rate of exploration of geothermal energy, KenGen has invested in 3 drilling rigs and 3 other contracted rigs which it uses to explore the availability of steam. The cost used by the company is refunded by the government as this is not the function of the company.

Regulation

The energy and petroleum sector in Kenya is regulated by The Energy Regulatory Commission (ERC).

ERC mandated with regulating the energy sector

The ERC was established upon the enactment of the Electric Power Act, No 11 of 1997. The commission was mandated with the task of regulating the sector while the Ministry of Energy was made responsible for sector policy.

The ERC through its regulation has created an enabling environment for energy businesses to thrive in the region.

Some of the key functions of ERC when it comes to the power sector include:

- Review of and advise on government policy on the electricity sub-sector.
- Licensing of the generation, transmission, distribution and supply of electricity.
- Reviewing of power purchase agreements and network service contracts.
- Generation and transmission expansion planning.
- Regulating the use of electrical energy including metering and meter certification.
- Licensing of electricians and registration of electrical contracts.

The list of licensed electric power producers, according to ERC, that sells their output to KPLC

Name of Licensee	Technology	Location of Power Plant	Capacity (MW)
KenGen	Hydro	Masinga, Kamburu, Kindaruma, Gitaru, Kiambere	563
	Hydro	Tana, Wanjii, Sagana, Ndula and Mesco	22
	Hydro	Turkwel	106
	Hydro	Sondu Miriu	60
	Hydro	Gogo	2
	Hydro	Sosiani	0.40
	Geothermal	Olkaria I	45
	Geothermal	Olkaria II	105
	Thermal	Kipevu, Mombasa	120
	Wind	Ngong	5
Tsavo Power Company	Thermal	Kipevu, Mombasa	74
Iberafrica (EA) Ltd	Thermal	Nairobi	103
OrPower 4 Inc	Geothermal	Olkaria III	48
Mumias Sugar Company	Cogeneration	Mumias	38 (26)
Rabai Power Ltd	Thermal	Rabai, Mombasa	90
Total			1275.40(1263.40)

Source: Energy Regulatory Commission

High Tariff Costs

According to the research conducted by the IMF, the average cost of electricity in Sub Saharan Africa between 2008 - 2010 was about USD 0.17 per Kilowatt hour. Notably, countries that relied primarily on thermal generation was

Countries that relied primarily on thermal generation paid a higher cost of electricity

even higher at USD 0.21 per kilowatt hour. This is almost double compared to most parts of the developing world where power tariff costs fall in the range of USD 0.04 to USD 0.08 per kilowatt hour.

High cost of power attributed to inefficiencies in power companies

The high cost of power has been attributed to inefficiencies in power companies, high use of costly emergency power generation, low economies of scale in generation and limited regional integration.

In Kenya we attribute the high cost of power to

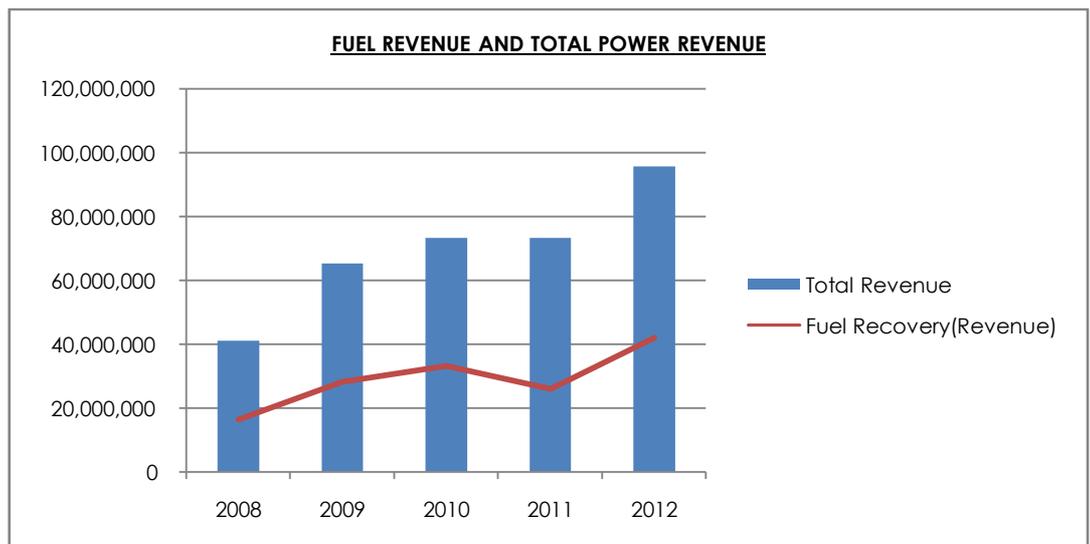
- 1) **Relatively high system losses:** This comes about when Kenya Power, the distributor of electricity to the consumer, sells less than it purchased. This is discussed in greater detail in the Kenya Power section.
- 2) **Fluctuating hydrology:** This is brought about by the fluctuating level of hydrology resulting in the use of thermal generators, which run on diesel, to substitute and provide for the difference. This fuel cost is passed through to the consumer which results in the high tariff cost in the country.

Unreliability

In addition to the high cost, power in Sub Saharan Africa is unreliable.

Kenya has relied heavily on hydroelectric generated power

In Kenya, during the past five years the country has relied heavily on hydroelectric generated power (Approximately 50%) which has seen the revenues collected by the Kenya Power Company fluctuate as shown by the graph below.



Source: Kenya Power annual report

When the fuel component declined or slowed in growth, so has the total revenues of the Kenya Power who acts as the collector for the industry.

Generation companies substitute and boost generation capacity using thermal power plants

This has led to generation companies substituting and boosting generation capacity by generating using thermal power plants, which run on diesel. Currently, thermal generation accounts for 35% of the total electricity generated in the country.

Untapped Generation Potential

Regional power potential is still relatively untapped

Given the environmental landscape of most of the countries in Sub Saharan Africa, the regional power potential is still relatively untapped when compared to other developing countries.

According to KenGen, Kenya has significant natural power potential in the form of; geothermal (approximately 7,000 MW), Hydro (approximately 1,500MW) and Wind (approximately 4,400MW).

a) Hydroelectric Power Generation

Sub Saharan Africa has massive untapped hydroelectric generation potential.

Congo regarded as the country with the highest power potential in Africa

The Democratic Republic of Congo is regarded as the country with the highest hydro power potential in Africa, 100,000 MW according to the government. Plans are underway to rehabilitate the two Inga dams located in Western DRC, Inga I and Inga II (1,775 MW) including two massive new hydroelectric stations, Inga III (4,500 MW) and Grand Inga (39,000 MW).

This grand plan envisions the interconnection of the electric grids of the DRC, Namibia, Angola, Botswana and South Africa at an estimated cost of USD 80 billion.

Ethiopia is in the process of building the Grand Millenium Dam

In East Africa, Ethiopia has a plan to build a dam on the blue Nile, the Grand Ethiopian Renaissance dam, formally known as the Grand Millenium Dam. When completed in 2015, the dam will be the largest hydroelectric power plant in Africa with the ability to supply more than 5,000MW of electricity. Four additional dams would also be built on the blue Nile in conjunction with the Grand Ethiopian Renaissance Dam to generate more than 15,000MW of electricity.

The estimated cost for this project is USD 4.7 billion which will be funded by the Government of Ethiopia. According to the government 14% of the project were completed in the previous year and 26% will be completed by the end of 2013.

Kenya has signed agreement to import power from Ethiopia

Kenya has signed an agreement to import 400MW of power from Ethiopia beginning 2016 in order to tap into the Gibe III hydro power project. Meanwhile, both countries are negotiating for a USD 1.2 billion loan with the World Bank, The African Development Bank and French Agency Development. The construction of this 1,050 KM high voltage line is expected to be completed by 2016.

b) Geothermal Power Generation

Great Rift Valley offers massive geothermal potential

The Great Rift Valley offers tremendous geothermal potential (about 7,000MW) which Kenya is aggressively exploiting. This is more than 4 times the current installed generation capacity of the country.

Geothermal electricity is renewable and reliable. It has a high initial cost in the drilling and fixing of the well heads but thereafter is much cheaper to generate than hydro and thermal, as shown in the table below.

Set up capital cost of geothermal plant at KES 273 billion

In terms of absolute set up capital cost, importation of power has the least capital requirement at KES 126 billion compared to geothermal at KES 273 billion. The average thermal station has a capital cost of KES 168 billion.

The table below shows estimates of the cost of power by generation source per kilowatt hour

Generation Type	Amount in US Cents
Solar	30 – 50
Hydro	12.50
Wind	12.50
MSD (Medium Speed Diesel)	10.20
Coal	9.30
Nuclear	8.60
Natural Gas	8.40
Geothermal	6.40

Source: KenGen

As the table above shows, geothermal generation has the lowest cost of power compared to other sources of generation.

c) Wind Power generation

The United Nations Environment Programme (UNEP) estimates wind power generation in Kenya could reach 3,000 Megawatts (MW).

The most promising project in Kenya is The Lake Turkana Wind Power Project (LTWP) which aims to provide 300MW of reliable power at a cost of KES 70 billion. Financing of USD149.5 million has already been provided by The African Development Bank.

Other wind power projects approved by the Ministry of Energy include a 300MW project in Marsabit in the Upper Eastern Province, 350MW from various sites in the Lamu Coast province and a 60MW facility in Kinangop north of Nairobi.

d) Thermal Diesel Power Generation

As discussed earlier, the thermal generation plants run on diesel which is a pass through cost and one of the reasons for the high tariff cost.

However, as much as the country has long term plans and initiatives to move to more renewable sources of energy, the rising demand has pushed the industry to provide short to medium term solutions, in the form of thermal generators.

Five more thermal generation plants with a total estimated capacity of 340 MW are expected to come into the grid by FY2014. They include:

- ✓ Thika MSD Plant (Melec) with an estimated capacity of 87MW
- ✓ Muhoroni MSD (KenGen) with a capacity of 80MW
- ✓ Athi River MSD Plant (Triumph) with an estimated generation capacity of 83MW
- ✓ Athi River MSD Plant (Gulf) with an estimated generation capacity of 80MW
- ✓ Garissa MSD with an estimated generation capacity of 10MW

Lake Turkana Wind Project aims to provide 300MW

Rising demand has pushed the industry to use short-term ad hoc solutions

Five more thermal generation plants expected to come into the grid by FY2014

Sector Growth Drivers

GDP Per Capita Growth

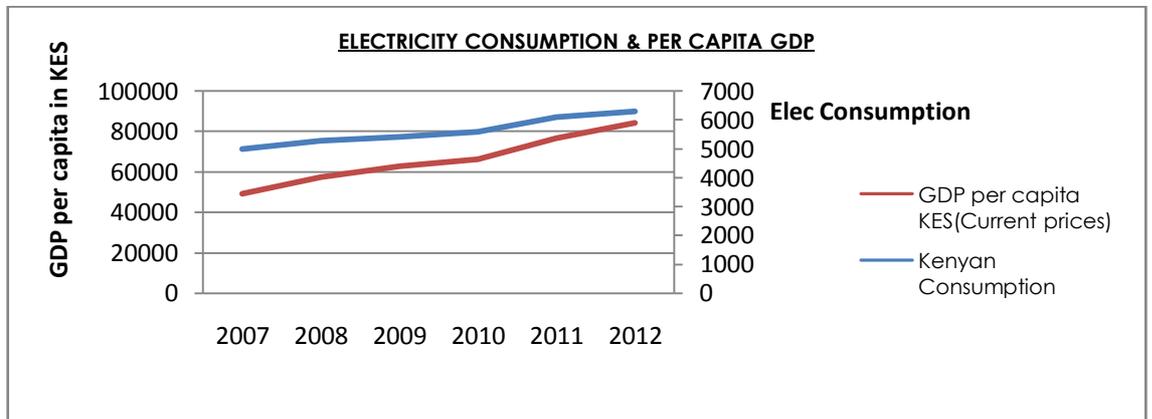
Sub Saharan Africa per capita consumption of electricity averaging 40 kWh

According to the mentioned IMF report, per capita consumption of electricity is extremely low in Sub Saharan Africa, averaging 40 kWh a month. This comes down to 10 kWh if South Africa is excluded. This is in contrast to about 100 kWh in other developing countries and 1,000 kWh in high-income countries.

This shows much room for growth of consumption in the region.

In Kenya, as the graph below shows, electricity consumption has a direct correlation with GDP per capita. As the GDP per capita for the country grows, so does the spending power for the country hence a rise in electricity consumption.

Graph showing GDP per capita vs consumption/DD



Source: World Bank, Kenya Power

Going forward, the world bank projects the country's GDP to grow by 5.0% in FY2013.

Decentralisation

Local government offices being set up at county level will increase demand for electricity

The upcoming counties will facilitate expansion of electricity into areas that did not have access to power before. We attribute this to the local government offices being set up at the county level.

This will see the county government prioritise relevant development in the county. This is likely to increase penetration of electricity, especially in counties with limited to no access to electricity.

REA undertook 1,336 projects during FY2012

We see this being provided by the Rural Electrification Authority (REA). During FY2012, REA undertook 1,336 projects at a cost of KES 3.5 billion.

These projects benefited 734 market centres, 569 public schools, 177 health centres, 44 governments/ administrative centres, 31 coffee factories, 75 tea buying centres and 127 water projects among others.

In addition, government spending in the counties will also increase, hence boosting local industries in the area. This is likely to facilitate an increase in electricity demand.

Industrialization and Expansion of large and industrial power consumers

As industrialization increases, so does the demand for electricity. This is due to the fact that energy consumption for commercial and industrial use accounts for more than 50.0% of the total consumption in the country.

A table showing Kenya Power Sales distribution by customer category

TYPES OF CUSTOMERS COVERED BY THIS TARIFF	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
Domestic	23.3%	24.9%	24.3%	24.3%	24.6%	25.4%
Small Commercial	11.7%	11.7%	16.0%	15.5%	15.6%	16.6%
Commercial and Industrial	63.7%	61.6%	58.6%	59.3%	58.8%	57.1%
Off – peak	1.0%	1.5%	0.8%	0.7%	0.7%	0.7%
Street lighting	0.2%	0.3%	0.3%	0.3%	0.3%	0.3%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Kenya Power

Commercial and industrial customers account for almost 60.0% of the total electricity sold

As the table above shows, commercial and industrial customers of power in Kenya have accounted for almost 60.0% of the total electricity sold in Kenya, since FY2006. Although the sales to the large and medium commercial consumers declined to 3.41 billion kWh (57.1%) in 2012, they still accounted for the largest share of the total demand.

Some of the commercial and industrial consumers that provide this demand include; cement manufacturers, hotels and restaurants, and other industrial manufacturing companies.

Energy costs account for about 40.0% of the total expenses of cement companies.

The continued investment in infrastructure in the region coupled with the economic growth that comes with it, is constantly increasing the need for cement. New cement companies are therefore, coming up as existing ones increase capacity.

New cement market entrants likely to increase demand for electricity

Some new cement market entrants in the country are likely to increase demand for electricity. Mombasa Cement commenced the construction of a new grinding plant in Athi River designed to double its production capacity this year (2013). The plant will take the company's production to 1.5 million tonnes per annum (this will likely make them secure a third of the local market share).

Devki, a local steel manufacturing company, announced plans to build a new plant worth USD 447.2 million in Taita. This would increase capacity from 250,000 to 1 million tones of steel. This is expected to meet the steel demands of the whole of East Africa. The company also received the go ahead to set up a KES 14.0 billion plant in Kitui to mine and process iron ore deposits.

It is estimated that energy costs account for approximately 30.0% of the total expenses of an average steel mill.

In the hospitality sector, some new hotels that have been set up or are planned to be set up include;

- ✓ Kempinski (200 rooms)
- ✓ Emaar, Radisson Blu (244 rooms),
- ✓ Marriot, Park inn Hilton
- ✓ Lansmore hotel by Lonrho(200 rooms),
- ✓ Best Western
- ✓ Hemingways,
- ✓ Virgin Limited Edition Collection
- ✓ Leisure Park Hotel(128 rooms)
- ✓ Rezidor.

As the expansion of industries in the manufacturing and hospitality sectors in the country continue to expand so will the demand for electricity.

Key infrastructure projects

As urbanization intensifies and the middle income segment of the economy expands, the household demand for energy increases in tandem. The major players in the energy sector are embarking on preparations to be able to meet this growth in demand which is being fuelled by the road to attaining vision 2030.

The Vision 2030 framework aspires to pursue a macroeconomic framework anchored on the availability of adequate, reliable and affordable energy.

Kenya Power estimates that key Vision 2030 flagship projects have an estimated demand of 876 MW which makes the availability of adequate and reliable power supply critical for its success.

Therefore, as these key vision 2030 projects come to completion the demand for electricity will continue to grow in line with the figures shown above.

Summary of industry analysis

In summary, we view the energy sector in Kenya having much room for growth in terms of both the demand side and the supply side.

Kenya's installed effective generation capacity has grown at a CAGR of 7.2% from 1,153MW in FY2007 to 1,637MW in 2012.

We estimate this effective capacity in the country to increase by 1,236MW in the next four years to about 2,872MW by FY2016 largely driven by the new projects to be commissioned by KenGen and other independent power producers.

We are likely to see KenGen bring in at least 668MW to the national grid by FY2016 through Olkaria 1 and II extension (280MW), Kindaruma upgrade (8 MW), Mombasa coal power plant (300MW) and Muhoroni MSD (80MW). This is explained further in the KenGen report, in the next section.

We expect to see other IPP's increase capacity from 347MW in FY2012 to 970.5MW in FY2016. The capacity for IPP's has grown at a CAGR of 19.4% from 143MW in FY2006 to 347MW in FY2012. This growth is going to be driven by the new thermal stations mentioned earlier, i.e. Melec, Triumph and Gulf Energy, including LTWP's wind power plant bringing in 300MW to the grid.

Vision 2030 flagship projects have an estimated demand of 876 MW

Installed generation capacity has grown at a CAGR of 7.2%

KenGen likely to bring in at least 668MW to the national grid by FY2016

According to Kenya Power's projections, the future composition of electricity generation is as shown in the table below.

A table showing the expected generation mix in the country according to Kenya Power

Year	Hydro	Medium speed diesel	Import	Cogeneration	Gas turbine - Kerosene	Gas turbine/natural gas	Geothermal	Coal	Wind
2011	50.6%	30.1%		1.7%	4.0%		13.2%		0.3%
2015	26.5%	22.3%	6.3%	0.8%			26.6%	0.6%	16.9%
2020	16.1%	15.0%	15.5%			5.6%	26.8%	9.6%	11.4%

Source: Kenya Power Annual Report

On the other hand, as shown in the key sectoral growth drivers, we expect to see a rise in the demand for power driven by; GDP per capita growth, key infrastructure projects and increased industrialization and expansion of the existing industries.

KENYA ELECTRICITY GENERATION COMPANY (KENGEN)

Year to June 30th	2011A	2012A	2013F	2014F
Net Profit (KES '000)	2,080,165	2,822,642	3,356,838	3,988,494
Earnings Per share	0.95	1.28	1.53	1.81
Book Value Per Share	31.58	31.92	33.61	38.17
P/E	16.96	12.50	10.51	8.85
P/B	0.51	0.50	0.48	0.42
ROE	2.97%	4.04%	4.54%	4.75%
ROA	1.29%	1.73%	1.94%	1.77%

A graph showing the movement of KenGen share price against the NSE 20 index



Source: Bloomberg

Investment Summary

We initiate coverage on Kenya Electricity Generating Company (KenGen) with a BUY recommendation. Based on our EV/EBITDA valuation we arrive at a price target of KES 21.70 which represents an 35.2% upside from the current share price of KES 16.05 (17.06.2013).

Our investment considerations for this company were:

- **Increased generation capacity:** KenGen has a vision of making available 2,405MW by 2018 through its Horizon I and Horizon II projects which is likely to see the company record increased revenues given the high energy sales.
- **Industrial and commercial growth:** As Kenya's economy continues to expand, so does the rate of industrialization and demand for power. If the country is to achieve vision 2030 the installed capacity for the country needs to increase to 17,754 MW by the year 2030. KenGen is at the forefront to produce a majority of this power.
- **Leveraging on the government:** The company is also able to get cheap financing from the Government of Kenya and also form partnerships with other government parastatals in the energy sector such as Geothermal Development Corporation (GDC) and Kenya Power in order to fast track electricity generation projects.
- **Low ROE and ROA:** We note that KenGen has low return ratios, Return on Average Equity (ROaE) and Return on average Assets (ROaA).

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I herein is obtained from sources, which to the best of our knowledge are deemed reliable. As such, we are not responsible for errors arising thereof. Any opinions expressed herein are ours and are bound to change anytime at no

We place a BUY recommendation on KenGen

History

The history of Kenya Electricity Generating Company (KenGen) goes all the way back to 1954, when The Kenya Power Company (KPC) was registered and commissioned to construct transmission lines as well as develop geothermal and other generation facilities in the country.

KPC then sold the electricity in bulk and at cost to Kenya Power and Lighting Company (KPLC) which managed the company, under a management contract.

In January 1997, KPC was formally separated from KPLC and tasked with the sole responsibility and function of power generation while KPLC became responsible for transmission and distribution.

On October 2nd 1998, KPC was rebranded under a new name and corporate identity, The Kenya Electricity Generating Company Ltd, (KenGen).

On 17th May 2006, KenGen shares listed on the Nairobi Securities Exchange through an initial public offer. This was after the Government of Kenya offered 30.0% of its shareholding for sale to the public.

KenGen is currently the largest power producer in the country whose core function entails developing, managing and operating power generation plants in the country. It then sells this power to Kenya Power which then distributes and sells to consumers.

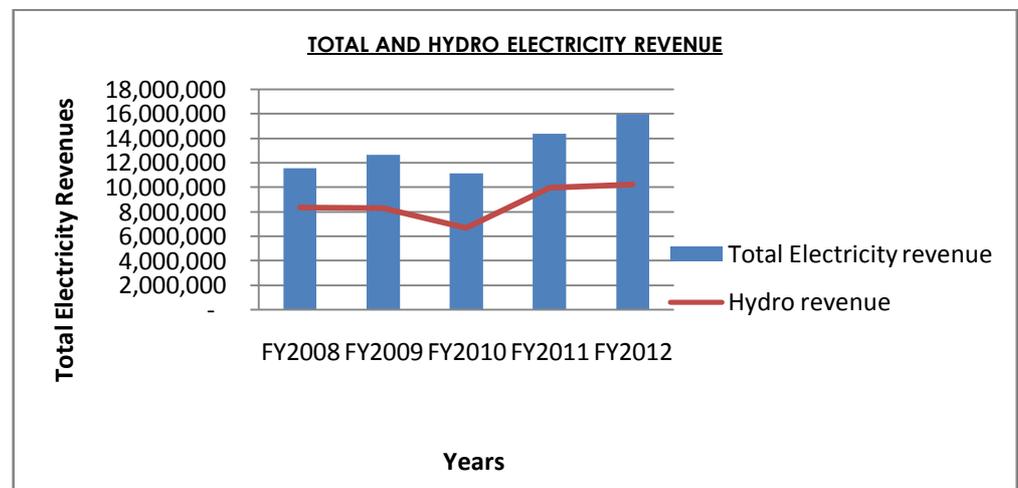
Key Theme

The Evolution of KenGen

Over the past five years, we have observed that KenGen's top and bottom line have been highly volatile.

Although, KenGen has largely relied on various sources to generate electricity i.e. hydro, geothermal, thermal and wind; hydro has been the leading source and accounted for up to 66.0%, as at 2012, of the total power generated.

This hydroelectric power has been erratic due to its dependence on hydrology resulting in the company switching to thermal stations and emergency power generators. The company has plans to reduce this reliance on hydroelectric and thermal power.



Source: KenGen and Kenya Power annual reports

In 1998, KPC was rebranded under a new name, KenGen

KenGen shares listed in the NSE through an IPO in May 2006

Hydro has been the leading source of electricity generation

Company plans to reduce reliance on hydroelectric and thermal power

As the graph above shows, the total revenue for the generation company has fluctuated with the level of hydrology.

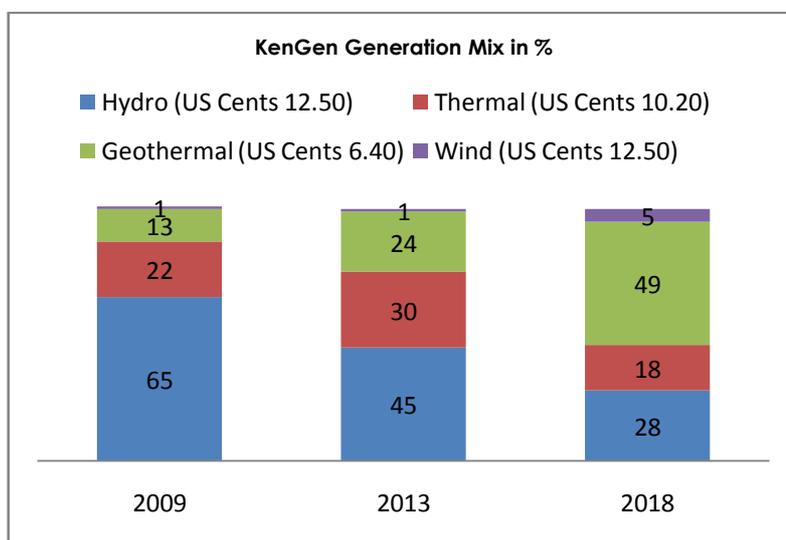
Going forward, we see less volatility in the company's earnings due to its plan to reduce reliance on hydrology by increasing generation of electricity from other sources such as geothermal.

According to a study conducted by KenGen and McKinsey & Company, although the construction of geothermal power stations is capital intensive, it is the cheapest and most sustainable option for Kenya.

KenGen has a plan to tap approximately 800MW from the Olkaria fields and 460MW from other geothermal fields by 2018. These sites include: 140MW Olkaria 2013, 140MW Olkaria 2014, 140MW by 2015, 140MW by 2016 and 280MW by 2018.

The company projects to commission the first 140MW of the Olkaria by June 2014 and the next 140MW by the end of 2014.

By 2018, KenGen projects to have a generation mix that is as follows with a geothermal base load and accounting for almost 50.0% of the total installed portfolio:



Source: KenGen

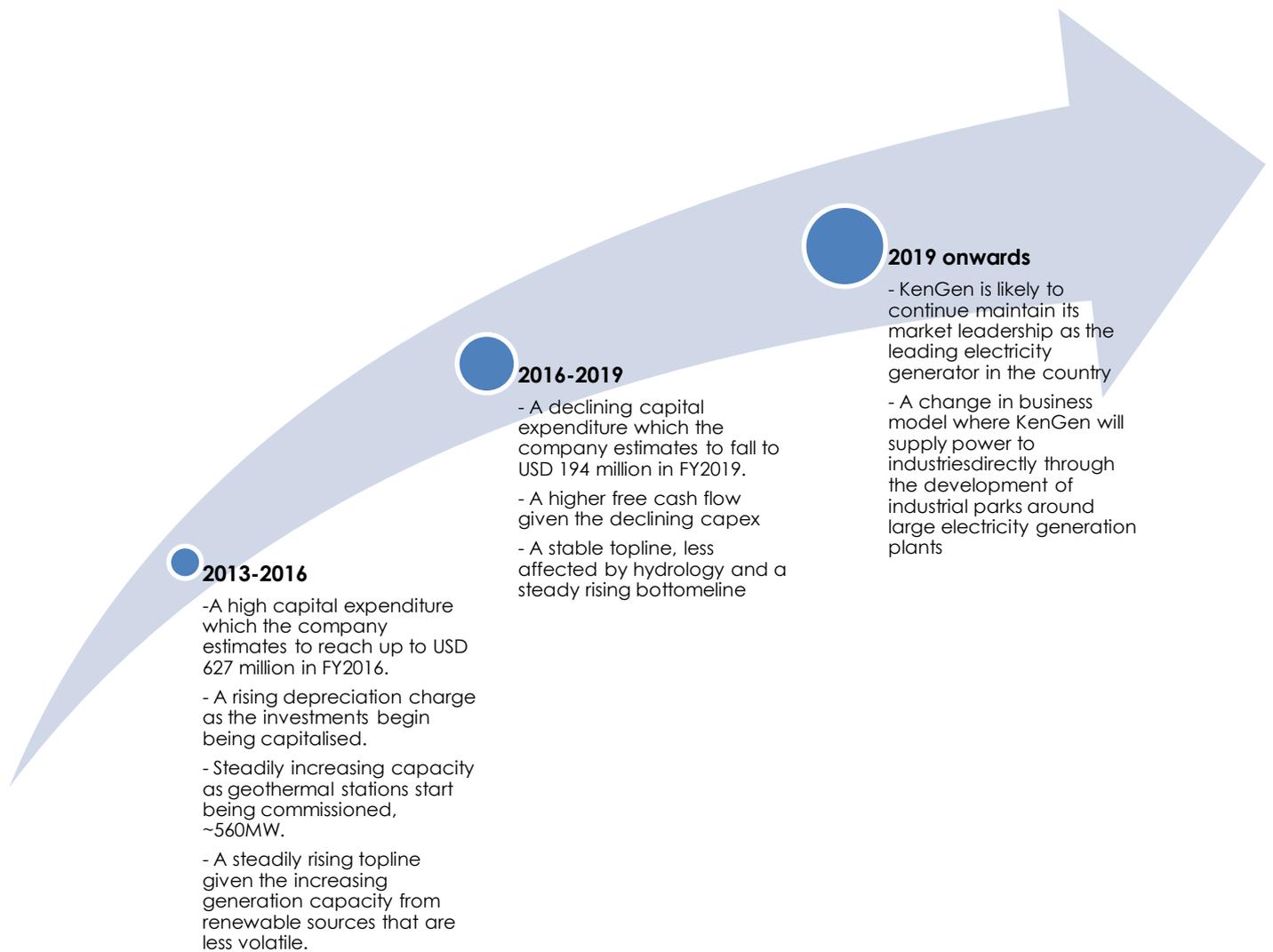
KenGen estimates that if the component of geothermal generation in production of electricity increases to become the largest contributor, the cost of electricity in the country could come down by about 50.0%, if one accounts for affordability and reliability in times of erratic weather pattern.

Geothermal power is the cheapest and most sustainable option for Kenya

KenGen plans to tap 800MW from the Olkaria fields and 460MW from other geothermal fields by 2018

KenGen estimates that the cost of electricity could come down by about 50.0%

The evolution story:



Growth drivers

Increased generation capacity

KenGen has a vision of making available 2,405MW by 2018 through its Horizon I and Horizon II projects which are likely to see the company record increased revenues given the high energy sales.

In 2007 KenGen began this transformation agenda, where it planned to add 699.8MW by the year 2012. This is in line with the company's plan to diversify generation of power to more renewable sources.

**Vision of making available
2,405MW by 2018**

The table below shows how this has progressed:

HORIZON 1 COMPLETED (2008-2012) MW	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013 & FY2014 (Expected)
Sondu Miriu Hydro	60					
Optimization of Kiambere Hydro		24				
Ngong Wind – Phase 1		5.1				
Olkaria li 3 rd unit			35			
Redevelopment of Tana				20		
Kipevu III				120		
Eburru					2.5	
Sang'oro					21	
Ngong wind I Phase II						6.8
Ngong Wind II						13.6
Olkaria I (Unit 4&5) & Olkaria IV						280
Kindaruma 3 rd Unit					24	
Kindaruma Upgrade of Unit 1&2						8
Muhoroni MSD						80
Wellhead Generators(Pilot)					5	
Cummulative total	60	89.1	124.1	264.1	316.6	684.6

Source: KenGen annual report

As the table above shows, a total of 10 Horizon I projects were completed successfully by FY2012 out of 15 projects in total, producing a total of 316.6 MW, a 45.2% success rate by the date of targeted completion.

We estimate that the remaining 383.2 MW is likely to be commissioned over the next 3 years and will see the top line of the company increase by about KES 11.2 billion over the period. We have assumed that in 2014, 140MW from the Olkaria 1 extension while 140MW Olkaria IV and the remaining extension of 140 MW of Olkaria 1 would be brought in during FY2015.

We note that apart from the heavy capital requirement, geothermal plants also take a long time to build, where the conventional plant could take 4 years to complete from initial drilling. In order to fast track geothermal generation KenGen has initiated portable geothermal power plants/ wellheads which can take up to six months to construct.

KenGen has initiated portable geothermal power plants

Using this innovative technology, KenGen Commissioned a pilot wellhead of 5MW in FY2012. Going forward, KenGen expects to deploy an additional 65MW of this technology by 2014.

In the Horizon II project, for the period between 2012 to 2018, the company has a plan to inject 1705.4 MW into the national grid, as shown in the table below.

A conservative total of 770MW is likely to be brought in by the year 2018

Assuming a similar success rate in Horizon II as in Horizon I, a conservative total of 770MW is likely to be brought in by the year 2018. This increase of capacity is likely to yield sales of approximately KES10.4 billion, 64.8% of the total revenues as at FY2012.

A Table showing the key horizon II projects

HORIZON 2 (2013-2018)	Capacity(MW)
Geothermal Development	650
Hydro	90
Thermal(Coal & LNG)	795
Wind	170.4
	1705.4

Source: KenGen annual report

Industrial and commercial growth

As Kenya's economy continues to expand, so does the rate of industrialization and demand for power.

If the country is to achieve Vision 2030 goals, the installed capacity for the country needs to increase to 17,754 MW by the year 2030. KenGen is at the forefront to produce most of this power, as we expect KenGen to maintain its market leadership.

As shown earlier in the industry overview, commercial and industrial customers accounted for 58.8% of the total power consumed in the country in FY2012. This was approximately KES 25.7 billion in FY2012, which goes up to KES 33.1 billion (73.6% of total electricity sales) when the small commercial purchasers of power are included.

As new industry's continue setting up in the country and existing ones continue expanding, the business case for KenGen to expand capacity continues to be made.

Furthermore, as industrialization continues to intensify, industrial parks are likely to begin forming especially close to the generation source. These industries will be able to purchase power directly from the generation company. This is in line with KenGen's medium to long term business model.

Industries will be able to purchase power directly from KenGen

Leveraging on the Government

The Government of Kenya is currently the single largest shareholder of KenGen, at 70.0% shareholding as at FY2012, as the table below shows.

	Number of Shares	%
Permanent Secretary – Treasury	1,538,853,019	70.00%
Board of Trustees, National Social Security Fund	11,593,029	0.53%
National Social Security Fund, Board of Trustees	10,899,800	0.50%
Standard Chartered Nominees Limited A/C 9230	10,175,300	0.46%
Standard Chartered Nominees Limited A/C 9098AC	8,194,631	0.37%
CFC Stanbic Nominees Ltd A/C R10602	6,185,131	0.28%
Standard Chartered Nominees Limited A/C 1853	5,046,204	0.23%
CFC Stanbic Nominees LTD A/C NR 1030682	4,725,700	0.21%
Jubilee Insurance Company of Kenya Limited	4,571,600	0.21%
Standard Chartered Nominees Limited A/C 9098AP	4,379,731	0.20%
Total	1,604,624,145	72.99%
202,701 other shareholders	593,737,311	27.01%

Government acts as guarantor of loans

This has enabled the company to leverage on the government in order to get cheap financing from global lenders where the government guarantees the loan.

KENGEN						
Government of Kenya Guaranteed Loans	Maturity year	2008 Shs'000	2009 Shs'000	2010 Shs'000	2011 Shs'000	2012 Shs'000
2.6% Japan Bank for International Cooperation KE P20 2005/2025 (JPY 5,529,108,000)	2025	4,416,470	5,535,494	5,899,122	6,642,285	5,868,894
2.3% Japan Bank for International Cooperation KE P21 2007/2027 (JPY 5,072,910,000)	2027	3,924,950	4,947,161	5,316,175	6,036,200	5,384,661
0.75% Japan Bank for International Cooperation KE P23 2014/2044 (JPY 10,554,000,000)	2044	6,102,786	8,509,772	9,758,914	11,773,209	11,202,585
0.75% Japan International Cooperation Agency KE P24 (approved JPY 5,620,000,000), (Disbursed JPY 4,033,432,047)	2047	56,829	891,999	1,626,282	3,238,222	4,281,303
0.20% Japan International Cooperation Agency KE P26 (approved JPY 29,516,000,000), (Disbursed JPY 1,730,129,822)	2040	-	-	-	-	1,836,453
2.5% Kreditanstalt Fur Wiederaufbau-Kindaruma (approved EUR 39,100,000), (Disbursed Euro 19,642,349)	2024	-	-	-	-	2,081,305
Total						30,655,201

Source: KenGen annual report

KenGen able to form strategic partnerships with other government parastat

The table above shows the loans that the company has acquired where the Government of Kenya acted as a guarantor. This represents 44.9% of total borrowings as at June 2012.

Over the past 8 years we have calculated the average cost of the total borrowings for the company to be at 3.7% per annum.

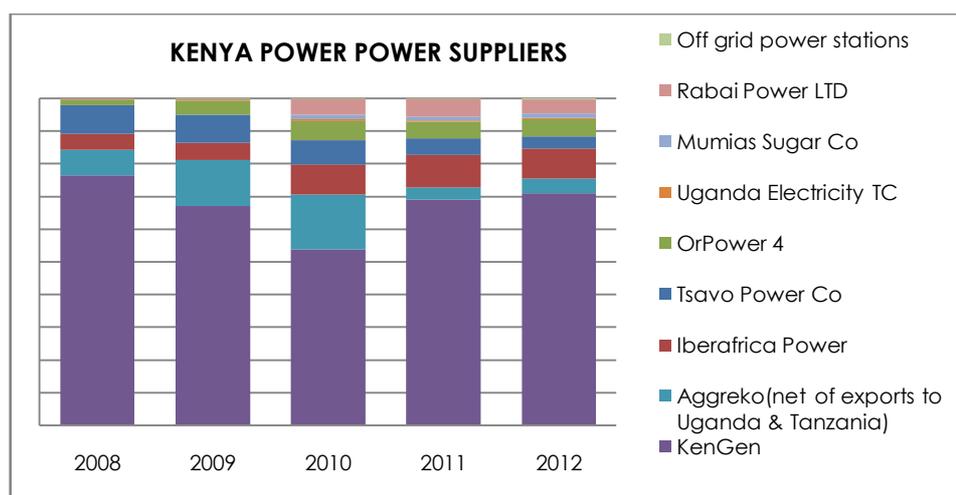
Furthermore, the company is also able to get cheap financing from the Government of Kenya and also form partnerships with other government parastatals in the energy sector such as Geothermal Development Corporation (GDC) and Kenya Power in order to fast track electricity generation projects.

An example of such a partnership is in Olkaria & Menengai where KenGen is drilling in search for steam on behalf of GDC so as to develop geothermal stations.

Largest power supplier to Kenya power

KenGen is currently the largest power producer in the country accounting for about 70.9% of the total installed capacity of the country, as at FY2012.

A Graph showing electricity producers over the past five years



Source: Kenya Power annual report

This has enabled the company leverage on economies of scale in running of their power plants. One of the benefits can be in terms of engineers and other staff, which the company employs on a permanent basis and whose functions can be spread across their plants where possible.

KenGen enjoys benefits of scale in running of power plants

Financial Analysis

KenGen Income Statement KES '000	Jun-07	Jun-08	Jun-09	Jun-10	Jun-11	Jun-12	5 Year CAGR
REVENUE							
Electricity revenue	10,852,766	11,371,532	11,518,156	9,818,889	13,428,674	14,773,521	6.4%
Energy related revenue	288,453	176,644	1,134,232	1,179,540	960,353	1,225,557	33.6%
Total revenue	11,141,219	11,548,176	12,652,388	10,998,429	14,389,027	15,999,078	7.5%
Operating Expenses	8,011,461	8,011,602	8,246,999	8,558,419	10,013,463	10,265,980	5.1%
Gross Profit	3,129,758	3,536,574	4,405,389	2,440,010	4,375,564	5,733,098	12.9%
Gross Profit Margin	28.1%	30.6%	34.8%	22.2%	30.4%	35.8%	
Interest and other Income	710,838	331,501	731,142	786,463	1,272,738	1,284,442	12.6%
Operating Profit	3,853,009	3,868,075	5,136,531	3,226,473	5,648,302	7,017,540	12.7%
Financing costs - Net	(866,268)	789,310	580,250	741,491	1,996,951	2,972,308	
Profit before tax	4,719,277	3,078,765	4,556,281	2,484,982	3,651,351	4,045,232	-3.0%
Taxation	(2,273,613)	2,818,114	(2,485,368)	801,534	(1,571,186)	(1,222,590)	-11.7%
Profit after Tax	2,445,664	5,896,879	2,070,913	3,286,516	2,080,165	2,822,642	2.9%

KenGen Balance Sheet KES '000	Jun-07	Jun-08	Jun-09	Jun-10	Jun-11	Jun-12	5 Year CAGR
ASSETS							
Property plant & equipment	87,357,082	91,822,390	92,699,405	102,230,784	116,786,429	120,664,699	6.7%
other non current assets	4,785,534	4,516,023	7,376,074	15,486,688	24,667,827	20,192,108	33.4%
Current Assets	9,824,245	10,655,138	12,869,681	32,849,414	19,539,034	22,288,066	17.8%
TOTAL ASSETS	101,966,861	106,993,551	112,945,160	150,566,886	160,993,290	163,144,873	9.9%
EQUITY AND LIABILITIES							
Total Equity	63,638,189	68,125,174	66,980,112	70,530,868	69,418,587	70,179,554	2.0%
Borrowings	16,040,695	19,466,078	25,793,197	59,636,829	64,166,527	61,850,220	31.0%
Other non current liabilities	15,053,788	11,477,355	14,304,108	13,429,374	16,151,583	16,114,142	1.4%
Current liabilities	7,234,189	7,924,944	5,867,743	6,969,815	11,256,593	15,000,957	15.7%
TOTAL EQUITY AND LIABILITIES	101,966,861	106,993,551	112,945,160	150,566,886	160,993,290	163,144,873	9.9%

Source: KenGen annual report

Volatility of revenue attributed to over-reliance on hydroelectric energy

Over the last 5 financial years KenGen's revenues have fluctuated but otherwise grown at a compounded annual growth rate (CAGR) of 6.4% to KES 14.7 billion in FY2012 from KES 10.9 billion recorded in FY2007. The fluctuating revenue has been brought about by the over-reliance of the company on hydroelectric energy which is affected by hydrology.

Rising revenue due to higher rise in other energy related revenues

Total revenue during the same period has risen at a slightly higher CAGR of 7.5% to KES 16.0 billion in FY2012 from KES 11.1 billion in FY2007. This was due to the higher rise in other energy related revenues which includes the charge on Emergency Power Producers, energy charge to Kenya Power and the foreign exchange adjustment.

Operating expenses have risen steadily at a CAGR of 6.1% to KES 10.3 billion in FY2012 compared to KES 7.6 billion recorded in FY2007. The gross margin for the company has improved from 32.3% in FY2007 to 38.8% in FY2012.

Greater efficiency has also seen the firm record a higher operating profit margin of 43.9% in FY2012 compared to 37.8% in FY2007.

Going forward, we are confident of the firm increasing value to its shareholders driven by improving efficiency of the firm coupled with the expected growth of its revenues due to increasing generation capacity.

Investment Consideration

Low ROE and ROA

We note that KenGen has low return ratios, Return on Average Equity (ROaE) and Return on average Assets (ROaA), as shown in the table below.

	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
Return on Average Equity	10.8%	4.9%	9.0%	3.1%	4.8%	3.0%	4.0%
Return on Average Assets	2.6%	1.5%	2.8%	0.9%	1.2%	0.7%	0.9%

KES 25.1 billion revaluation surplus recorded in FY2007

ROaE for the firm dropped from 10.8% in FY2006 to 4.0% in FY2012 while the ROaA dropped to 0.9% from 2.1% during the same period. This was due to a KES 25.1 billion revaluation surplus recorded by the company in FY2007 when it commissioned a revaluation of plant and machinery.

The table below shows a deeper analysis, using Dupont analysis, of the above metrics.

Dupont analysis	2006	2007	2008	2009	2010	2011	2012
Net Income/ EBT(PBT)	101.3%	51.8%	191.5%	45.5%	132.3%	57.0%	69.8%
EBT(PBT)/EBIT	98.5%	122.5%	79.6%	88.7%	77.0%	64.6%	57.6%
EBIT/ Sales	26.4%	26.5%	33.5%	40.6%	29.3%	39.3%	43.9%
Sales/Av. Assets	10.0%	8.7%	5.5%	5.8%	4.2%	4.6%	4.9%
ROaA	2.6%	1.5%	2.8%	0.9%	1.2%	0.7%	0.9%
A.Assets/Av.Equity	408.1%	333.1%	317.2%	325.6%	383.3%	445.2%	464.4%
ROaE	10.8%	4.9%	9.0%	3.1%	4.8%	3.0%	4.0%

As the table above shows, the tax burden (Net Income/EBT) on the firm has fluctuated over the seven year period, FY2006 and FY2012, between 191.5% and 69.8% depending on the deferred tax recorded by the firm.

The interest burden (EBT/EBIT) on the company's earnings has increased steadily from 122.5% in FY2007 to 57.6% in FY2012. This can be explained by increased

Interest burden has increased steadily

borrowings by the firm when they revalued the plant and property allowing them to leverage on the balance sheet without significantly changing the leverage ratio (average assets/average equity).

This saw the firm raise KES 25.0 billion by issuing a 10 year public infrastructure bond in 2009 at a fixed rate of 12.5%.

As a result of the revaluation of plant and property, the asset turnover (sales/average assets) of the company also declined significantly from 10.0% in FY2006 to 4.9% in FY2012.

The operating margin (EBIT/Sales) for the firm has grown to 43.9% in FY2012 from 26.4% in FY2006.

Going forward, for the company to improve these return ratios the sales and earnings of the firm need to grow significantly to compensate for the increase in asset and equity value during the revaluation. We are likely to see steady growth as revenues for the company grow and remain steady and the other plants and property continue depreciating. We forecast the ROaE of the firm to go to 4.5% in FY2013 and to 8.1% in FY2015 given the growth in earnings driven by the new capacity additions.

We are likely to see steady growth as revenues grow and plants and property continue depreciating

Forecasts

KenGen Income Statement KES '000	Jun-11	Jun-12	Jun-13	Jun-14
REVENUE				
Total revenue	14,389,027	15,999,078	16,688,351	18,574,497
Operating Expenses	10,013,463	10,265,980	10,402,918	11,542,887
Gross Profit	4,375,564	5,733,098	6,285,433	7,031,610
Gross Profit Margin	30.4%	35.8%	37.7%	37.9%
Interest and other Income	1,272,738	1,284,442	1,595,351	1,770,839
Operating Profit	5,648,302	7,017,540	7,880,783	8,802,449
Financing costs - Net	1,996,951	2,972,308	3,085,300	3,104,601
Profit before tax	3,651,351	4,045,232	4,795,483	5,697,848
Taxation	(1,571,186)	(1,222,590)	(1,438,645)	(1,709,354)
Profit after Tax	2,080,165	2,822,642	3,356,838	3,988,494

KenGen Balance Sheet KES '000	Jun-11	Jun-12	Jun-13	Jun-14
ASSETS				
Property plant & equipment	116,786,429	120,664,699	127,108,393	175,084,894
other non current assets	24,667,827	20,192,108	19,454,781	21,591,175
Current Assets	19,539,034	22,288,066	26,051,281	28,262,172
TOTAL ASSETS	160,993,290	163,144,873	172,614,456	224,938,242
EQUITY AND LIABILITIES				
Total Equity	69,418,587	70,179,554	73,888,998	83,220,010
Borrowings	64,166,527	61,850,220	63,766,061	101,887,912
Other non current liabilities	16,151,583	16,114,142	19,145,450	17,812,269
Current liabilities	11,256,593	15,000,957	15,813,946	22,018,051
TOTAL EQUITY AND LIABILITIES	160,993,290	163,144,873	172,614,456	224,938,242

Valuation

	EBITDA Multiple	FY2012	FY2013F
Earnings before Interest Tax and Depreciation		12,818,533	14,319,928
EBITDA Per Share		5.83	6.51
Enterprise Value		106,487,869	
Enterprise Value per share		48.44	
EV/EBITDA		8.31	
Forecasted Enterprise value		118,960,459.23	
Forecasted Borrowings		71,256,617.19	
Forecasted Market Cap		47,703,842.04	
<i>Price per share</i>		21.70	
Upside/downside		35.2%	

Conclusion

We recommend a BUY on KenGen with a 35.2% upside on the share price to KES 21.70 from the current share price of KES 16.05 (17.06.2013).

We place a BUY recommendation with a target price of KES 21.70

This is informed by increased and steady earnings that we expect from the firm given the new capacity additions, especially in geothermal generation.

However, what concerns us is the low return on shareholder funds as highlighted earlier.

KENYA POWER COMPANY LIMITED

Year to June 30th	2011A	2012A	2013F	2014F
Net Profit (KES '000)	4,219,566	4,617,115	4,587,017	5,026,744
Earnings Per share	2.16	2.37	2.35	2.58
Book Value Per Share	20.30	22.30	24.22	26.25
P/E	7.17	6.55	6.59	6.02
P/B	0.76	0.70	0.64	0.59
ROE	9.30%	9.38%	8.13%	7.46%
ROA	2.96%	2.91%	2.52%	2.42%

A Graph showing the share price movement of Kenya Power against the NSE 20 share index



Source: Bloomberg

Investment Summary

We initiate coverage with a NEUTRAL recommendation

We initiate coverage on Kenya Power with a NEUTRAL recommendation. Based on our EV/EBITDA valuation we arrive at a price target of KES 14.72 which represents an 5.2% downside from the current share price of KES 15.50 (17.06.2013).

We highlight that the system losses encountered by Kenya Power are a major source of efficiency gains given that the firm is loosing up to KES 10.0 billion as at FY2012.

Since 2008, Kenya Power has been connecting an additional 200,000 customers to the national grid every year. Going forward, the utility firm has a plan of connecting more than 300,000 customers annually.

Our key investment considerations included:

- **Increase in generation:** Going forward, the new plants to be commissioned by KenGen and other IPP's is going to see the firm increase the amount of power distributed to the consumer.
- **Monopoly:** Kenya Power is currently the only licenced distributor of electricity in the country. Therefore, although the electricity tariff charged to consumers is set by ERC, the company is almost guaranteed that all power generators will sell their power to the end consumer through Kenya Power.
- **Leveraging on the Government:** The government currently holds 50.1% of the total shares of the company. This has enabled the

company borrow at relatively competitive rates from global lenders with the Government of Kenya acting as the guarantor.

- **Rural Electrification:** REA has accounted for the majority of the new customers that Kenya Power has added to the national grid. During FY2012, the number of customers connected by REA went up by 23.7% to 382,631 from 309,287 in FY2011. Going forward, as REA continues to increase the electricity penetration in the country Kenya Power's revenue will benefit from the growth in customer numbers.
- **Low ROE and ROA:** Over the past 7 years, the Return on Average Equity (ROaE) for Kenya Power has fluctuated between 9.4% and 6.3% as shown in the table below. The ROaE for FY2012 stood at 9.3%.

History

The history of Kenya Power can be traced back to 1875 when the Sultan of Zanzibar acquired a generator to light his palace and nearby street which led to the formation of a utility company, Mombasa Electric Power and Lighting Company in 1908.

In 1983, EAP&L was renamed to KPLC

During the same year, Nairobi Power and Lighting Syndicate and Mombasa Electric Power and Lighting Company merged to form the East African Power and Lighting Company (EAP&L).

In 1983, EAP&L was renamed, The Kenya Power and Lighting Company Limited (KPLC). In 1997 the functions of generation were split from transmission and distribution while 2008 saw the function of transmission split from distribution through the formation of the Kenya Electricity Transmission Company (KETRACO).

It is worthy to note that Kenya Power retained ownership and operation of all existing transmission networks while KETRACO undertook transmission of new transmission lines.

KETRACO was to remove the burden of development cost from the customers

The main objective of KETRACO was to remove the burden of financing the development of the transmission network from the customers as the capital cost will now be funded by the government.

On 18th November 2011, Kenya Power redeemed preference shares held by the Government of Kenya and issued them with 76,622,891 new ordinary shares. This helped reduce the huge financial burden the company had to the preference shareholders. The preference shares attracted a fixed dividend payout of 7.85% amounting to approximately KES 1.25 billion annually.

During the same year, The Kenya Power and Lighting Company rebranded to Kenya Power.

The Key functions of Kenya Power are electricity transmission, distribution and retail supply of electricity to end users.

It is currently the only company authorized to distribute and supply electricity to the end user.

KEY THEMES

System Losses

Sub Saharan Africa distribution losses average at about 25.0%

According to the IMF, the distribution losses experienced by power utility companies in Sub Saharan Africa average at about 25.0%. This is far above the international norm of 10.0%

ELECTRIC POWER TRANSMISSION AND DISTRIBUTION LOSSES (% OF OUTPUT)	2008	2009	2010
Kenya	16	16	17
Tanzania	19	22	21
South Africa	9	10	10
Ghana	22	20	24
Nigeria	9	6	17
France	6	7	6
Russia	11	11	10

Source: World Bank & Faida estimates

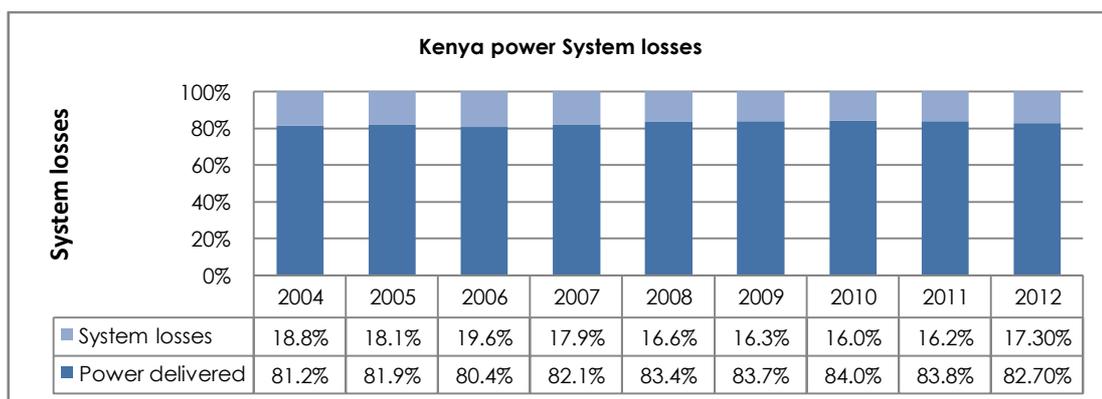
Kenya power encounters system losses at three levels;

Kenya Power encounters system losses on three levels

- 1) During transmission from the power generation station to transmission substation.
- 2) In the course of distribution from the transmission substation to the customers.
- 3) At some customers premises through tampering of metering systems.

Transmission and distribution of electricity over long distances and overloading of lines results in higher system losses.

A graph showing the ratio of system losses to power delivered since FY2004 to FY2012



Source: Kenya Power annual report

Power delivered and charged to the customer has held at an average of 82.6% over the past 9 years

As the graph above shows, over the past 9 years, power delivered and charged to the consumer has held at an 82.6% average of the total power purchased by the company. This is not encouraging given that the firm is losing over 1,000 Gwh every year, approximately KES 10.0 billion in FY2012.

We have calculated system losses as the difference between the total energy purchased by Kenya Power in Gwh less the energy billed to consumers in Gwh.

The table below shows, our scenario analysis of various levels of system losses and what revenues they would have yielded in FY2012.

A table showing a scenario of various system losses and the effect on Kenya Power earnings

FY2012 Scenario Analysis	FY2012 (Actual)						
System losses as a %	17.3%	17.0%	16.5%	16.0%	15.5%	15.0%	14.5%
Total GWh bought (FY2012)	7,670	7,670	7,670	7,670	7,670	7,670	7,670
Absolute system loss	1,329	1,304	1,266	1,227	1,189	1,151	1,112
Electricity sales	47,637,288	47,825,854	48,113,961	48,402,069	48,690,176	48,978,284	49,266,392

Source: Kenya Power annual report and Faida estimates

Assuming system losses are lowered to 15.0%, this would have seen the revenues for the company increase by approximately KES 1.3 billion in FY2012.

Kenya Power unveiled a KES 16.4 billion plan to reinforce its electricity network in Nairobi to reduce power outages and lower technical losses.

Kenya Power plans to build 10 new substations and more than 400km of distribution and alternative supply lines

It plans to build 10 new substations and more than 400km of distribution and alternative supply lines to enhance stability and reliable supply of electricity. The IFC has pledged to fund this project and has advanced the power firm a KES 4.2 billion loan to undertake the first phase of the project.

Company plans to install 500,000 meters by 2013 in order to reduce system losses at the consumer level

Additionally, the firm intends to complete the installation of prepaid power meters by 2015. This is so as to reduce system losses at the consumer level. During FY2012, the firm had installed a total of 164,117 customer premises with prepaid power meters, a 38.3% increase compared to 118,698 pre paid meters installed in FY2011. The company aims to install 500,000 meters by 2013.

PREPAID METRES INSTALLED IN KENYA	Jun-12	Feb-13	Jun-13	Jun-14
Already installed	164,000	175,000		
To be installed (targets)			214,000	464,000

Plans are underway to reduce extensive distribution and transmission of electricity over long distances

Source: Kenya Power annual report

Kenya Power also plans on reducing the extensive distribution and transmission network of electricity over long distances. An example of this is the transmission and distribution of electricity from the new Kipevu III generation plant in the Coast, which is to be resolved with the commissioning of the 400KV Nairobi-Mombasa transmission line currently under construction. Furthermore, construction and upgrading of substations is also likely to reduce the system losses incurred from the transmission and substation level.

System losses have remained largely in the same levels

Therefore, a successful implementation of these system loss minimization methods will see the firm unlock as much as 15.0%, KES 8.6 billion in FY2012, of the top line every financial year which is lost through system losses.

200,000 customers connected to the national grid every year

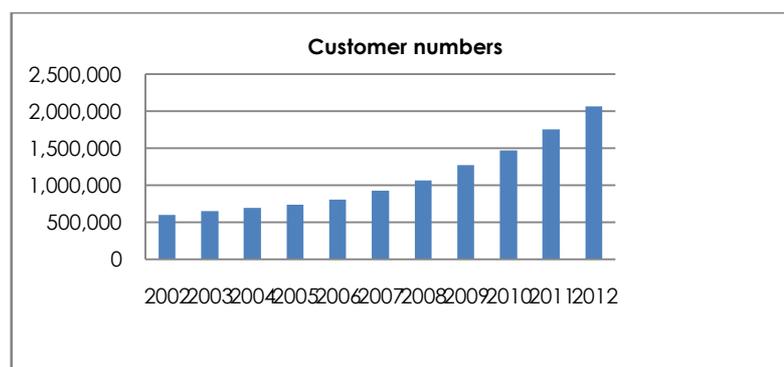
However, we note that over the 9 year period shown in the graph above, the system losses have remained largely at the same level despite the company fighting these system losses during the period.

Deepening Electricity Penetration

Since 2008, Kenya Power has been connecting an additional 200,000 customers to the national grid every year. Going forward, the utility firm has a plan of connecting more than 300,000 customers annually.

The affordability of this connection is a major constraint to some customers and therefore, in the 2010 Kenya Power in partnership with Agence Française de Développement (Afd), set up a revolving loan fund of Euro 4.5 million for lending to potential customers under the Stima loan flagship.

During FY2012, the company connected a total of 307,001 new customers to the national grid. Between July 2005 and June 2012, it had connected more than 1.3 million new customers, compared to 735,144 connected between 1922 and June 2005.



As the graph above shows customer numbers for Kenya Power has been growing steadily since 2002. This growth has been supported by various non governmental and governmental partnerships with Kenya Power such as rural electrification project and the revolving loan fund by AfD.

Growth Drivers

Increase in generation

The new plants to be commissioned will see an increase in the amount of power distributed

Going forward, the new plants to be commissioned by KenGen and other IPP's is going to see the firm increase the amount of power distributed to the consumer.

The table below shows a list of upcoming generation projects by KenGen and other IPP's

KENGEN	Type	Capacity(MW)	Commissioning Date
Kindaruma Upgrade of Unit 1&2	Hydro	8	2013
Muhoroni MSD	Thermal	80	2013
Olkaria I (Unit 4&5) & Olkaria IV	Geothermal	280	2014
Isiolo Wind I	Wind	50	2016
Olkaria I (Unit 6) & Olkaria IV(Unit 3)	Geothermal	140	2016
Olkaria IV (Unit 4 & 5)	Geothermal	170	2016
Kilifi Coal	Thermal	600	2016
Menengai I	Geothermal	400	2016
Olkaria V	Geothermal	140	2015
Isiolo Wind II	Wind	100	2017
Mombasa LNG* Power plant	Thermal	450	2017
Olkaria VI - VIII	Geothermal	420	2019
Bogoria-Silali I	Geothermal	800	2019
Menengai II	Geothermal	800	2021
INDEPENDENT POWER PROVIDERS			
Gulf Power- Athi River	Thermal	80	2013
Thika Power Ltd plant	Thermal	87	2013
Aeolus Kinangop Plant	Wind	61	2013
OrPower4 - Olkaria III	Geothermal	36	2013
Triumph Power Gen Co-Athi River	Thermal	81	2013
Lake Turkana Wind Power Project	Wind	300	2016

Customer numbers have been growing at a CAGR of 17.4%

As the sole distributor of electricity and the collector of the entire sector, Kenya Power's revenues are likely to increase with this growth in electricity capacity. This power is going to be supplied to the growing customer base for the company as well as key infrastructure projects coming up in the country. Customer numbers for Kenya Power have been growing at a compounded annual growth rate of 17.4% from 924,329 customers in 2007 to 2.1 million customers in 2012.

Taking a similar rate over the next five years, we are likely to see customer numbers increase to 4.6 million customers, which is more than double the current customer numbers for the company thereby translating to increased revenues for the firm.

Assuming all this power is going to come in in the next 10 years, and it is going to be sold only to Kenya Power, the revenues for the company are likely to increase by as much as 266.6%, KES 120.0 billion.

Monopoly

It is almost a guarantee that all power generators will sell their power through Kenya Power

Kenya Power is currently the only licenced distributor of electricity in the country. Therefore, although the electricity tariff charged to consumers is set by ERC, the company is almost guaranteed that all power generators will sell their power to the end consumer through Kenya Power.

Leveraging on the Government

Company is able to borrow at relatively competitive rates

The government currently holds 50.1% of the total shares of the company. This has enabled the company borrow at relatively competitive rates from global lenders with the Government of Kenya acting as the guarantor. This leads to wider margins by the firm as finance costs are now contained to a minimum.

A table showing the government guaranteed loans under Kenya Power

Kenya Power	Maturity year	2012 Shs'000
6.125% Kenya Government/Swiss mixed credit (CHF 2,331,110) 1996-2007	2007	205,416
4% Kenya Government/European Investment Bank - Olkaria loan (Euro 14,126,752) 2005-2020	2020	1,496,872
7.7% Kenya Government/IDA 2966 KE loan 1997-2017	2017	188,349
4.5% GOK/IDA 3958 KE ESRP (USD 55,425,729) 2004-2024	2024	4,685,061
4.5 % GOK/ Nordic Development Fund 435 ESRP (Euro 9,062,500) 2006-2024	2024	960,263
4.5% GOK/ AgenceFrancaise de Development 3008 ESRP (Euro 23,833,620) 2006-2024	2024	2,470,361
3.97% GOK/EIB 23324 KE ESRP (Euro 30,070,655) 2006-2025	2025	3,186,290
2.5% GOK/Export Import Bank of China(RMB Yuan) 2007-2026	2026	-
0.75% Japan Bank for International Cooperation(J. Yen) 2007 - 2043	2043	-
Kenya Electricity Expansion Project Loan (USD 3,715,620)		314,810
Total		13,507,422

Source: Kenya Power annual report

Therefore, going forward, we see major advantages to the majority ownership of Kenya Power by the Government of Kenya which the company can leverage on especially when it comes to financing of its projects.

On the flipside however, the government shareholding can also be seen as a disadvantage to the company where inefficiencies can brew in the company as a result of government interference in the management of the company and political appointments.

Rural Electrification

The Rural Electrification Authority (REA) was established in 2006 as a corporate body. The main purpose of the authority was to accelerate the pace of rural electrification in the country.

According to REA, 23,167 public facilities have been connected to electricity out of 25,873 identified in the master plan. A balance of 2,706 trading centres are yet to be connected.

The table below shows the customers connected to the national grid through the Rural Electrification Authority.

A table showing the new customers connected under REA and Kenya Power

	2007	2008	2009	2010	2011	2012
Customers connected under Rural EP	133,047	161,354	205,287	251,056	309,287	382,631
New connections by KPLC	99,757	107,747	162,882	150,672	231,478	211,933
Total customers	924,329	1,060,383	1,267,198	1,463,639	1,753,348	2,038,625
% connected under Rural EP	57.15%	59.96%	55.76%	62.49%	57.19%	64.35%
REP Sales (in GWh)	221	240	250	279	307	308
Total sales (in GWh)	5,064	5,322	5,432	5,624	6,123	6,341
As a % of total sales	4.4%	4.5%	4.6%	5.0%	5.0%	4.9%

Source: Kenya Power annual report

REA accounts for majority of the new customers

As the table above shows, REA has accounted for the majority of the new customers that Kenya Power has added to the national grid. During FY2012, the number of customers connected by REA went up by 23.7% to 382,631 from 309,287 in FY2011.

According to the Kenya National Bureau of Statistics, the units of electricity sold for Rural Electrification Programme (REP) schemes increased to 308 million kWh in FY2012 compared to 307 million kWh in FY2011. During the same period, revenues recorded under the REP schemes increased by 35.1% to KES 5.8 billion compared to KES 4.3 billion

Going forward, as REA continues to increase the electricity penetration in the country Kenya Power's revenue will benefit from the growth in customer numbers.

Financial Analysis

Kenya Power Income Statement Kshs '000	Jun-07	Jun-08	Jun-09	Jun-10	Jun-11	Jun-12	5 - year CAGR
REVENUE							
Electricity Sales	23,303,233	23,917,599	36,458,817	39,107,277	42,485,593	45,007,884	14.1%
Forex & fuel recoveries	14,641,053	17,001,539	30,580,436	36,801,629	30,668,428	50,654,543	28.2%
<u>Total revenue</u>	<u>37,944,286</u>	<u>40,919,138</u>	<u>67,039,253</u>	<u>75,908,906</u>	<u>73,154,021</u>	<u>95,662,427</u>	<u>20.3%</u>
Power purchase & Fuel cost	26,112,363	28,747,323	48,948,526	56,588,917	49,789,577	69,962,179	21.8%
Gross Profit	11,831,923	12,171,815	18,090,727	19,319,989	23,364,444	25,700,248	16.8%
Gross Profit Margin	31.2%	29.7%	27.0%	25.5%	31.9%	26.9%	
Operating Expenses	9,950,204	9,615,701	13,570,397	15,023,265	17,979,407	19,679,846	14.6%
Other Income	500,615	965,926	1,154,282	1,652,738	1,697,410	1,788,118	29.0%
<u>Operating Profit</u>	<u>2,382,334</u>	<u>3,522,040</u>	<u>5,674,612</u>	<u>5,949,462</u>	<u>7,082,447</u>	<u>7,808,520</u>	<u>26.8%</u>
<u>Operating Profit Margin</u>	<u>20.1%</u>	<u>28.9%</u>	<u>31.4%</u>	<u>30.8%</u>	<u>30.3%</u>	<u>30.4%</u>	<u>8.6%</u>
Financing costs - Net	266,357	(783,731)	(892,179)	(316,505)	(827,696)	698,173	21.3%
<u>Profit before tax</u>	<u>2,648,691</u>	<u>2,738,309</u>	<u>4,782,433</u>	<u>5,632,957</u>	<u>6,254,751</u>	<u>8,506,693</u>	<u>26.3%</u>
Taxation	(930,214)	(973,439)	(1,557,339)	(1,916,587)	(2,035,185)	(3,889,577)	33.1%
Profit after Tax	1,718,477	1,764,870	3,225,094	3,716,370	4,219,566	4,617,116	21.9%

Kenya Power Balance Sheet Kshs '000	Jun-07	Jun-08	Jun-09	Jun-10	Jun-11	Jun-12	5 - Year CAGR
ASSETS							
Property plant & equipment	28,147,019	38,925,317	49,974,859	64,310,486	84,590,569	105,671,370	30.3%
other non current assets	136,281	131,926	331,874	131,819	1,430,270	301,229	17.2%
Current Assets	19,953,947	21,670,262	21,257,075	20,583,585	35,150,676	28,159,384	7.1%
TOTAL ASSETS	48,237,247	60,727,505	71,563,808	85,025,890	121,171,515	134,131,983	22.7%
EQUITY AND LIABILITIES							
Total Equity	22,249,400	23,881,922	26,848,063	28,740,877	39,606,376	43,511,553	14.4%
Borrowings	2,683,117	11,368,208	11,545,014	13,113,434	19,757,132	21,512,025	51.6%
Other non current liabilities	7,906,456	8,295,655	14,615,665	24,568,028	33,677,496	37,725,267	36.7%
Current liabilities	15,398,274	17,181,720	18,555,066	18,603,551	28,130,511	31,383,138	15.3%
TOTAL EQUITY AND LIABILITIES	48,237,247	60,727,505	71,563,808	85,025,890	121,171,515	134,131,983	22.7%

Growth in sales driven by increased generation capacity

Over the past five years, electricity sales for Kenya Power have risen steadily at a rate of 14.1% to KES 45.0 billion in FY2012 from KES 23.3 billion in FY2007. This growth was driven by increased generation capacity from KenGen and other independent power producers.

Room for growth in revenues if system losses are minimized

However, we note that the revenues can increase by up to 10.0% if greater efficiency in the delivery of power can be attained in order to minimize on system losses.

During the same period total revenues rose at a CAGR of 20.3% to KES 95.7 billion from KES 37.9 billion recorded in FY2007. This is due to the rise in fuel and forex recoveries to KES 50.7 billion in FY2012 from KES 14.6 billion recorded in FY2007. A CAGR of 28.2%.

The gross profit margin for the electricity distributor have fluctuated between 25.5% and 31.9% closing FY2012 at a gross profit margin of 26.9%.

Operating profit rose at a CAGR of 26.8% to KES 7.8 billion in FY2012 from KES 2.4 billion in FY2007. The operating margin has fluctuated between 6.3% and 9.7%. This settled at 8.2% in FY2012.

Going forward, what concerns us with Kenya Power is the high system losses which have shown little to no improvement over the years as shown earlier.

Investment Consideration

Low ROE and ROA

Over the past 7 years, the Return on Average Equity (ROaE) for Kenya Power has fluctuated between 9.4% and 6.3% as shown in the table below. The ROaE for FY2012 stood at 9.3%.

Return on Assets (ROaA) for the firm have fluctuated between 3.1% and 2.3%. The ROA for FY2012 stood at 3.4%.

A table showing the ROaE and ROaA of the firm

Dupont analysis	2006	2007	2008	2009	2010	2011	2012
Net Income/ EBT(PBT)	65.8%	64.9%	64.5%	67.4%	66.0%	67.5%	54.3%
EBT(PBT)/EBIT	69.6%	68.0%	51.9%	61.1%	64.3%	57.2%	68.8%
EBIT/ Sales	10.6%	10.3%	12.9%	11.7%	11.5%	14.9%	12.9%
Sales/Av. Assets	55.9%	57.4%	52.3%	65.0%	59.5%	51.2%	60.5%
ROaA	2.7%	2.6%	2.3%	3.1%	2.9%	3.0%	2.9%
A.Assets/Av.Equity	254.3%	260.8%	281.7%	301.7%	307.2%	314.1%	319.7%
ROaE	6.9%	6.8%	6.3%	9.4%	8.9%	9.3%	9.3%

Source: Faida analysis

Financial leverage has increased to 319.7% in FY2012

As the table above shows, the financial leverage for the firm has increased from 254.3% in FY2006 to 319.7% in FY2012. However, the firm has been able to increase its operating margin to 12.9% in FY2012 compared to 10.6% in FY2006 and the interest impact on the bottom line has been minimal given that the EBT/EBIT ratio has dropped slightly to 68.8% in FY2012.

The firm has increased asset turnover to 60.5% from 55.9% in FY2006. However, it is worthy to note that the firm states its plant and property at acquisition cost unlike KenGen which states it at the revaluation cost.

A cause for concern is the rejection of tariff increase by the Government of Kenya

Going forward, we forecast a drop in ROaE to approximately 8.1% in FY2013 due to a slower growth in profits compared to balance sheet growth.

Furthermore, in May 2013, Kenya Power had its request for a tariff increase rejected by the Deputy President.

This concerns us given that, Kenya Power expressed fears of a drop in profits if the increase in power tariff is declined. Kenya Power made its case to the Energy Regulatory Commission (ERC) on the basis of the need for money in order to invest in reducing its system losses.

Forecasts

Kenya Power				
Income Statement KES '000	Jun-11	Jun-12	Jun-13	Jun-14
REVENUE				
Electricity Sales	42,485,593	45,007,884	45,988,115	50,439,093
Forex & fuel recoveries	30,668,428	50,654,543	41,261,074	45,254,543
<i>Total revenue</i>	<u>73,154,021</u>	<u>95,662,427</u>	<u>87,249,189</u>	<u>95,693,636</u>
Power purchase & Fuel cost	49,789,577	69,962,179	61,088,125	67,000,564
Gross Profit	23,364,444	25,700,248	26,161,064	28,693,072
Gross Profit Margin	31.9%	26.9%	30.0%	30.0%
Operating Expenses	17,979,407	19,679,847	20,560,468	22,550,421
Other Income	1,697,410	1,788,118	2,442,977	2,583,728
<i>Operating Profit</i>	<u>7,082,447</u>	<u>7,808,519</u>	<u>8,043,573</u>	<u>8,726,380</u>
<i>Operating Profit Margin</i>	<u>30.3%</u>	<u>30.4%</u>	<u>30.7%</u>	<u>30.4%</u>
Financing costs - Net	(827,696)	698,173	(913,022)	(912,269)
<i>Profit before tax</i>	<u>6,254,751</u>	<u>8,506,692</u>	<u>7,130,551</u>	<u>7,814,111</u>
Taxation	(2,035,185)	(3,889,577)	(2,543,534)	(2,787,366)
Profit after Tax	4,219,566	4,617,115	4,587,017	5,026,744

Kenya Power				
Balance Sheet KES '000	Jun-11	Jun-12	Jun-13	Jun-14
ASSETS				
Property plant & equipment	84,590,569	105,671,370	122,115,410	135,202,455
other non-current assets	1,430,270	301,229	286,391	286,391
Current Assets	35,150,676	28,159,384	28,359,909	31,109,088
TOTAL ASSETS	121,171,515	134,131,983	150,761,709	166,597,933
EQUITY AND LIABILITIES				
Total Equity	39,606,376	43,511,553	47,256,594	51,221,038
Borrowings	19,757,132	21,512,025	28,521,504	33,160,098
Other non current liabilities	33,677,496	37,725,267	40,877,424	45,640,312
Current liabilities	28,130,511	31,383,138	34,106,187	36,576,485
TOTAL EQUITY AND LIABILITIES	121,171,515	134,131,983	150,761,709	166,597,933

Valuation

	EBITDA Multiple	FY2012	FY2013
Earnings before Interest Tax and Depreciation		16,935,835	17,625,363
EBITDA Per Share		8.68	9.03
Enterprise Value		64,533,739	
Enterprise Value per share		33.07	
EV/EBITDA		3.81	
Forecasted Enterprise value		67,161,174.39	
forecasted Borrowings		38,426,847.02	
Forecasted Market Cap		28,734,327.37	
	Price per share	14.72	
	Upside/Downside	-5.2%	

Conclusion

We are NEUTRAL on Kenya Power

We are NEUTRAL on Kenya Power with a fair value of KES 14.72 providing a 5.2% downside from the current share price of KES 15.50 (17.06.2013).

Bottom line for the firm coming under pressure

Going forward, we see bottom line growth for the firm coming under pressure even with the growth in capacity additions. This is informed by the disclosure by the firm that they expect lower earnings in FY2013 coupled with the inefficiencies in the firm, especially in the system losses, which have remained relatively unchanged.

The firm is in a unique position to capitalize on capacity additions

However, we note that if the firm succeeds in improving its efficiencies, the firm is in a unique position in the power sector to capitalize on the capacity additions by generators since they are the sole distributor to the consumer and revenue collecting agent for the entire sector.