Kenya Power – FY2013 Results Note

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Summary

Recommendation: BUY

Current Market price (16.10.2013)	KES 14.20
Trailing EBITDA: FY2013	9.33
3- Year Average P/E	3.88X
Forecasted EBITDA: FY2014	9.46
Target Price	**16.96**
Upside Potential	**19.4%**

We upgrade our investment recommendation on Kenya Power from **NEUTRAL** to **BUY** and review our price target to **KES 16.96** which provides a 19.4% upside from the current share price of KES 14.20 (as at 16th October 2013).

We arrived at our price target using a 3 year historical average EV/EBITDA and our forecasted FY2014 EBITDA.

Our upgrade is informed by:-

Slightly higher than expected top line

- **Slightly higher than expected top line:** Total revenues for the company were higher than expected at KES 88.9 billion compared to our estimate of KES 87.2 billion. This was still in the context of a higher than expected system losses which management expects to start trending downwards in FY2014.

Increased generation by 540MW

- **Increased Generation:** During the current financial year, the utility firm expects to bring in 540MW from KenGen and other independent power producers which we expect to translate into higher revenues.
- **Tariff review:** In addition, we expect to see a tariff review upwards by the energy sector regulator.

Other Results Highlights

System losses up to 17.9%

- ✓ **System losses continued its upward trend:** We note that the system losses for the firm increased to 17.9% in the financial year under review from 17.3% recorded in FY2012. We forecasted system losses to remain constant in FY2013 at 17.3%.

Drop in revenues due to lower fuel cost recoveries

- ✓ **Fuel cost recoveries dropped by 24.2%:** During the financial year under review, the total revenues also recorded a 7.1% drop y-o-y from KES 95.7 billion. This is largely due to a 24.2% drop in fuel cost recovery to KES 31.8 billion from KES 41.9 billion.

Gross margin in line with expectations

- ✓ **Gross profit margin improved by 3.2%:** The gross profit margin improved to 30.1% from a gross profit margin of 26.9% recorded in FY2012. This was in line with our forecasted gross profit margin 30.0%.

Higher capex

- ✓ **Higher than expected Capex (to KES 40 billion):** The power firm also increased its capital expenditure to KES 40.0 billion from KES 26.0 billion recorded during the previous year. This saw the company record a negative cash position during the financial year thereby not paying a dividend.

Increased borrowings

- ✓ **Increased borrowing by the firm see's finance costs rise:** Finance costs increased by 105.2% to KES 2.5 billion compared to KES 1.2 billion recorded in FY2012.

Kenya Power FY2013 Results

Kenya Power KES '000,000	FY2012	FY2013	% Change
Revenue			
Non fuel revenue	45,008	47,916	6.5%
Foreign exchange losses recovered			
Power purchase	6,094	5,120	-16.0%
KPLC operations	2,665	4,102	53.9%
Fuel Cost recovery	41,896	31,771	-24.2%
Total revenue	**95,663**	**88,909**	**-7.1%**
Power Purchases Costs			
Non fuel	21,080	24,761	17.5%
Fuel costs	42,789	32,297	-24.5%
Foreign Exchange	6,094	5,120	-16.0%
Total Power Purchase Costs	**69,963**	**62,178**	**-11.1%**
Gross Margin	**25,700**	**26,731**	**4.0%**
	26.9%	**30.1%**	
Other Revenue	1,788	3,192	78.5%
Transmission & Distribution costs	(19,680)	(21,130)	7.4%
Operating Profit	7,808	8,793	12.6%
Interest Income	489	111	-77.3%
Finance Costs	(1,216)	(2,495)	105.2%
Net foreign exchange gains/(losses)	1,425	15	-98.9%
Profit Before Tax	**8,506**	**6,424**	**-24.5%**
Income Tax Expense	(3,889)	(2,072)	-46.7%
Profit After Tax	**4,617**	**4,352**	**-5.7%**
Earnings Per Share	2.36	2.23	-5.5%
Diluted Earnings Per Share	2.36	2.23	-5.5%
Dividends Per Share	0.50	NIL	

Results Analysis

Profit after tax dropped by 5.7%

Kenya Power released its FY2013 results which showed a 5.7% drop in profit after tax to KES 4.35 billion compared to KES 4.62 billion recorded in FY2012. This is a KES 240 million variance with our forecasted profit after tax of KES 4.59 billion.

Improved average yield led to higher revenues

Revenues came in higher than expected: Total revenues for the company were higher than expected at KES 88.9 billion compared to our estimate of KES 87.2 billion. Management explained this higher than expected revenues to an improved average yield.

KES 540 million lost due to the higher system losses y-o-y

System losses continued its upward trend: We note that the system losses for the firm increased to 17.9% in the financial year under review from 17.3% recorded in FY2012. This translates to an additional KES 540 million lost during the financial year from this increase. Management estimates that 1.0% of system losses translate to a loss of KES 900 million in revenue for the company.

Lower fuel cost recoveries due to improved hydrology

Fuel cost recoveries dropped by 24.2%: During the financial year under review, the total revenues also recorded a 7.1% drop y-o-y from KES 95.7 billion. This is largely due to a 24.2% drop in fuel cost recovery to KES 31.8 billion from KES 41.9 billion. The decline in fuel cost recoveries was attributed to increased reliance on hydro power coupled with reduced generation from emergency thermal plants. Generation from hydro plants increased to 4,340 GWh compared to 3,450 GWh recorded during the previous financial year.

Gross profit closed at KES 26.7 billion

Gross profit margin improved by 3.2%: The gross profit margin improved to 30.1% from a gross profit margin of 26.9% recorded in FY2012. This was in line with our forecasted gross profit margin of 30.0%. In absolute terms the gross profit closed at KES 26.73 billion, a 4.0% increase from the KES 25.7 billion recorded in the previous year. Absolute gross profit was also in line with our forecast of KES 26.16 billion.

Expansion of electricity network led to higher costs

Costs came in slightly higher than expected: Transmission and distribution costs came in higher than expected at KES 21.1 billion, compared to our forecast of KES 20.6 billion. According to management, the 7.4% increase y-o-y in transmission and distribution costs was attributed to the expansion of the company's electricity network and facilities to support the increased demand and improvement of the quality of power supply.

Capex up to KES 40 billion

Capex up to KES 40 billion: The power firm also increased its capital expenditure to KES 40.0 billion from KES 26.0 billion recorded during the previous year. Management intimated that KES 16 billion was used in connecting new customers while the rest was used for reinforcement and upgrading of existing systems, substation and feeder improvement.

Increased borrowing by the firm see's finance costs rise: Finance costs increased by 105.2% to KES 2.5 billion compared to KES 1.2 billion recorded in FY2012. This was attributed to short term financing taken by the firm to meet short term obligations and the expensing via the income statement of loans acquired from the World Bank.

Overdraft of KES 6.8 billion acquired

We note that the firm also acquired an overdraft facility of KES 6.8 billion. This was attributed to an increase in power purchases due to increased capacity from generation plants while the tariff to consumers has remained constant.

Management indicated that the overdraft facility, which is usually drawn at the beginning of the month when generators of electricity are receiving their monthly payments, is likely to come to an end when they receive the approval to increase the electricity tariff.

Key Developments & Revenue drivers

Aggreko EPP retired

- ✓ **Increased installed capacity:** During the current financial year, FY2014, Kenya Power retired the 90MW emergency power from Aggreko and replaced it with 104MW from Kindaruma (24) and Thika Power MSD (80). Going forward, the company expects a total of 540MW to be introduced during the current financial year by KenGen and other independent power producers (IPPs).

KenGen		
Kindaruma	Hydro	24MW
Olkaria Wellheads	Geothermal	40MW
Olkaria IV	Geothermal	140MW
Olkaria I	Geothermal	70MW
Total KenGen		*274MW*
Independent Power Producers		
Thika Power	MSD	87MW

Gulf Power	MSD	80MW
Triumph Power	MSD	83MW
Orpower4	Geothermal	16MW
Total IPPs		*266MW*
TOTAL CAPACITY		**540MW**

Source: Kenya Power

Company revenues to be boosted by new capacity

This translates to 32.5% of the total current installed capacity. If successfully implemented, the company's revenues will be boosted.

As the country's power industry continues to be a single buyer model, Kenya Power will be the sole buyer of all the new power being generated by KenGen and other IPP's.

Customer numbers up by 13.1%

- ✓ **Increase in customer numbers:** The customer numbers for the power distributor increased by 13.1% to 2,330,962. This continuous y-o-y growth in customer numbers leads to an increase in the demand for power thereby forming a business case for generators to expand capacity.

Government gives KES 2.7 billion towards new connections

- ✓ **New connections resume:** The recent tussle between the government and Kenya Power about the increase in cost of new connections, from KES 35,000 and KES 45,000 for single phase and three phase connections respectively to KES 75,000 and KES 85,000, has come to an end and new connections have resumed. This was done by the government putting in KES 2.7 billion towards the project and launching a research on the actual price of new connections. In addition to increased earnings due to a rise in new customers, this is likely to translate into improved margins for the company as it will not incur losses when connecting new customers as was witnessed in the previous financial year.

Tariff review upwards is expected

- ✓ **Tariff review:** In addition, we expect to see a tariff review upwards by the energy sector regulator. This is informed by the precedent set by other reviews in the past, done every three years due to increased costs. Management was also confident of getting a tariff adjustment upwards. However, we remain cautious of the time this review will happen given that it will affect the company's margins if it stretches out too long.

Strategy and Outlook

High inefficiencies continue to be exhibited

In our view, and as alluded to in our initiation of coverage report of the Power Sector, Kenya Power continues to exhibit high inefficiencies in the transmission and distribution of power.

Increased debt continues to be a concern

We are concerned with the increased debt level and how other additional debt will be managed going forward. Kenya Power's bottom line was hard hit by an increase in finance costs as indicated above.

Going forward, Kenya Power intends to reduce its system losses as shown in the table below:

	FY2013A	FY2014E	FY2015E	FY2016E
Target System losses	**17.9%**	**16.8%**	**16.6%**	**15.9%**

Source: Kenya Power

The main initiatives that will lead to this reduction in system losses include:

Installing 2,000 meters a day

- ✓ Pre-paid meters being installed by the power firm. Currently 400,000 customers are on prepaid metering. The company has a target of connecting 2,000 customers per day.
- ✓ The 400Kv transmission line from Mombasa to Nairobi is due to be completed this financial year reducing the system losses incurred on the current line due to overloading.

Transmission line from Mombasa to Nairobi to be completed

In spite of these inefficiencies, we still see the huge potential for Kenya Power. Considering that Kenya Power is a monopoly (in the distribution of power in the country) and is the sole revenue collecting agent for the entire sector, any improvement in system losses could unlock value for the shareholders.

Recommendation

We recommend a BUY

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