KenGen:
'Regaining Momentum for Growth'

INVESTMENT SUMMARY:

We issue a **BUY** recommendation on Kenya Electricity Generating Company (KenGen) based on a Target price of KES 7.61per share representing a 28.10% upside. We view KenGen as an attractive company in the utility sector with significant opportunities for growth and margin expansion. The company announced plans to commission additional 246.5MW of geothermal power in FY20 and FY21 to its current capacity of 1,631MW. This is expected to spur the electricity revenues to KES 36Bn in FY20 and KES37Bn in FY21 and also provide tax credit which will improve the Net profits.

Positives

- Expected Capacity additions to support revenue growth. The Company is expected to commission Olkaria V in FY20 and Olkaria 1 unit 6 in FY21. This is expected to improve both the capacity revenues and the energy revenues.

- Available opportunities for growing both capacity and energy revenues. Kenya has a potential of generating 7000-10000MW of geothermal power but less than 10% of this has been utilized. The electricity demand has also grown by a CAGR of 5% over the past 5 years. The government is also helping in the funding of power projects and increasing connections to the grid through the last mile connectivity project.

- A stable dividend payment policy. The new finance bill will exempt the power producers from paying compensating tax which will enable the firm to adopt stable dividend policy. The expected tax allowances from the additional power plants will also boost the firm's earnings.

- KenGen is undervalued in relation to the peers. Both the P/E and EV/EBITDA multiples reveal that the company's share is currently trading at a discount and this offers an opportunity to the value investors.

DATE: 28th June 2019
Recommendation: BUY
Target Price: Kshs 7.61
Current Price: 5.90
Potential Upside: 28.10%
-week Trading Range:
Kshs 5.46 to Kshs 7.50
EPS: 1.2
P/E: 6.13
ROaE: 4.23
ROaA: 2.09
Dividend Yield: 6.69%

Analyst

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- Leverage on green energy. The company's "Good to Great" strategy is geared towards adding 721MW of green power to its capacity by 2025.This will comprise both geothermal and wind power. Geothermal is more profitable and reliable than hydro. It has a higher load factor of 90% and sells at ksh 4.5 per Kwh compared to traditional hydro which sells ksh 2.75 Kwh and has a fluctuating and relatively lower load factor of 50%.

Potential downsides

- Earnings are likely to be affected by project delays. It takes approximately 10 years to develop and commission a geothermal plant. The process of commissioning a plant is also very complex which may lead to delays of achieving the company's target of adding 721MW by 2025.

- The company's ROaE of 4.2% is way below the peer value of 13.94%. The ROaA is also currently 2.09% which is below the peer value of 4%. The low ROaE may be attributed to the huge revaluation on assets and the long time lag for their

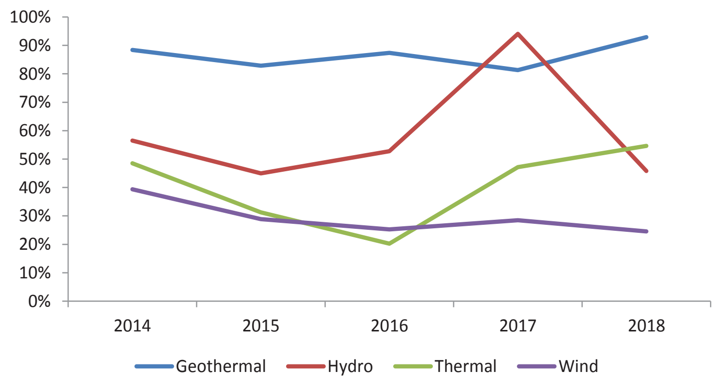
Attractive trading multiples due to low investor sentiments

The low investor sentiment about the profitability of the utility sector.The peer P/E multiple of 7.96x and EV/EBITDA multiple of 8.12x against the company P/E and EV/EBITDA multiples of 6.48x and 7.66x respectively reveals that the stock is currently undervalued and has not maximized its flair. We believe that with the rising demand or power, expected pipelines and the expected resumption of a stable dividend policy, the investor sentiments will change.

Leverage on green Energy

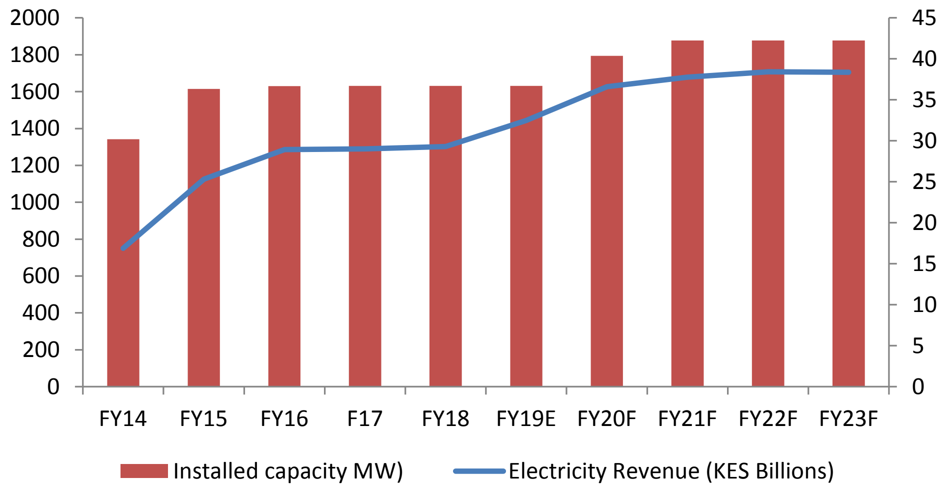
The Firm aims at adding additional 721MW of green energy by 2025 with 163.5MW to be added in FY20 and 83MW in FY21.green energy is cheaper compared to thermal and the good news is that it is geothermal which is immune to poor hydrology which affects hydro power. geothermal energy has a higher load factor compared to hydro energy and has strongly complimented the hydro power over the past five years. currently, 88% of the total electricity revenue comes from green energy and 58% is from geothermal power. geothermal is more profitable than hydro power and we expect geothermal revenue to hit KES 22Bn in FY20 and KES 24Bn in FY21 from the current KES 17Bn after the new capacity has been commissioned.

Load factor distribution for the power sources



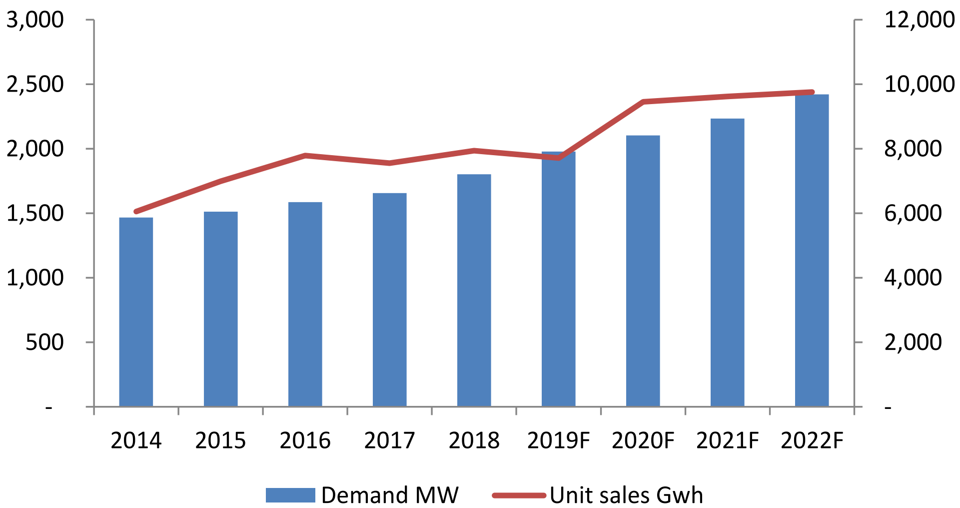
Growing electricity revenue

The past 5 years has seen the electricity revenues grow by a CAGR of 12% to KES29Bn in FY18 from KES17Bn in FY14.the growth has been supported by the rise in the geothermal capacity which has increased by a CAGR of 14% and currently stands at 533.9MW from 256.1MW in FY14.geothermal power increases the total units produced and sells at an average tariff of Ksh 5 per kilowatt hour which is higher compared to the traditional hydro which sells at Ksh 2.75 per Kilowatt hour.The anticipated rise in installed capacity especially geothermal are expected to increase the total electricity revenue to KES36Bn in FY20 and KES 37Bn in FY21from the current KES29Bn.The burgeoining top line and the expected capital tax allowances (150% for the projects outside the city) will improve the net earnings of the firm.



Growing electricity demand to shore up the unit sales

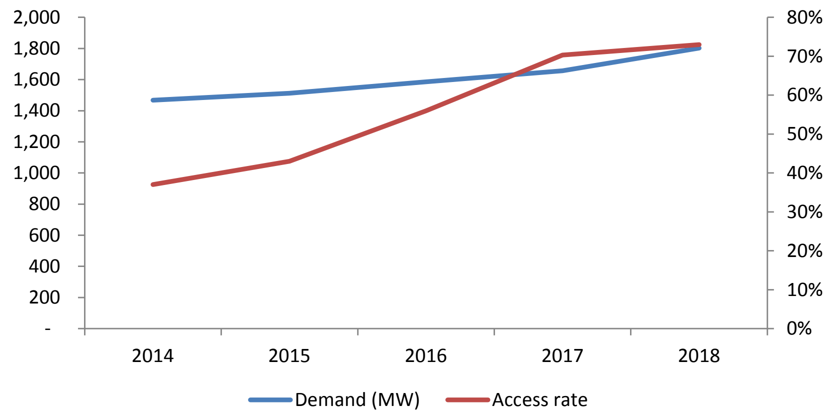
Electricity demand has recorded a CAGR of 4% over the past 5 years and is poised to grow by 5% for the next five years.we expect the rising demand for electricity to support the growth in the energy revenue from the unit sales.



Source; Least cost power development plan.

Existing growth opportunities in the Power sector

The government through the last mile connectivity project has doubled the electricity access rate to 70.3% in 2018 from 37% in 2014 which is expected to buoy the electricity demand. The government aims to add additional 2600MW to the National grid by 2023. The additional capacity will majorly comprise renewable Non Hydro Energy power from Wind, Solar, Geothermal, Nuclear, Gas and Coal. Kenya has geothermal potential of 7,000 MW to 10,000 MW spread over 14 prospective sites and the government aims to build most of its geothermal capacity Additions through KenGen and GDC. However, we are concerned about the fact that the demand projections are aggressive

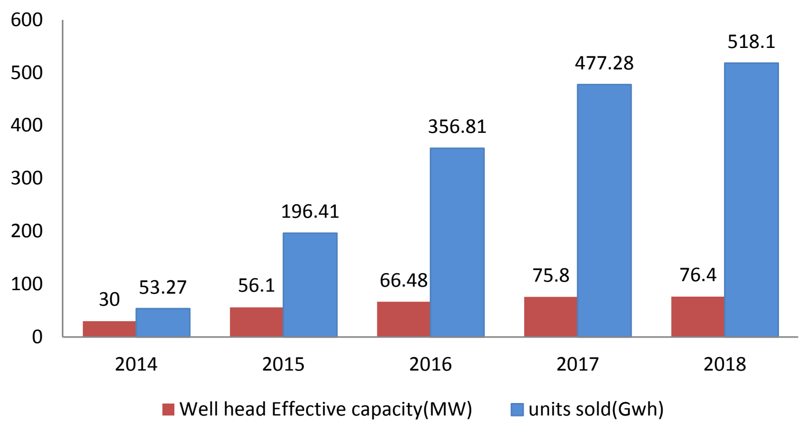


Source; Kenya Power

The innovative wellhead Technology to boost geothermal generation.

Currently, the geothermal well heads have an effective capacity of 76.4MW which is 15.17% of the current effective geothermal capacity. The wellhead package allows the company to earn revenue from drilled wells before the development of the conventional power plants which takes a minimum of 5Yrs to fully operationalize and therefore reduces the payback period. In the FY18, The Company announced plans to add 124.34MW from the innovative geothermal wellheads, we however did not incorporate it in our assumptions because of the uncertainty of the commissioning year but we expect an increase in the capacity due to the expected increase in the geothermal

Well head Effective capacity vs. Unit sales



Source, company data and Team Analysis

Anticipated Resumption of Dividend Payments

The company deferred dividend payments in the FY16 and FY17 due to heavy Capex. The expected additional capacity in the FY20 and FY21 which have already been funded are expected to boost the electricity revenue. Both the expected tax credits and the exemption from payment of compensating tax by the new finance bill will allow the firm to resume dividend payments from FY20 going forward. The management also expects the new bill to enable them adopt a stable dividend policy of 30% of the total PBT which will enhance certainty on the dividends of the company.

Project Delays

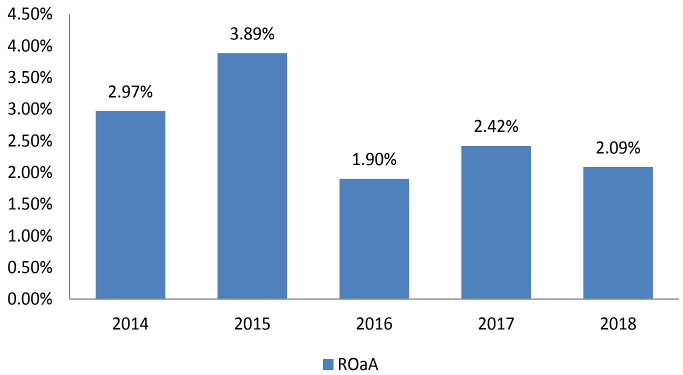
It's already june 2019 and the additional capacity in FY19 is yet to materialize but the management promised to commission the first unit of Olkaria V (82.7MW) by April 2019. Our projected Electricity revenues heavily rely on the projected capacities especially in the FY20 and FY21 and the delays or failure of delivery by the management will negatively affected our cash flows. The process of Implementation of a power plant is very complex and this exposes our analysis and valuations to a very high risk and thus we have only incorporated 246.5MW in our projections. We see this as a real challenge and we are unsure if the management will stick to their promise of delivering 246.5MW by 2021.

Company pipeline projects.

Project	Capacity MW	Status	Commissioning year
Ngong 1 phase III	10	Optimization study	2020
Olkaria 1 unit 6	70	Procurement of contractors	2019
Olkaria 1AU uprating	30	Financing	2020
Olkaria IV uprating	30	Financing	2020
wellheads	25	Project completed	2017
Olkaria 1 rehabilitation	6	Financing committed	2020
Wellhead plants	50	Procurement of a developer	2019
Olkaria V	140	Construction ongoing	2019
Meru Wind phase 1	80	Financing committed	2020
Olkaria VI	140	Project development	2020
Olkaria VII	140	Project development	2020

Unattractive ROaE

The ROaE of the company as at FY18 was 4.23% which is way below the peer median of 13.94%. Even though the ROaE was highest in FY15 at 10.55% when huge commissioning happened, it has recorded an average of 4% over the last 3Years and this should be a source of concern to the shareholders. The unfavourable ROaA due to lower selling prices especially hydro which is currently Ksh 2.75KWh has continued to suppress the ROaE of the company. The frequent revaluation of the company assets has also suppressed the ROaE of the company. We expect the ROaE in FY19 to remain at 4%, rise to in FY20 and FY21 due to slight increase in the profit margins to 24% in FY20 and FY21 from the current 22% when most of the promised commissioning would have materialized.



The return on asset trend of the company

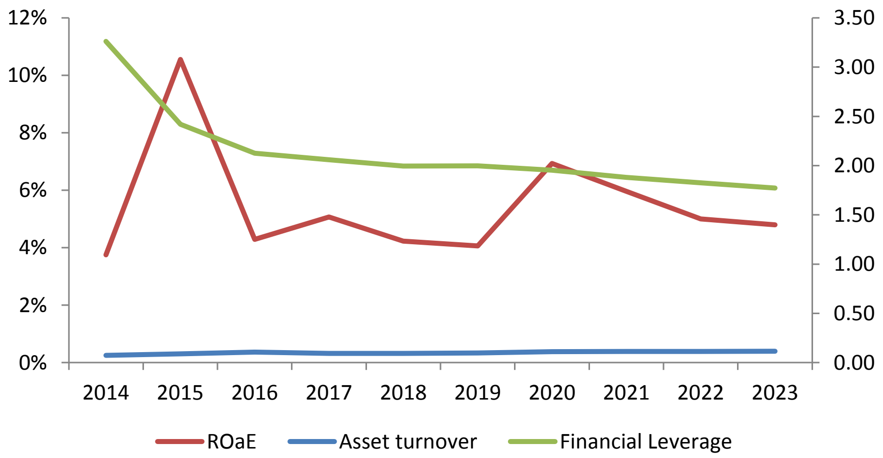
Financial Analysis

In the FY18, the company recorded a 12% drop in the PAT to KES 7.9Bn from KES9Bn in FY17 due to increase in the tax component because of lack of the capital allowance from commissioned projects. We expect a flat result in the PAT in the FY19 due to flat energy revenues and lack of additional capacity. Driven by the expected decline in the finance costs, the burgeoning Top line and the anticipated capital Allowances, we anticipate a 79.24% y/y growth in PAT to KES 14.02Bn in FY20 and record KES 12.80Bn in FY21. The Key risks in our projections still remain the delayed commissioning.

DuPont Analysis

The company has recorded unfavourable ROaE of an average of 4% over the last 3yrs compared to the peer value of 13.94%.This has been attributed to the poor return on average assets which has been approximately 2% over the past 5years compared to a peer value of 4% due to the low price of hydro. The huge revaluation on assets of the company has also continued to negatively influence the return on assets of the company which lowers the profitability of the company. The investment in geothermal which has a very long time lag has also negatively affected the return on assets of the company. We however expect an improvement in the ROaE in the FY20 to 6.93% and 5.96% in FY21 due to the expected increase in the profit margins and the declining finance costs.

AssetTurnovervs.ROaEvs.FinancialLeverage



Ratios

Ratio	FY15	FY16	FY17	FY18	FY19E	FY20F	FY21F	FY22F	FY23F
Gross Profit Margin	59.49%	68.62%	64.47%	61.49%	61.81%	64.53%	63.85%	62.71%	61.93%
EBIT Margins	59.49%	68.62%	64.47%	61.49%	61.81%	64.53%	63.85%	62.71%	61.93%
Net Profit Margin	37.86%	42.14%	38.32%	32.59%	33.43%	37.85%	37.57%	36.70%	35.62%
ROaE	38.45%	17.47%	25.48%	22.48%	20.49%	31.35%	27.69%	23.69%	23.11%
ROaA	10.55%	4.29%	5.07%	4.23%	4.06%	6.93%	5.96%	5.00%	4.80%
ROCE	3.89%	1.90%	2.42%	2.09%	2.03%	3.51%	3.11%	2.70%	2.67%
Asset Turnover	4.07%	5.44%	4.36%	3.67%	3.99%	5.04%	5.10%	5.05%	4.96%
Fixed Assets Turnover	0.09	0.11	0.09	0.09	0.1	0.11	0.11	0.11	0.11
Current Ratio	0.1	0.12	0.11	0.11	0.11	0.13	0.14	0.14	0.15
EPS	0.95	1.2	1.48	1.5	1.39	1.73	2.13	2.52	2.59
Cash to Debt ratio	1.75	1.02	1.37	1.2	1.19	2.13	1.94	1.7	1.7
Debt to Equity ratio	0.02	0.05	0.06	0.03	0.01	0.05	0.12	0.2	0.23
Debt/(Debt Equity)	103.55%	79.25%	75.87%	69.39%	69.10%	65.62%	59.64%	54.99%	50.71%
Interest/EBIT	49.21%	42.21%	41.16%	38.95%	38.90%	37.71%	35.41%	33.49%	31.63%

Income Statement

KES 'Millions'	FY15	FY16	FY17	FY18	FY19E	FY20F	FY21F	FY22F	FY23F
Capacity Revenues	19,102	21,262	21,714	21,139	22,197	26,380	26,554	26,850	27,069
Energy Revenue	6,206	7,671	7,293	8,146	8,188	9,807	10,367	10,431	10,473
Electricity Revenue	**25,308**	**28,934**	**29,007**	**29,286**	**30,385**	**36,187**	**36,921**	**37,281**	**37,542**
Steam Revenue	3,689	6,856	5,189	6,222	6,844	7,529	8,282	9,110	10,021
Fuel & Water Charge			9,236	9,782	10,131	11,896	12,300	12,623	12,942
Reimbursable Expenses			-8,979	-9,406	-9,794	-11,500	-11,891	-12,204	-12,512
Other Revenues	666	2,210	896	-775	628	628	628	628	628
Total Revenues	**29,663**	**38,000**	**35,349**	**35,108**	**38,195**	**44,739**	**46,240**	**47,438**	**48,621**
Operating Expenses	-8,447	-8,948	-9,763	-9,970	-11,001	-11,928	-12,379	-12,918	-13,264
Steam costs	-3,689	-3,167	-2,796	-3,549	-3,585	-3,943	-4,337	-4,771	-5,248
EBITDA	**17,526**	**25,885**	**22,790**	**21,590**	**23,609**	**28,868**	**29,524**	**29,749**	**30,109**
Depreciation & Amortization	-6,479	-10,223	-9,244	-10,148	-10,841	-11,936	-12,152	-12,340	-12,792
EBIT	**11,047**	**15,661**	**13,545**	**11,442**	**12,768**	**16,933**	**17,371**	**17,409**	**17,317**
Compensating Tax	-	-2,431	-	-	-	-	-	-	-
Finance Income	359	556	1,333	3,341	833	894	902	905	908
Finance costs	-3,011	-3,132	-3,417	-3,038	-2,423	-2,463	-2,352	-2,261	-2,173
Profit Before Tax	**8,396**	**10,654**	**11,461**	**11,745**	**11,178**	**15,363**	**15,921**	**16,053**	**16,053**
Tax Expense /Credit	2,827	-4,521	-2,455	-3,855	-3,353	-1,339	-3,116	-4,816	-4,816
Profit After Tax	**11,223**	**6,134**	**9,006**	**7,891**	**7,824**	**14,024**	**12,805**	**11,237**	**11,237**

Balance Sheet

Assets KES 'Millions'	FY15	FY16	FY17	FY18	FY19E	FY20F	FY21F	FY22F	FY23F
Non-currents	321,151	345,332	347,090	347,941	359,751	368,138	363,100	357,715	360,314
Current Assets(Less cash)	18,077	15,160	21,808	28,029	29,118	34,197	34,942	35,368	35,718
Cash & Bank Balances	3,292	6,756	7,831	3,383	1,390	6,429	15,775	25,313	27,321
Total Assets	**342,520**	**367,249**	**376,730**	**379,353**	**390,259**	**408,763**	**413,817**	**418,396**	**423,352**
Equity & Liabilities									
Equity	141,594	172,743	182,836	190,104	195,290	209,314	220,015	229,332	238,883
Non-current Liablities	178,446	176,316	173,800	168,370	173,058	176,003	170,004	164,985	160,113
Current Liabilities	22,480	18,190	20,093	20,879	21,911	23,446	23,798	24,079	24,356
Total Equity & Liablities	**342,520**	**367,249**	**376,730**	**379,353**	**390,259**	**408,763**	**413,817**	**418,396**	**423,352**

Cash Flow Statement

Cash flow Statement KES 'Millions'	FY15	FY16	FY17	FY18	FY19E	FY20F	FY21F	FY22F	FY23F
Cash flows from operating activities	12,526	29,256	13,201	17,510	20,237	23,383	27,200	25,119	26,119
Cash flows from investing activities	-27,859	-26,786	-13,074	-14,843	-20,215	-18,272	-7,272	-6,279	-15,281
Cash flows from financing activities	13,998	994	946	-7,144	-2,015	-71	-10,582	-9,302	-8,830
Changes in cash and cash equivalents	**-1,336**	**3,464**	**1,073**	**-4,476**	**-1,994**	**5,039**	**9,346**	**9,538**	**2,008**
Opening cash and cash equivalents	4,628	3,292	6,756	7,831	3,383	1,390	6,429	15,775	25,313
Closing cash and cash equivalents	**3,292**	**6,756**	**7,831**	**3,383**	**1,390**	**6,429**	**15,775**	**25,313**	**27,321**

Valuation

Our valuation was based on a combination of both the relative and the discounted cash flow valuation methodologies. The DCF led to a target price of KES 6.43 while the relative valuation gave a target price of KES11.60 and KES 9.14 for EV/EBITDA and P/E methods respectively. We assigned weights to our valuations with 70% allocated to DCF method while 30% to the relative valuation methods. More weight was given to DCF because it included all major assumptions about the company. The peers used in valuations operate in different economic environments and thus we assigned less weight to the relative methods of valuation.

FCFF '000'	30-Jun-19	30-Jun-20	30-Jun-21	30-Jun-22	30-Jun-23
Net income	7,824,393	14,024,162	12,804,510	11,237,337	11,236,775
Add Non cash adjustments	10,846,637	11,941,122	12,157,895	12,345,516	12,797,600
Add Interest (1-TAX)	1,696,393	1,724,407	1,646,597	1,582,743	1,520,920
Less Investment in Fixed capital	(20,215,361)	(18,272,411)	(7,271,781)	(6,279,087)	(15,280,832)
Less investment in working capital	(1,201,760)	(5,045,907)	(114,548)	(724,789)	(88,253)
FCFF	(1,049,698)	4,371,373	19,222,673	18,161,719	10,186,210
Less interest (1-TAX)	(1,696,393)	(1,724,407)	(1,646,597)	(1,582,743)	(1,520,920)
Add net borrowing	3,046,000	2,392,000	(6,126,000)	(5,120,000)	(4,972,000)
FCFE	299,910	5,038,966	11,450,075	11,458,976	3,693,290
Periods	1.00	1.09	2.09	3.09	4.09
PV factor	0.8481	0.8352	0.7084	0.6008	0.5096
PV cashflows	254,365	4,208,680	8,111,116	6,884,713	1,882,007
Total PV cashflows					21,340,882
Terminal value					32,884,395
Present value of terminal value					16,757,055
Total Equity value					38,097,937
Number of shares outstanding					6,594,522.339
Target price					**6.43**

Relative valuation

EV/EBITDA METHOD	
Kengen EBITDA 2019	23,609,191
Peer Multiple	8.05
Enterprise value	190,084,683
Less Net debt 2018	121,287,608
Equity value	68,797,075
Number of shares Outstanding	6,594,522.339
Target price	**11.60**

P/E METHOD	
Kengen Net profit 2019	7,824,393
Peer Multiple	6.93
Equity value	54,197,226
Number of shares outstanding	6,594,522.339
Target price	9.14

Assumptions

Assumptions	
RFR	12%
Adjusted Beta	1.181
Equity risk premium	5%
cost of Equity	17.91%
Weight of Equity	60%
Cost of debt	3.10%
Tax rate	30%
After Tax cost of debt	2.17%
Weight of debt	40%
WACC	11.61%
Terminal growth rate	6%

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