Kenya Power - INITIATION OF COVERAGE

We initiate coverage with a **bearish outlook** based on a target price of KES 1.14 implying a downside of 39% relative to the volume weighted average price as at 11th November 2021. Our view is informed by the following factors;

Key Downsides

- **Scandals in the energy sector:** Negative publicity has seen the company come under pressure at the bourse and with the storm being far from over, the negative market sentiment may keep the price depressed.
- **Push to lower power costs:** The government is keen on delivering its promise of cheaper power in the country. Lower tariffs to consumers' points to lower profit margins. Moreover, the ERC had recommended scraping the forex element in power bills. This move would expose the company to greater foreign exchange risk.
- **Cash flow difficulties:** Improved efficiency in revenue collection is critical in improving the liquidity position of the company. We expect these challenges to remain even as Kenya Power restructures its operations to address is cash flow challenges.

Key Upsides

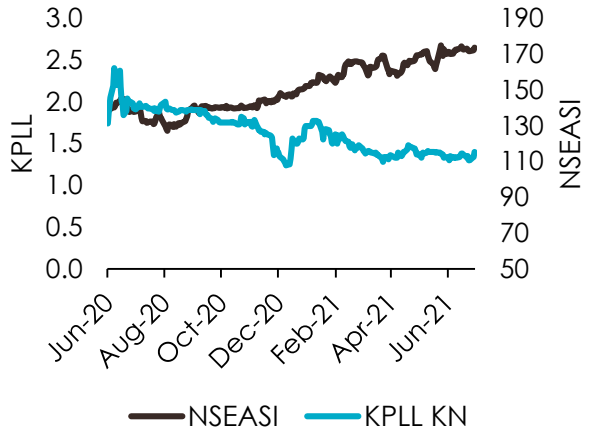
- **Leveraging the government:** Government support has enabled the company to borrow at relatively competitive rates from global lenders with the Government of Kenya acting as the guarantor, which tames financial costs.
- **Reliable power:** Installed capacity is growing, entrenching geothermal as the largest source of electricity. This will result in a steady supply of power displacing hydro and thermal power generation. The rise in geothermal power generation is expected to minimize volatility in supply caused by over-reliance on hydro power generation.
- **Rise in electricity demand:** Electricity demand has been increasing steadily, with the figure closing FY2021 at 1999MW. Demand will continue to grow, supported by the ongoing investment in the national grid transmission network.

Share Data

Bloomberg Ticker	**KPLL KN**
Reuters ticker	**KPLC.NR**
Current Price(KES)	**1.88**
Target Price(KES)	**1.14**
Downside	**39%**
Rating	**SELL**
52WK High (KES)	**1.99**
52WK Low (KES)	**1.29**
Market Cap (Bn)	**3.67**
Shares outstanding (Bn)	**1.95**
Dividend yield (%)	**0.00**
EPS	**0.76**

Source: Bloomberg, NSE, NCBA IB research

Kenya Power one-year return



Source: NSE, NCBA IB research

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Analyst certifications and required disclosures begin on page 11

Energy sector overview

The Kenyan energy sector is structured as a single buyer market with Kenya Power, the distribution utility, buying electricity from power generators on the basis of negotiated power purchase agreements for onward distribution and retail to consumers.

Developments in the energy sector

In 1997, the Government of Kenya initiated reforms in the energy sector, separating generation, transmission, and distribution of electricity into distinct and autonomous functions. Kenya Power is tasked with the responsibility of distribution of electricity while KenGen is responsible for generation in competition with Independent Power Producers (IPPs).

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

Another restructuring took place in the last decade 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.

The Energy and Petroleum Regulatory Authority (EPRA) was established as the successor to the Energy Regulatory Commission (ERC) under the Energy Act, 2019. The Authority is responsible for the economic and technical regulation of the electric power, renewable and petroleum sub-sectors.

The Kenya National Electrification Strategy (KNES) launched in December 2018 provides a roadmap to achieving the universal electricity access goal by 2022. This initiative includes concerted efforts to increase access to electricity in the 14 under-served counties through grid, mini-grid, and off-grid options.

Sector performance

The sector's financial sustainability has been precarious, with increases in average tariffs, lagging increases in operating costs and substantial nonpayment problems. This situation occurred despite the steady improvements in labor productivity and generation capacity. It hinders the mobilization of the investment funding needed to increase power supply in line with the increase in demand.

High tariff costs. According to the research conducted by the IMF, the average cost of electricity in Sub-Saharan Africa is about USD 0.20 - 0.50 per kilowatt hour. This is very high compared to the global average power tariff cost of USD 0.10 per kilowatt hour. The high cost of power has been attributed to inefficiencies in the power companies, high use of costly emergency power generation, low economies of scale in generation and limited regional integration.

Untapped generation potential. Given the environmental landscape, the power generation potential is still relatively untapped when compared to other developing countries. Geothermal energy currently accounts for about 50% of Kenya's total installed generation capacity while unexploited geothermal resources are estimated to be between 7,000MW to 10,000MW in the Rift Valley province alone.

Unreliability. This is brought about by the fluctuating level of hydrology resulting in the use of thermal generators, which run on fuel, to substitute and provide for the difference. This fuel cost is passed through to the consumer which results in the high tariff costs in the country.

Increased system energy losses. System losses occur during the distribution of electricity to the consumer. This is discussed in greater detail in the Kenya Power section.

Environmental sustainability Indicatively, generation from renewable sources accounts for approximately 90%. Thermal power generation has declined recently to reduce carbon emissions which have considerable effects on the environment.

Energy sector in 2021: the green recovery

The Covid-19 pandemic upended energy markets in 2020 with lockdowns, crimped industrial activity and restrictions on travel causing global energy consumption to contract by an estimated 4%. Power uptake was adversely affected with demand dropping significantly. In 2021, the World Bank forecasts that energy will rebound by 2.6%, as global GDP growth returns.

The world remains in the grip of the Covid-19 pandemic and a seemingly accelerating pace of climate change. Worldwide efforts to slow the pace of climate change will have clear benefits in slowing the impact of global warming. On the other hand, carbon taxes and the removal of fossil fuel subsidies, along with possible addition of levies on electricity bills, could add to the cost of electricity and fuels, leading to affordability challenges for large portions of the population.

Kenya's power sector is set to undergo a dramatic change in the energy mix by 2030, with geothermal set to overtake hydro power as the dominant source of electricity. Overdependence on hydro power generation has resulted in supply disruptions during periods of drought, with costly thermal sources being used to boost output. As a result, the government aims to introduce coal as well as gas-fired capacity into the power generation mix. The government's vision 2030 strategy also stipulates the development of nuclear energy as a viable means of providing the much-needed reliable and affordable electricity.

Economic growth and electricity growth

The country has continued to scale up electricity production mainly from renewable sources. As the graph below shows, electricity consumption has a direct correlation with GDP growth. An efficient and cost effective energy sector is the driving force for growth of any economy. As the GDP of the country grows, so does the electricity consumption.

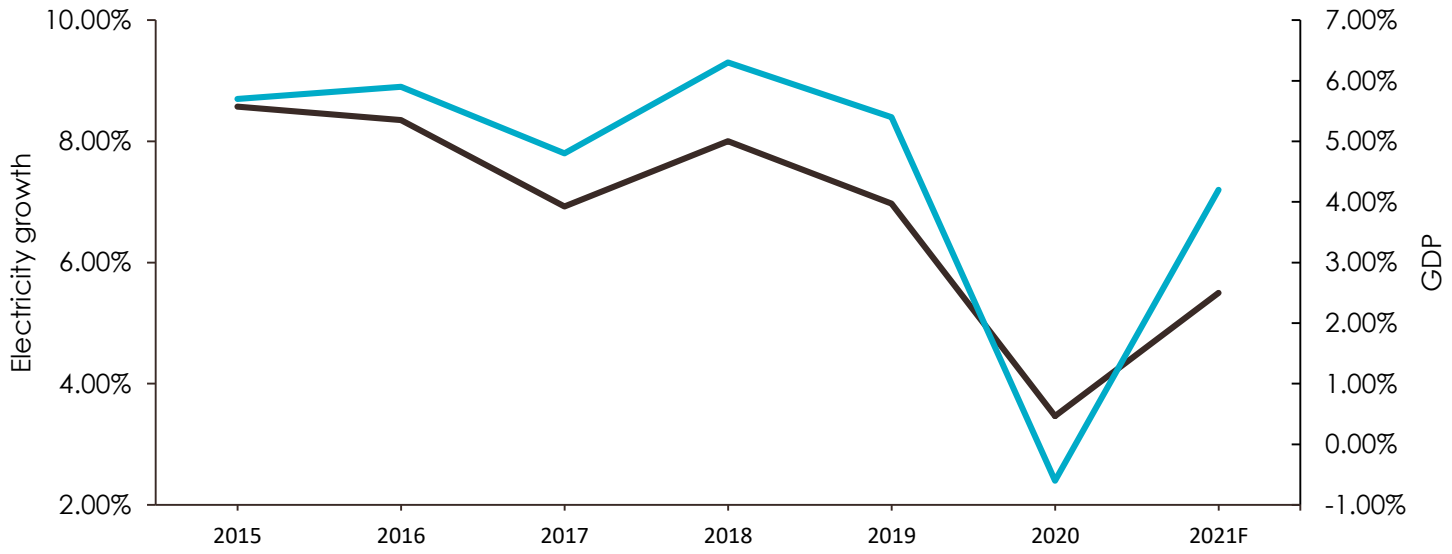

Figure 1: Annual GDP and electricity growth Rates *Source: KNBS and NCBA IB research*

Industrialization and manufacturing sector growth

Energy is a key input to any production process. As the economy grows, increased production capacity by industries lead to a surge in electricity demand. Peak demand reached 1,999MW in the FY2021 surpassing the pre-Covid peak of 1926MW (February 2020).

Infrastructure projects

The energy and infrastructure sectors recorded a slowdown in growth from a five-year average of 7.8% to 1.3% in 2020 as a result of the Covid-19 pandemic. The government's continued pursuit to complete flagship development projects provides ready demand for electricity consumption.

Finance Bill and 2021/2022 Budget

The energy and infrastructure sectors were allocated KES 182.5Bn and KES 71.9Bn, respectively in the 2021/2022 budget (up from KES 172.4Bn and KES 63.3Bn allocated in the previous financial year).

Further, the Finance Bill proposed VAT exemptions for taxable goods excluding motor vehicles imported or purchased for direct and exclusive use in geothermal, oil or mining prospecting or exploration and specialized equipment for the development and generation of solar and wind energy.

The factors above are expected to complement growth of up to 5.0% in the sector that will primarily be driven by the resumption of large-scale infrastructure projects such as the Jomo Kenyatta International Airport (JKIA)-Nairobi railway line and the JKIA–Westlands Highway.

Kenya Power

Company description

Kenya Power and Lighting Company Plc, is a public company domiciled in the Republic of Kenya. It was incorporated on 6 January 1922, as East Africa Power & Lighting Limited. The Company changed its name to Kenya Power and Lighting Company on 11 October 1983.

The core business of the company continues to be the distribution and retail of electricity purchased in bulk from Kenya Electricity Generating Company Plc (KenGen), Independent Power Producers (IPPs), Uganda Electricity Transmission Company Limited (UETCL) and Tanzania Electric Supply Company Limited (TANESCO).

The shares of the company are listed on the Nairobi Securities Exchange. The Government of Kenya is the principal shareholder in the Company holding a 50.1% equity interest.

Shareholding structure	Ordinary shares	4% Pref.	7% Pref.	Percentage
The National Treasury	977,641,695	656,808	193,531	50.09%
Standard Chartered Nominees Accounts	113,107,414	-	-	5.79%
Kenya Commercial Bank Nominees Accounts	46,771,827	-	-	2.40%
NIC Custodial Services Accounts	24,273,199	-	-	1.24%
Stanbic Nominees Accounts	23,354,238	-	-	1.20%
The Jubilee Insurance Company Limited	20,315,096	59,828	17,160	1.04%
Suresh Naran Ratna Varsani	17,221,225	-	-	0.88%
Naran Khimji And Virji Khimji Hirani	17,080,964	-	-	0.87%
Mahendra Kumar Khetshi Shah	13,458,000	-	-	0.69%
Ramaben Sumantrai Pursottam Patel	10,397,300	-	-	0.53%
John Njuguna Ngugi	7,987,800	-	-	0.41%
Other Shareholders	679,858,287	1,083,364	139,309	34.86%
Grand Totals	1,951,467,045	1,800,000	350,000	100.00%

Figure 2: Shareholder composition ***Source: Company financials and NCBA IB research***

Key Themes

Power Purchase Agreements (PPA's)

The FY21 financial results reflect costs of sales of KES 94.2Bn (KES 87.5Bn in FY20). This includes KES 49.2Bn which relates to capacity charges accordant with power purchase agreements with Independent Power Producers (IPP's). These charges account for 52% of the total cost of sales and considering their fixed nature, adversely affect the company's performance resulting in losses.

The basic power purchase costs according to source in FY2021 were as follows:

Source/Power producer	Power purchase costs (MM)	Units purchased (GWh)	Purchase Cost per unit
KenGen	41,142.19	8,443	4.87
Lake Turkana Wind Power	17,337.24	1,559	11.12
OrPower 4 Inc.	11,895.50	981	12.13
Rabai Power Limited	2,948.80	266	11.09
Triumph Power Generating Company Limited	2,621.27	22	119.15
Tsavo Power Company Limited	2,478.62	183	13.54
Thika Power Limited	2,394.76	93	25.75
Gulf Power Limited	2,207.28	21	105.11
Uganda Electricity Transmission Company Ltd	2,095.16	192	10.91
Iberafrica Power (E.A.) Company Limited	1,765.09	45	39.22
Kipeto Energy Plc	1,137.97	88	12.93
Garissa Solar Power Plant	515.18	86	1.76
Regen-Terem	223.63	22	10.17
Metumi Power Plant	118.22	14	8.44
Ethiopia Electric Utility	108.91	5	21.78
Gura	97.83	11	8.89
Power Technology Solutions Limited	19.22	2	9.61
Selenkei Solar Farm	14.47	1	14.47
Chania Power Limited	10.53	1	10.53
Hydro Project Services Peters	4.10	-	-
Biojoule Kenya Limited	3.60	-	-
Imenti Tea Factory	2.74	-	
Strathmore University	1.20	-	

Figure 3: Power purchase costs ***Source: Company Financials, NCBA IB Research***

The government is keen on delivering on its promise of cheaper power in the country. However, lower tariffs to consumers, with generation costs remaining unchanged, points to lower profit margins. Considering the lower-than-expected demand growth, the company is pursuing rescheduling of planned generation capacity projects to maintain an optimal power demand supply balance. On 29th September 2021, the government indicated that plans are underway to re-negotiate the high fixed capacity charges on the existing power purchase agreements. New projects in the pipeline whose PPA's have not been approved, face the threat of lower capacity and/or energy revenue.

System losses

The national grid is operated as an integrated network linked by a transmission system. The grid is one of the main challenges for Kenya Power - its limited number of transmission lines and deficiencies lead to frequent power outages as well as technical and non-technical losses. Over the past five years, the power distribution network has expanded considerably in tandem with the rapid pace of new electricity connections. The extended network and growth in customer numbers has led to a consequent increase in system losses as shown in the table below;

	FY17A	FY18A	FY19A	FY20A	FY21A
System losses (GWh)	1,932	2,244	2,724	2,689	2,899
Percentage (%)	18.9%	21%	23.69%	23.46%	23.95%

Figure 4: System Losses ***Source: Company Financials, NCBA IB Research***

These losses contribute to high power charges to consumers given that the industry regulator allows the company to charge up to 19.9% of the power losses to consumer. Through ongoing system upgrades, Advanced Metering Infrastructure (AMI) and energy balancing, the company expects to achieve reduction in system losses from the current 23.95% to the allowable level of 19.9%, as determined by the regulator, by 2025. Reduced system losses would have immediate positive impact on sales, revenue and business sustainability.

Working capital challenges

Over the past five years, risk has manifested in the business through inconsistent cash flows. The company has reported a negative working capital position for the past five consecutive years attributable to persistent increase in trade payables (average increase rate of 13%). Moreover, the current ratio has consistently been less than the required regulatory threshold. This indicates that a material uncertainty exists, which casts significant doubt on the company's ability to continue as a going concern. In the financial year 2021, the company reported current liabilities of KES 116.1Bn, exceeding its current assets of KES 49.6Bn by KES 66.5Bn.

	FY17A	FY18A	FY19A	FY20A	FY21A
Working capital (MM)	(23,788.66)	(56,012.99)	(70,969.86)	(74,848.82)	(66,479.17)
Current ratio	0.69	0.47	0.39	0.36	0.43

Figure 5: working capital positions ***Source: Company Financials, NCBA IB Research***

The company has obtained waivers from the Capital Markets Authority (CMA) for breach of the current ratio and is cognizant of the fact that achieving the covenanted position on the ratios may be infeasible in one year. It has initiated discussions with key lenders on a potential review of the debt covenants as well as seeking debt repayment moratoria and debt restructuring.

Our view:

A rocky path lies ahead as the company seeks to restructure its operations and change its administration to implement critical and far-reaching reforms. The inefficiencies highlighted, especially the power purchase agreements, will be a major turning point for the company. If the firm succeeds in ameliorating its inefficiencies, it will be in a good position to capitalize on electricity demand growth driven by GDP growth, key infrastructure projects and increased industrialization.

Financial performance

Kenya Power condensed Income Statement KES 'MM

	FY17	FY18	FY19	FY20	FY21
Electricity sales post-paid	91,952	95,435	95,753	98,355	105,349
Electricity sales pre-paid	-	-	16,676	17,818	20,578
Foreign exchange adjustment	6,683	9,322	860	924	6,333
Fuel cost charge	22,108	26,622	19,852	16,162	11,860
Total Revenue	**120,742**	**131,379**	**133,141**	**133,259**	**144,120**
Power purchase costs	(80,477)	(84,100)	(90,152)	(87,499)	(94,220)
Gross Profit	**40,265**	**47,278**	**42,989**	**45,759**	**49,900**
Net operating expenses	(34,745)	(44,541)	(41,043)	(47,834)	(39,861)
Operating Income	**5,520**	**2,738**	**1,945**	**(2,075)**	**10,039**
Other income	8,130	9,178	8,586	7,387	7,046
Operating profit	**13,651**	**11,916**	**10,531**	**5,312**	**17,085**
Finance income (Net)	(5,994)	(6,948)	(10,197)	(12,354)	(8,887)
Profit before tax (PBT)	7,657	4,968	334	(7,042)	8,198
Income tax (charge)/credit	(2,376)	(1,700)	(72)	6,103	(6,708)
Profit after tax (PAT)	**5,280**	**3,269**	**262**	**(939)**	**1,490**
EPS	2.71	1.67	0.13	(0.48)	0.76
DPS	0.50	0.00	0.00	0.00	0.00

Kenya Power condensed Balance sheet KES 'MM

	FY17	FY18	FY19	FY20	FY21
ASSETS					
Property, plant and equipment	262,348	273,377	277,067	276,860	277,305
Other non-current assets	7,595	8,658	6,717	5,781	5,290
Inventories	9,626	9,745	9,835	4,831	5,896
Trade receivables	40,794	35,220	30,111	33,815	37,683
Other current assets	655	492	481	539	510
Cash and cash balances	2,942	4,777	4,284	3,442	5,547
Total assets	**323,960**	**332,269**	**328,495**	**325,267**	**332,230**
EQUITY AND LIABILITIES					
Total Equity	58,398	60,622	56,231	54,897	57,174
Non-current Borrowings	111,075	96,929	92,615	94,957	91,043
Other non-current liabilities	76,681	68,471	63,968	57,938	67,899
Current trade Payables	57,545	71,259	81,196	88,503	91,522
Current Borrowings	9,918	15,788	18,768	15,004	15,947
Other current liabilities	10,343	19,200	15,716	13,969	8,645
Total Equity and Liabilities	**323,960**	**332,269**	**328,495**	**325,267**	**332,230**

Source: NCBA IB Research Estimates, Company Financials

Key Results Highlights FY'21

- **Profitability.** Profit before tax rose to KES 8.198Bn compared to a loss before tax of KES 7.042Bn the previous year, an increase of KES15.240Bn.
- **Unclear dividend policy dampening investor appetite.** The company has not paid dividends in four consecutive years.
- **Finance costs decline, but the absence of finance income results in net finance loss.** Finance costs reduced from KES12.477Bn to KES 9.050Bn following the partial conversion of overdrafts and continued repayment of commercial loans. In addition, the unrealized foreign exchange losses reduced due to prudent planning of foreign exchange transactions.
- **Negative working capital position.** The company has remained in a net current liability position for the fifth consecutive year. Working capital remained adverse in FY21 at KES 66.5Bn. This is however an improvement of 12.6% from the previous financial year.
- **Increase in power purchase costs**. Power purchase costs rose by 7.7% to KES 94.22Bn in the year attributable to cost of power disparities between the cost of power procured from KenGen and IPP's. The effective unit cost of power purchased from IPP's was as high as 119 per KWh while the same was sold at an average of KES 15.66 per Kwh.

Valuation

We derive our target price using price to book (P/B) target price to arrive at a 12-month target price of KES 1.14, implying a downside of 39% to the current trading price of KES 1.88.

Valuation summary	
Estimated Fair Value	**1.14**
Current price	1.88
Downside	(39%)

P/B Valuation	
Adjusted P/B Multiple	0.46
Book value	4,835.67
Fair value of equity	2,224.41
Estimated Fair value	1.14

Source: Company financials, NCBA IB Research Estimates

Financial Forecasts

Income Statement	FY22F	FY23F	FY24F	FY25F	FY26F
Electricity sales post-paid	110,525	115,956	121,654	127,631	133,903
Electricity sales pre-paid	22,877	25,433	28,274	31,432	34,943
Foreign exchange adjustment	1,040	1,103	1,169	1,240	1,317
Fuel cost charge	12,564	13,316	14,120	14,980	15,902
Total Revenue	**147,006**	**155,807**	**165,217**	**175,284**	**186,065**
Power purchase costs	(96,901)	(102,702)	(108,904)	(115,540)	(122,646)
Gross Profit	**50,106**	**53,105**	**56,313**	**59,744**	**63,418**
Net operating expenses	(43,153)	(45,715)	(48,455)	(51,386)	(54,525)
Operating Income	**6,953**	**7,390**	**7,858**	**8,358**	**8,894**
Other income	7,974	8,451	8,961	9,508	10,092
Operating profit	**14,926**	**15,841**	**16,819**	**17,866**	**18,986**
Finance income (Net)	(11,296)	(11,972)	(12,695)	(13,469)	(14,297)
Profit before tax (PBT)	3,631	3,869	4,124	4,397	4,689
Income tax (charge)/credit	(1,997)	(2,128)	(2,268)	(2,418)	(2,579)
Profit after tax (PAT)	**1,634**	**1,741**	**1,856**	**1,979**	**2,110**
EPS	0.84	0.89	0.95	1.01	1.08

Statement of Financial Position	FY22F	FY23F	FY24F	FY25F	FY26F
ASSETS					
Non-current assets	292,315	297,456	302,706	308,065	313,535
Current assets	59,477	71,558	84,749	99,148	114,865
Total assets	**351,792**	**369,013**	**387,454**	**407,214**	**428,399**
EQUITY AND LIABILITIES					
Total Equity	59,596	62,212	65,036	68,087	71,382
Non-current liabilities	171,311	179,197	187,629	196,651	206,311
Current liabilities	120,885	127,604	134,789	142,476	150,706
Total Equity and Liabilities	**351,792**	**369,013**	**387,454**	**407,214**	**428,399**

Cash Flows	FY22F	FY23F	FY24F	FY25F	FY26F
Cash from operating activities	39,180	49,137	60,106	73,833	90,114
Cash used in investing activities	(20,274)	(22,550)	(25,084)	(27,905)	(31,047)
Cash from Financing activities	(14,904)	(18,912)	(24,483)	(32,422)	(40,469)

Key Ratios	FY22F	FY23F	FY24F	FY25F	FY26F
Debt-Equity ratio	208%	211%	214%	217%	220%
Current ratio	0.49	0.56	0.63	0.70	0.76
Return on Assets	0.46%	0.47%	0.48%	0.49%	0.49%
Return on equity	2.74%	2.80%	2.85%	2.91%	2.96%

Source: Company financials, NCBA IB Research Estimates

About NCBA Investment Bank

NCBA Investment Bank is a subsidiary of NCBA Group. The services offered by the brokerage department include equities trading for listed securities, fixed income trading for both corporate and government bonds, Over the Counter (OTC) equity transactions as well as execution of equities transactions across the East African countries. Additionally, NCBA Investment Bank backs these activities with solid advice from the research team to enable investors meet their return objectives. NCBA Investment Bank deploys simple and convenient client driven technologies, robust risk management, highly competent and experienced staff and has the backing of robust research capabilities to differentiate itself from other players in the market.

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Certification

The following analyst who prepared this research report: Victoria Mututu hereby certifies that:

(i) all of the views and opinions expressed in this research report accurately reflect the research analyst's(s') personal views about the subject investment(s) and companies (y) and

(ii) no part of the analyst's compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed by the analyst in this research report.

Rating Definitions

STRONG BUY – Total expected 12-month return (incl. dividends) greater than 20%
BUY-Total expected 12-month return (incl. dividends) between 10%- 20%
HOLD – Total expected 12-month return (incl. dividends) between 0%-10%
SELL – Total expected 12-month return (incl. dividends) less than 0%

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