EQUITY RESEARCH

Bloomberg: **APAF** <GO>

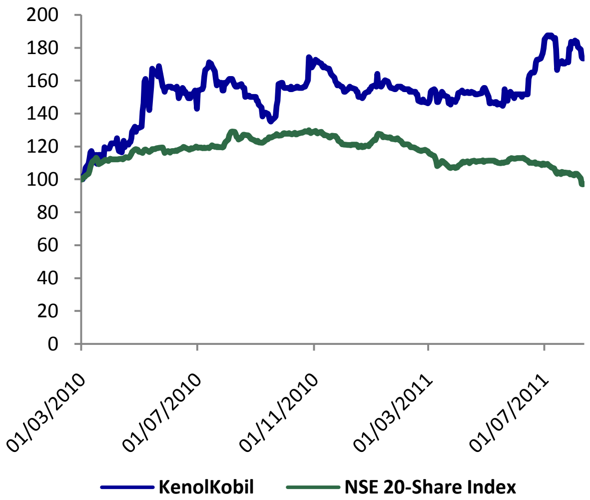
ApexAfrica CAPITAL LTD
Member of Nairobi Stock Exchange

KenolKobil
Fuelling Shareholder **value**

We initiate our coverage of KenolKobil with a **BUY** recommendation and advise investors to increase their exposure to this stock based on our 12-month price target of 15.92, a 53.08% upside from the current price levels. At a price-to-book value (PBV) of 1.39x, we hold the view that the stock's price discovery process has consistently stagnated with the market's 'imperfect' valuation paradigm often failing to price in the underlying strong earnings potential. KenolKobil, in its pursuit for value, has continually demonstrated high appetite for high yielding markets while at the same time protecting and enhancing shareholder wealth; in this breadth, we hold the view that a combination of the on-going geo-diversification strategy and focus on high yielding business lines will continue to demonstrate KenolKobil's resilience in the face of sectoral risks locally; and a summation of the above stands to potentially trigger an upward re-rating of the stock.

- ✓ KenolKobil's turnaround strategy that can be traced back 12 years ago has yielded a two-pronged approach that has continued to re-emphasize topline and midline turnaround; we expect significant margin growth as a result and we specifically see a 42.80% EPS upside in the FY2011/12 period. This will substantially enhance the quality of the Return on Equity "RoE" and coupled with a clearly spelt out payout policy, we project a 45.63% growth on average terms in free cash flow attributable to equity holders over the next 2 years; additionally, we see FY2011 dividend yield hovering in the region of 6.92%.
- ✓ Amidst the underlying sectoral risks in Kenya, KenolKobil continues to demonstrate high level resilience by continually de-emphasizing Kenya's contribution to its group performance; the company has consequently dropped the 'country contribution' view of its numbers and is adopting the 'business-line contribution' approach to its performance with more focus on certain niche business lines. We specifically remain bullish on its Mozambique trading desk and the Zambian business and see both units fuelling significant margin growth.
- ✓ Our back of the envelope calculations suggest gross margins could grow in the count of 11.29% in compounded terms over the next 5 years; additionally, trickle-down effects could see both EBITDA and net margins return 4.63% and 2.43% performances respectively in FY2011.

Date	16th Sept 2011
Bloomberg Ticker	KNOC KN
Key Statistics	
Price	10.40
Shares Oustanding	1,471.761mln
Market Cap (KES)	15,306.30mln
Market Cap (USD)	176.453mln
Year End	31st December
Free Float	32.23%
Trailing EPS (KES)	1.21
Forward PE	5.39
Trailing PE	8.62
Dividend Yield	5.00%
Returns	
3 Months	14.43%
6 Months	18.09%
12 Months	10.45%
Website:	www.kenolkobil.com



Share Price (Normalized) Source: Bloomberg

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Sectoral Overview

Although Kenya's oil sector is fully liberalised (ex-pricing), the sector continues to tread on 'cyclic' structural inefficiencies with the main players being the Kenya Petroleum Refineries Ltd "KPRL" and the Kenya Pipeline Company "KPC".

"KPRL"

This is a joint venture between the Government of Kenya "GoK" and Essar of India; the Government of Kenya owns 50% of the company's equity and the other 50% is held by Essar Energy Overseas Limited. The refinery's principal activity remains the conversion of crude oil to its respective oil products some of which include:

- ✓ Liquid Petroleum Gas (LPG)
- ✓ Premium Petrol
- ✓ Dual Purpose Kerosene
- ✓ Automotive Gasoil
- ✓ Fuel Oil

Additionally, all oil marketers are required to process about 65% of their requirements through KPRL.

Refinery Production

In the period through January to March 2011 alone, KPRL processed a total of 477, 397 metric tons of crude oil (Source: PIEA).

CRUDE OIL	INTAKE	%
Murban	472,399	98.95
Slops	4,998	1.05

Source: PIEA

Crude Imports: January-March 2011

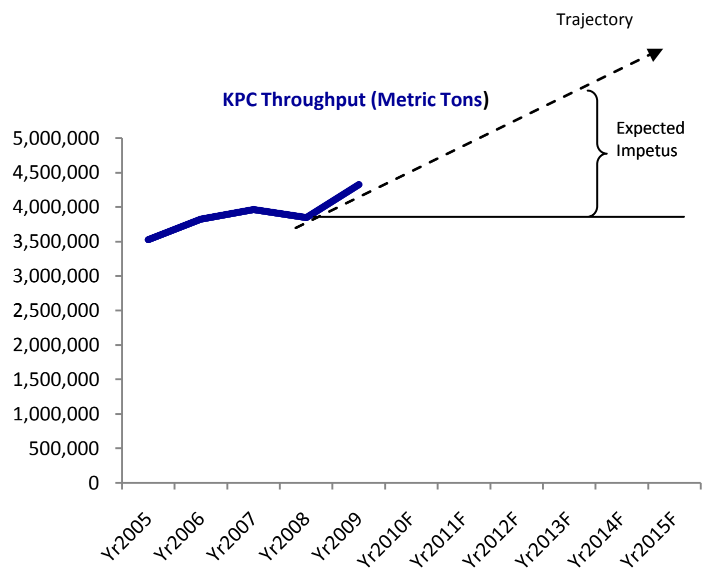
Importer	Metric Tons	%
KenolKobil	245,551	43.15
Gulf Energy	82,029	14.42
Essar	81,822	14.38
Addax Kenya	81,532	14.33
Galana Oil Kenya	78,086	13.72
TOTAL	**569,020**	**100.00**

Source: PIEA

We hold the opinion that KPRL has more headroom to re-invent itself and cement its position as the only refinery within the larger Eastern Africa region. Although privatization was largely meant hasten modernization, we find the process notoriously falling behind schedule even as demand for crude products in the East Africa region continues to outweigh supply. Further, downstream oil marketers continue to adjust upwards their pricing paradigms in a bid to factor in 'inefficiency premiums' that span from delays in unloading crude to 'imbalanced' ullage allocations. Amidst all the inherent inefficiencies, KPRL hiked its crude processing fees by about 17.35% in 2008 in a move that irked KenolKobil. This matter was the subject of a prolonged court battle as both parties 'locked horns'; KPRL claimed cumulative arrears amounting to Kshs.600mln versus KenolKobil's claim of Kshs.5.3bn in damages. In early 2011, an out of court settlement was reached between both parties after dumping their 'hardline' positions.

"KPC"

The Kenya Pipeline Company Limited is a State Corporation whose principal objective remains providing efficient, reliable, safe and cost effective means of transporting petroleum products from Mombasa to Nairobi and Western parts of the country. KPC operates the pipeline system that transport refined oil products from Mombasa to the hinterland. KPC's installed flow rate stood at $440M^3$ per hour, translating to deliveries of 3.85billion litres per year. KPC's installed pipeline system currently operates at 100% utilization and the company has embarked on an expansion drive that will see flow rate double to $880m^3$/hr.



Source: KPC

The Future: Is less Government good Government?

Industry players continue to reiterate their positions that time is ripe for the Government to 'de-invest' its stake in the oil sector. But it remains a classical dichotomy for the Government; between aiding KenolKobil enhance its shareholder wealth and protecting the consumer rights of its populace. We hold the opinion that Government should reduce its role to equilibrating 'supply side' dynamics and more specifically cement its role as the infrastructure provider. Most multinational oil corporations, and more recently BP, have exited the low yielding downstream operations in African markets; Shell is pulling out of the downstream market in 21 African countries to concentrate on the upstream mining and exploration. On the flipside, there exists some upside to the 'indigenous' giants like KenolKobil; the firm was part of a consortium that bought Shell's (Ex-Agip) assets in Ethiopia and Rwanda. It also saw a joint venture (50:50) with Engen to acquire the whole operations in Zimbabwe from Shell/BP blocked on the 'indigenization law' grounds.

The Company

KenolKobil Limited (formerly Kenya Oil Company Limited, "Kenol") was founded and incorporated as a private Limited Company in Kenya on May 13th 1959 and subsequently became a public company in September of the same year. The company's name changed from Kenya Oil Company Ltd to KenolKobil Ltd in June 2009 after acquiring Kobil Kenya Ltd's assets.

Background:

Kobil Petroleum Ltd "Kobil" acquired what were the assets of Mobil Oil in Kenya and Uganda in 1984 (which was a private company domiciled in Delaware, US). It became a wholly owned subsidiary of Kenol effective January 2008 and ceased to operate as a separate legal entity on 1st July 2011. In December 2007, Kenol acquired 100% shares of Kobil and effectively became KenolKobil. (Source: KenolKobil).

Top 10 Shareholding

Name	No. of Shares	%
Wells Petroleum Holdings Ltd	366,614,280	24.91%
Petroholdings Ltd	255,211,080	17.34%
Highfield Ltd	183,350,000	12.46%
Chery Holding Ltd	128,204,000	8.71%
Energy Resources Capital Ltd	88,185,720	5.99%
CFCStanbic Nominees (K) Ltd A/C NR13302	28,866,200	1.96%
StanChart Nominees Non-Resd A/C 9867	23,132,700	1.57%
KenolKobil ESOP	9,000,000	0.61%
KCB Nominees Ltd A/C 769G	8,603,610	0.58%
CFCStanbic Nominees Ltd A/C R48703	8,362,700	0.57%

Source: KenolKobil

1HY 2011 Perfomance Review

KenolKobil reported its half year performance for the 6-months period to 30th June with headline EPS surging to Kshs.1.47, (up 261.23%h/h; up 82.88%y/y). Key highlights:

- ✓ Group's sales recorded a 101.19%h/h; 38.05%y/y performance at Kshs.83.31bn, further underpinning the resilience of its operations despite price caps in Kenya, steep surge in global crude prices and weakening local currencies against the US dollar.
- ✓ Cost of sales grew 101.68%h/h; 36.53%y/y at Kshs.76.57bn while prudent management of distribution chains saw distribution costs return an impressive 6.10%h/h;-3.53%y/y performance at Kshs.527mln.
- ✓ Gross profit posted a 58.10%y/y growth at Kshs.6.74bn, driving up gross margins to 8.09% compared to 7.07% in FY2010 (14.52%y/y).
- ✓ The depreciating local currencies in which KenolKobil operates, and especially the Kenya Shilling, saw finance costs surge 85.47%y/y at Kshs.1.34bn.
- ✓ Profit before tax surged 233.57%h/h; 85.80%y/y to Kshs.3.22bn; and we also took delight in the firm's improving net margins which returned a 115bps upside (half-on-half) at 2.59%.

Statement of Comprehensive Income

Kshs. '000	1HY 2010	2HY 2010	1HY 2011
Sales	60,349,692	41,411,111	83,313,342
Cost of Sales	(56,085,214)	(37,967,334	(76,571,167
Gross Profit	4,264,478	3,443,777	6,742,175
Gross Margin	7.07%	8.32%	8.09%
Operating Profit	2,377,945	1,289,507	4,509,661
operating margin	3.94%	3.11%	5.41%
Profit before Tax	1,732,111	964,784	3,218,200
Income tax expense	(552,619)	(367,636)	(1,061,149)
Profit for the period	1,179,492	597,148	2,157,051
Net margin	1.95%	1.44%	2.59%
EPS	0.80	0.41	1.47

Source: ApexAfrica

Statement of Financial Position

Kshs. '000	2HY 2010	1HY 2011
Share Capital	73,588	73,588
Share Premium	5,166,350	5,166,350
Other Reserves	244,494	463,801
Retained Earnings	6,455,764	7,775,235
Proposed Dividends	765,316	838,904
Equity	12,705,512	14,317,878
Non-Current Liabilities	631,711	618,573
Equity+Non-Current liabilities	13,337,223	14,936,451
Non-Current Assets	6,154,562	6,324,130
Current Assets	26,062,068	39,786,666
Current Liabilities	18,879,407	31,174,345
Net Current Assets	7,182,661	8,612,321

Source: ApexAfrica

Group Overview:

1. Retail Operations

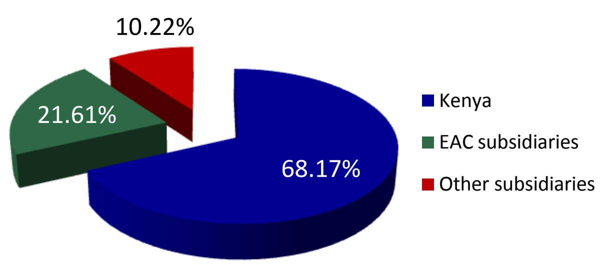
The group has 20 terminals from which it supplies its network of stations distributed as follows:

- ✓ **Kenya:** Is the only country in which it operates the KenolKobil brand. It operates as Kobil in other African subsidiaries. It currently has 89 stations under the Kobil brand and a further 67 stations under the Kobil brand.
- ✓ **Kobil Tanzania:** has been in operation since 2001 and currently commands 27 stations; the company projects 30 stations by end of FY2012.
- ✓ **Kobil Uganda:** Has been in operations since 2000 with the current stations numbering 64.
- ✓ **Kobil Zambia:** it has maintained its Zambian presence since 2002 with total stations numbering 25 and projects 30 stations by end of FY2012.
- ✓ **Kobil Rwanda:** it commenced operations in 2003 and currently has 46 stations.
- ✓ **Kobil Ethiopia:** commenced Ethiopian operations in April 2007 and it currently has 65 stations; the company projects the number to rise to 70 by end of FY2012.
- ✓ **Kobil Burundi:** the youngest acquisition having commenced operations in September 2010 with stations currently numbering 17.

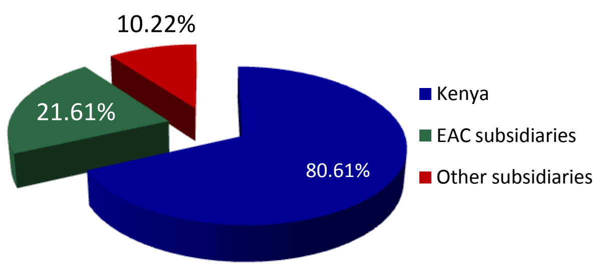
The company projects its total stations to rise to 413 by end of FY2012 purely from organic growth, up from the current 400 stations.

Bottomline Contribution

FY2009 Net Profit Contribution



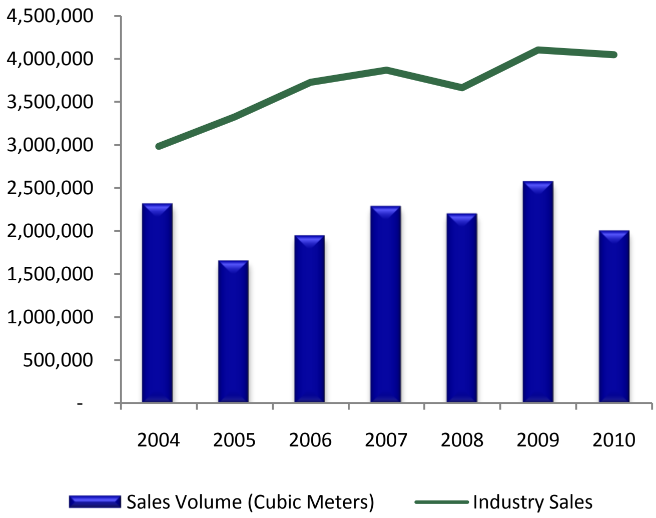
FY2010 Net Profit Contribution



Source: KenolKobil

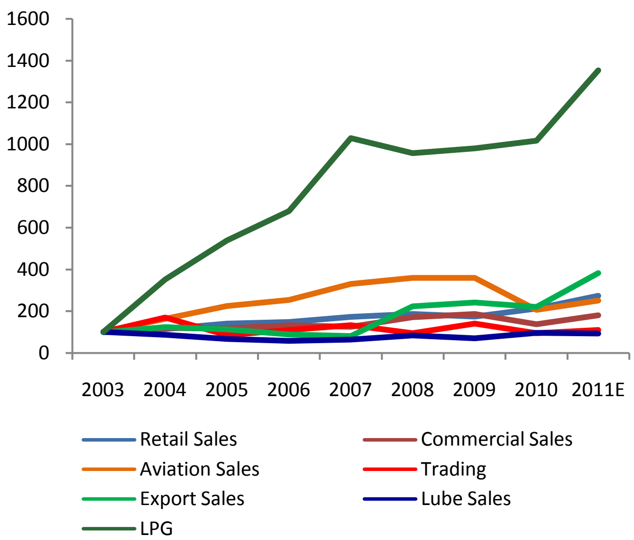
2. Sales Perfomance

KenolKobil has continued to deliver strong sales performance on a consistent basis with group sales volume (in cubic meters) returning a 91.81% performance in compounded terms over the last 17 years to FY2010. We project sales volume to deliver a 24.71%y/y performance for the FY2011 supported by increased business lines and the continued regional expansion drive.



Source: KenolKobil and PIEA

3. Business Lines Perfomance



Source: KenolKobil

The graph above demonstrates KenolKobil's diversification strategy over the last decade and their respective performance rates. Lubes perfomance has continued to tower above other product lines over the same period both in terms of margins and 'push-out' volumes.

Value Drivers

1. Margins

We expect the company's focus on both topline and midline to deliver table-topping margins among its peers. KenolKobil has continued to deliberately de-emphasize the low margin commercial and aviation sales over time and shift more focus to the high margin business lines like lube sales, LPG and its non-fuel business; and as we demonstrated in our 'business line performance' graph, the efforts seem to be paying off with Lube sales delivering a towering performance above other product lines. Management has also indicated its intentions to scale down its aviation exposure and specifically to the JET A-1 fuel as margins retreat principally due to the 'pricing differentials' in the aviation business. However, the company intends to deepen the low margin African trading desk by enhancing volumes in a typical 'trade-off' move. We specifically see gross margins returning a 2.24% performance in compounded terms over the next 2 years; additionally, we project FY2011 operating margins to rise in the count of 103bps at 4.63%.

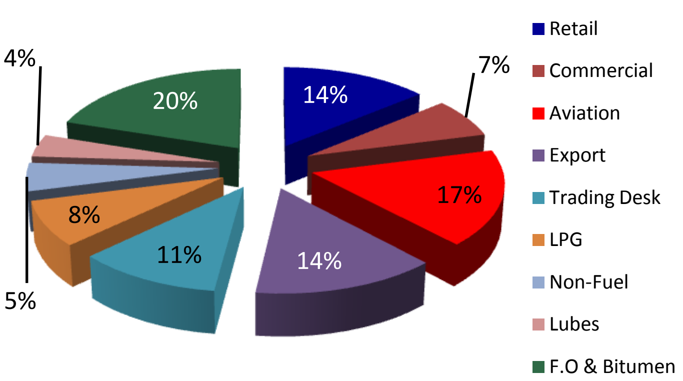
	2009	2010	2011F	2012F	2013F
Gross Margin	6.24%	7.57%	8.49%	9.07%	10.16%
Operating Margin	2.47%	3.60%	4.63%	5.53%	6.72%
Net Margin	1.34%	1.75%	2.43%	2.99%	3.72%

Source: ApexAfrica estimates

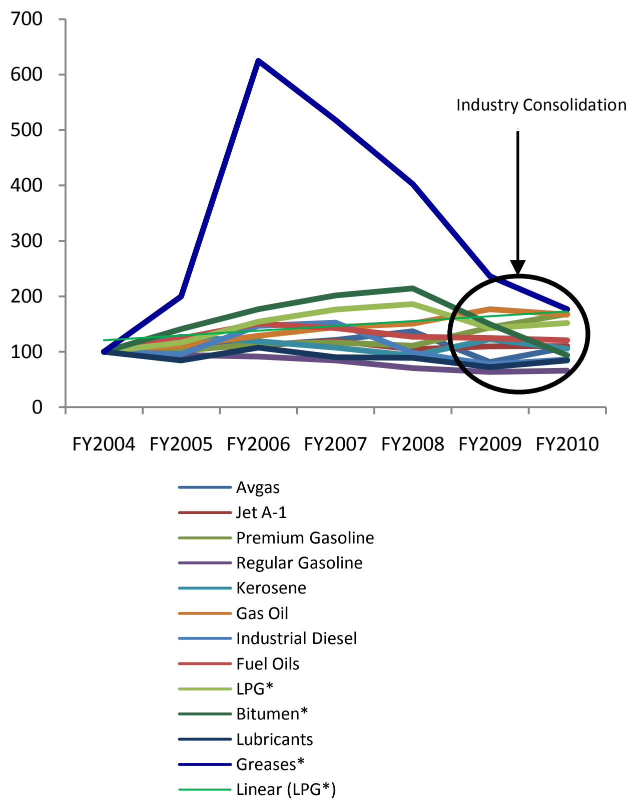
2. Continued diversification of the product-line 'basket'

We view this in a two-pronged context: continued regional expansion and the widening of product portfolio to de-risk earnings in the face of current industry turbulence.

'Product basket' and contribution to PBT as at 1HY 2011



Source: KenolKobil



Source: KenolKobil

The above graph demonstrates KenolKobil's well diversified product basket and their contribution to the bottomline as at 30th June 2011. We see this 'basket' offering more support to earnings stability going forward coupled with the company's continued focus on niche business; additionally, we introduce a base case for diversified basket as a correlation factor of sectoral risks of 0.50 (1 representing a high correlation).

Further, as demonstrated in the graph below, Kenya's petroleum sales has continued to stabilize as the industry consolidation 'troughs out'. We expect KenolKobil to bask in this while growing its topline numbers; we specifically see sales delivering 18.46% performance in compounded terms over the next 5 years. However, all these efforts will likely come at a cost with Cost Sales projected to post a 17.06% growth in compounded terms over a similar period.

Downside Potentials:

- ✓ High levels of crude prices are expected to prevail and will likely become part of the Oil industry. This in turn will continue to drive inflation up across the countries the group operates in; net effect would be a slowdown in demand. Murban crude prices have surged 49.93%y/y as at June 2011 while prices of most of the refined products jumped 30% in 2010.
- ✓ We hold the view that the current pricing regime enforced by the Ministry of Energy through the Energy Regulatory Commission (ERC) will also serve to limit the 'pass-on' effects of additional costs incurred due to the structural inefficiencies in both the KPRL's and KPC's systems.
- ✓ The sustained weakening of a basket of local currencies in countries where the group has presence will likely see finance costs surge going forward. The Kenya Shilling, for instance, has returned a -19%

perfomance on a YTD basis. As at HY 2011, the group's finance costs surged 238.62%h/h; 85.47%y/y as the effects of the depreciating Kenya Shilling versus a basket of major global currencies continued to bite. We project finance costs to stay high and we specifically see a further 50.59%y/y rise in FY2011.

Regional Peer Comparison:

	YTD Ret (%)	Mkt Cap (KES Bn)	P/E	ROE LF
AVERAGE	-12.27	15,030	12.23	-0.90
KENOLKOBIL LTD GROUP	**15.64**	15,306	**8.62**	**13.98**
PETROCELTIC INTERNATIONAL	-65.57	16,326		-3.94
PURE ENERGY SERVICES LTD	15.58	16,201	15.33	3.83
FORBES ENERGY SERVICES LTD	42.86	16,176		-2.28
EASTERN PACIFIC INDUS CORP	27.80	16,054	9.37	15.34
PANORO ENERGY ASA	-51.99	16,002		
PETRONOVA INC	-37.11	15,978		0.00
STRAD ENERGY SERVICES LTD	13.99	15,841	13.33	
ISRAMCO INC	-28.08	15,843		0.00
SHELL PAKISTAN LTD (PBS)	6.24	15,978	8.84	
TAP OIL LTD	-22.89	15,204		-24.00
CERAMIC FUEL CELLS LTD	-24.24	14,803		-42.29
MITCHAM INDUSTRIES INC	10.28	15,242	14.19	8.67
MAPLE ENERGY PLC	-2.19	15,081	19.78	4.01
EPSILON ENERGY LTD	4.75	14,888	6.22	27.74
SINOTECH ENERGY LTD-SPON ADR	-67.36	14,865	9.40	-6.38
RIALTO ENERGY LTD	-45.95	14,787		-14.74
PAN ORIENT ENERGY CORP	-59.55	14,739	5.17	10.40
MADALENA VENTURES INC	-28.05	14,693		-52.82
NATURAL GAS SERVICES GROUP	-34.90	14,471	17.59	5.72
TOA OIL CO LTD	-15.60	14,417	7.39	7.23
CE FRANKLIN LTD	17.86	14,361	16.84	5.90
SUNDANCE ENERGY AUSTRALIA LT	-27.70	14,614	26.25	9.82
NEON ENERGY LTD	135.71	14,044		-7.05
REX AMERICAN RESOURCES CORP	2.34	14,247	9.70	2.66
ENGEN	10.76	14,163	11.70	39.91
PETROMAGDALENA ENERGY CORP	-72.75	14,167		-25.79
DRILLSEARCH ENERGY LTD	-17.88	14,290		-6.36
TETHYS PETROLEUM LTD	-65.22	14,108		-14.04
CONOIL PLC	-4.90	14,011	8.21	19.39

Source: Bloomberg

Statement of Comprehensive Income:

Kshs. '000	2010	2011F	2012F	2013F	2014F	2015F	5-yr CAGR
Sales	101,760,803	117,024,923	135,514,861	149,229,851	172,211,249	194,530,389	18.46%
Cost of Sales	(94,052,548)	(107,091,020)	(123,219,760)	(134,069,825)	(153,458,831)	(171,771,254)	17.06%
Gross Profit	7,708,255	9,933,903	12,295,102	15,160,026	18,752,418	22,759,135	31.83%
Gross Margin	7.57%	8.49%	9.07%	10.16%	10.89%	11.70%	11.29%
Operating Profit	3,667,452	5,422,386	7,494,950	10,029,867	13,154,573	16,789,268	45.75%
Operating Margin	3.60%	4.63%	5.53%	6.72%	7.64%	8.63%	23.04%
Profit/(Loss) Before Income Tax	2,697,823	4,239,841	6,054,284	8,276,483	11,022,576	14,199,191	49.61%
Profit/(Loss) for the Year/Period	1,776,640	2,840,693	4,056,370	5,545,243	7,385,126	9,513,458	49.61%
Net Margin	1.75%	2.43%	2.99%	3.72%	4.29%	4.89%	26.30%
EPS	1.21	1.93	2.76	3.77	5.02	6.46	49.61%
DPS	0.52	0.77	1.10	1.51	2.01	2.59	49.61%
Dividend Yield	4.66%	6.92%	9.89%	13.52%	18.00%	23.19%	49.61%
RoE	13.98%	17.26%	20.37%	23.28%	25.65%	27.22%	16.40%

Source: ApexAfrica estimates

Statement of Financial Position:

Kshs '000	2010	2011F	2012F	2013F	2014F	2015F	5-yr CAGR
Share Capital	73,588	81,088	81,088	81,088	81,088	81,088	0.00%
Share Premium	5,166,350	5,676,350	6,186,350	6,696,350	7,206,350	7,716,350	10.78%
Other Reserves	244,494	268,943	295,838	325,422	357,964	393,760	13.55%
Retained Earnings	6,455,764	9,296,457	11,730,280	14,502,901	18,195,464	22,952,193	35.16%
Proposed Dividends	765,316	1,136,277	1,622,548	2,218,097	2,954,050	3,805,383	49.61%
Total Equity	12,705,512	16,459,116	19,916,103	23,823,858	28,794,916	34,948,775	28.53%
Non-Current Liabilities	631,711	771,259	918,477	1,107,606	1,327,357	1,595,698	27.42%
Total Capital Employed	13,337,223	17,230,375	20,834,580	24,931,464	30,122,274	36,544,472	28.48%
Non-Current Assets	6,154,562	5,958,555	5,890,962	5,772,676	5,689,930	5,599,446	-2.05%
Current Assets	26,062,068	29,807,981	33,165,749	37,146,039	41,942,764	47,660,400	16.93%
Current Liabilities	18,879,407	20,449,460	21,512,978	21,726,547	23,071,823	24,500,760	6.21%
Net Current Assets	7,182,661	9,358,521	11,652,771	15,419,492	18,870,941	23,159,640	35.26%

Source: ApexAfrica estimates

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