Kestrel Capital (East Africa) Ltd

Member of the Nairobi Stock

KENYA OIL COMPANY LIMITED **RESEARCH REPORT**

31 August 2006

Statistics

Par value/share (Kshs)	0.50
Issued Shares (m)	100.8
Authorised Shares	150.0
Free float	19.6%
Market cap (Kshs m)	11.9 bn
(US $ m)	162m
Year end	Sept -30
Price Range (12 months)	
High (Kshs)	152.00
Low (Kshs)	104.00

Share Price: **Kshs 119**
Recommendation: **BUY**

BUY THE BARRELS

Valuation Summary

	FY 2004	FY 2005	FY 2006F	FY 2007F
EPS	8.32	9.09	9.00	10.80
EPS Growth	+79%	+9%	-10%	+20%
P/E	n/a	13.1	13.2	11.0
DPS	2.00	2.25	n/a	n/a
Div Yield	n/a	1.9%	n/a	n/a
Div Payout	24%	25%	n/a	n/a
NAV/Share	33.7	39.8	n/a	n/a
P/NAV	n/a	3.0x	n/a	n/a

Investment Summary

- Kenya Oil Company Limited ('Kenol') is one of the largest and most profitable petrol marketing companies in the greater East African region. It is a wholesaler and retailer of principally fuel and associated products with some income also generated from other retail services at its stations.
- In 1H2006, gross sales were up 34% to Kshs 25.1 billion from Kshs 18.7 billion in 2005 supported by higher volumes and prices during the half. Gross profit however fell by by 25% to Kshs 1.1 billion fuelled by a 44% rise in cost of sales from Kshs 14.99 billion last year to Kshs 21.6 billion in 1H2006. The gross profit margin consequently fell to 4.5% from 8.1% last year as local retail price rises generally lag rises in product import prices.
- Currently, the industry faces a number of challenges among them the current wrangle with Kenya Pipeline Company ('KPC') with regards to oil storage and supply. This coupled with intense competition in a rising price environment have served to suppress the industry's margins. However, as international oil prices stabilize and the current KPC issues are resolved, we expect Kenol to continue on its normal growth path through both organic growth and acquisitions. In fact, 2H2006 should reflect a significant recovery of earnings.
- Despite the tough operating environment, Kenol continues to increase its market share both domestically and regionally with more acquisitions planned in the near future.
- We recommend a long term **BUY** for the stock.

Equity Sales & Trading
Samuel Wachira
Christine Kuria

Research
Snehal Shah
Eric Kimanthi

Fixed Income & Operations
Andrew Mwangangi
Abraham Too

Corporate Advisory
Ewart Salins
Vera Mungai

Executive Director
Andre DeSimone

Hughes Building, 7th Floor
Kenyatta Avenue. / Muindi Mbingu Street
P.O. Box 40005
Nairobi
Kenya

Tel: (254-2) 251758
Fax: (254-2) 243264

E-mail:
info@kestrelcapital.com
www.kestrelcapital.com

COMPANY OVERVIEW

The company

Kenya Oil Company Limited (Kenol) was incorporated in Kenya in 1959 and became a public company quoted on the Nairobi stock Exchange (NSE) in September 1959. Kenol's prime business remains the importation of crude and refined oil, and marketing of petroleum products.

Relationship with Kobil

Kenol is jointly managed with Kobil ("Kenol/Kobil Group") which together jointly operate several fuel storage depots and aviation refuelling facilities. In January 1986 Kenol and Kobil Petroleum Limited (Kobil) entered into a joint Operations and Management Agreement. This arrangement resulted in the sharing of a wide range of costs, including depots and managerial services. This arrangement has allowed Kenol to lower its costs and enhance its ability to bid for large supply contracts. Both Kenol and Kobil are audited by PriceWaterhouseCoopers.

Business and market position

In Kenya, Kenol/Kobil competes with BP/Shell, Caltex, Mobil and Total, among independent players. Kenol continues to face intense competition in the Kenyan inland market. This notwithstanding, the company has been able to continuously improve its domestic market share and currently holds the second largest market share at 19% second only to Total Kenya. The company, in line with its mission to be the leading brand in Kenya and a major player in Africa, is continuing to expand its network of operations in the Eastern Africa region.

Geographical diversification

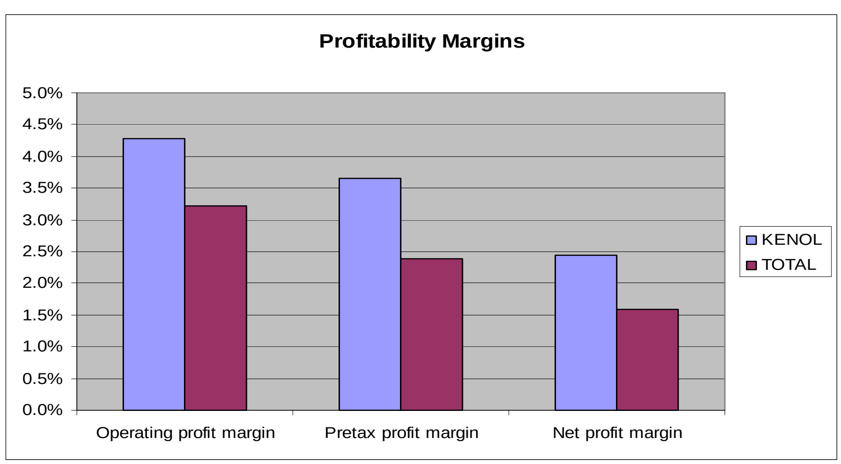
In a bid to diversify its risks in addition to taking advantage of higher margins in the region, Kenol embarked on a regional expansion programme in 2000 to enlarge its regional spread. To date, the company has a presence in four other countries namely Uganda, Tanzania, Zambia and Rwanda. Kenol also recently established a subsidiary in Ethiopia. Regional operations now constitute over 20% of Kenol's operating profits.

GCR credit rating

The Global Credit Rating Company Limited ('GCR') has issued a credit rating on the company, with Kenol's short term, long term and commercial paper getting A1+, AA- and A1+ ratings respectively. The GCR report is attached as an appendix to this research report.

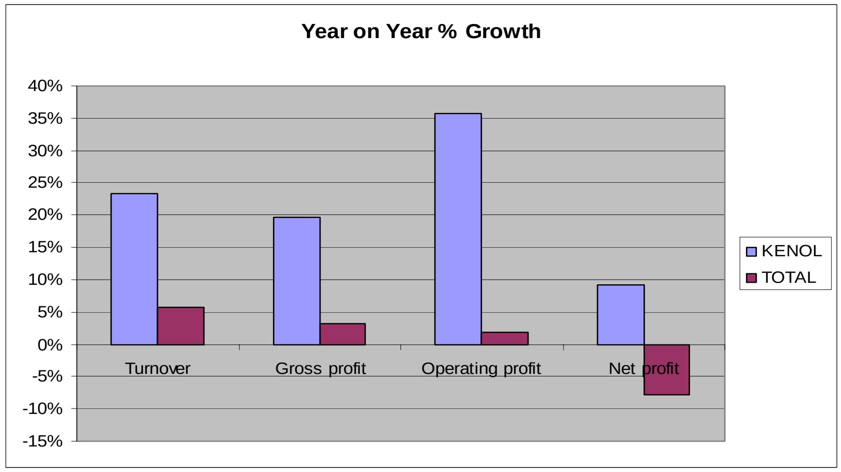
Comparison with Total

Based on the year end results for both Kenol (September 2005) and Total (December 2005), Kenol's operating profit, pre-tax profit and net profit margins at 4.3%, 3.7% and 2.4% respectively outstrips Total.



COMPANY OVERVIEW

Annual growth



Kenol registered an annual growth rate of 23% in turnover (Total 6%), 20% in gross profit (Total 3%), 36% in operating profit (Total 2%) and 9% in net profits (Total: -8%).

SEGMENT INFORMATION -KENYA

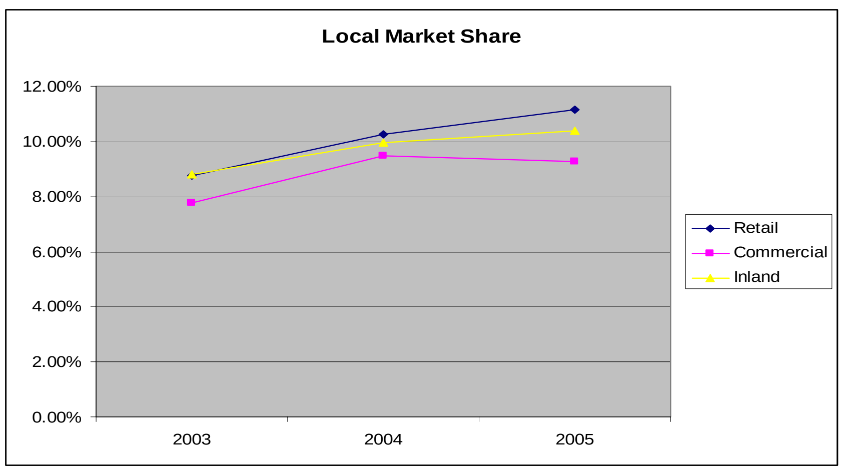
Market diversification

Kenol is active in the major sectors of the economy, such as transport, energy, agriculture, tourism, construction, manufacturing, aviation and marine. The company markets a wide range of petroleum products, such as gasoline, diesel, kerosene, jet fuel, bitumen products, fuel oil products, industrial diesel oil and liquefied petroleum gas. The company also markets lubricants covering a wide range of activities such as motoring, manufacturing, and marine.

Inland Kenya

Inland encompasses the retail sector which includes all service stations and resellers, and the commercial sector which includes all bulk sales to industries and certain large end users.

Kenol has an extensive distribution network locally currently operating 69 service stations in the country. Volume growth has been at an annual rate of 20% between 2003 and 2005 and is forecast at over 15% for the year ended 30 September 2006. Despite a competitive environment, Kenol has continued to increase its local market share in the retail and overall inland sectors.



Trading desk

The company formally established a Trading Desk jointly with Kobil in 2002 charged with developing new markets in African countries, especially those that have no refining facilities for petroleum products. The Trading Desk also encompasses the selling of bulk fuel in Kenya which is done via the Government Open Tender System ('OTS').

OTS

The OTS, established by the Ministry of Energy in January 2004, was set up to streamline and regulate the importation of crude and refined petroleum products into Kenya and thus create a level playing field for all petroleum companies in Kenya. In 2004, the Trading Desk won 70% of the crude and 45% of the refined products imported into Kenya under the OTS. This was an exceptional year. Increased competition from multinationals has seen this market share lowered to 50% of crude and 25% of refined products. This notwithstanding, trading volumes have increased from 518,631m^3 in 2004 to 657,960m^3 in 2005 and is forecast to almost double in 2006 on the back of increased sales.

SEGMENT INFORMATION -KENYA

Regional supply

Further, since its inception, the Trading Desk has won tenders to supply petroleum products to as far out as Mozambique. The Trading Desk is actively participating in tenders to supply petroleum products to Malawi, Sudan, Ethiopia, Mauritius and other countries in the region. Business in this market is denominated in US Dollars and is generally guaranteed and/or confirmed by letters of credit issued by reputable international banks, which reduces both foreign exchange and credit risk. The company is eyeing markets in South Africa and Mauritius with a view to improving margins and growing market share in this area.

Aviation

This sector includes the sale of jet fuel to the aviation sector at Nairobi and Mombasa international airports. It has grown by 40% annually in the last two years in volumes from 41,048 m3 in 2003 to 79,829 m3 in 2005 on the back of a new contract with a major airline. These volumes are expected to grow by at least 15% in 2006. Kenol currently services eleven airlines including Kenya Airways, KLM, Egypt Air, Gulf Air, Luftansa (cargo) and Air France (cargo).

Liquefied petroleum gas – K-Gas

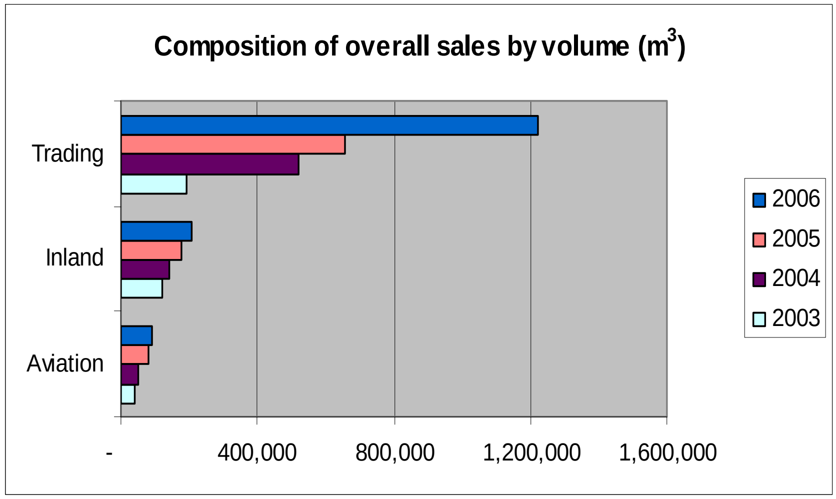
K-Gas, the Group's Liquefied Petroleum Gas ('LPG') brand, increased its market share by 100% currently standing at 12% in 2005 (8.5% attributable to Kenol) compared to 6% in 2004. K-gas now has over 150,000 cylinders in the market. To guarantee supplies of K-Gas to customers Kenol has invested in a modern LPG plant that cost Kshs 150 million which begun its operations in February 2006. The plant, which is ISO 9001 - 2000 certified, will also allow Kenol to penetrate the commercial segment, which previously could not be targeted due to capacity constraints. Net sales are expected to improve by over 70% with this new facility in place. Further, Kenol is planning to construct three similar plants in Sagana, Eldoret and Kampala. Kenol markets the K-Gas brand in its international subsidiaries, including Uganda and Rwanda where the business has expanded rapidly. The establishment of a mini filling facility in Tanzania is also being looked at. Compared to other regional markets like West Africa, LPG is a relatively new and smaller product in East Africa. Management believes this product has substantially more upside potential.

Lubricants

Kenol established a lubricants division in July 2003 to cater to this growing market. Its brand of lubricants, which are ISO 9001: 2000 certified, now accounts for 11.2% of market share of the total lubricants sold in the Kenyan market. The lubricants are also sold in neighbouring countries through the Kenol subsidiaries. Net sales for lubricants alone are expected to grow by 30% for the coming year. Further, the company has recently launched lubricants blending in Tanzania.

SEGMENT INFORMATION - KENYA

Overall sales

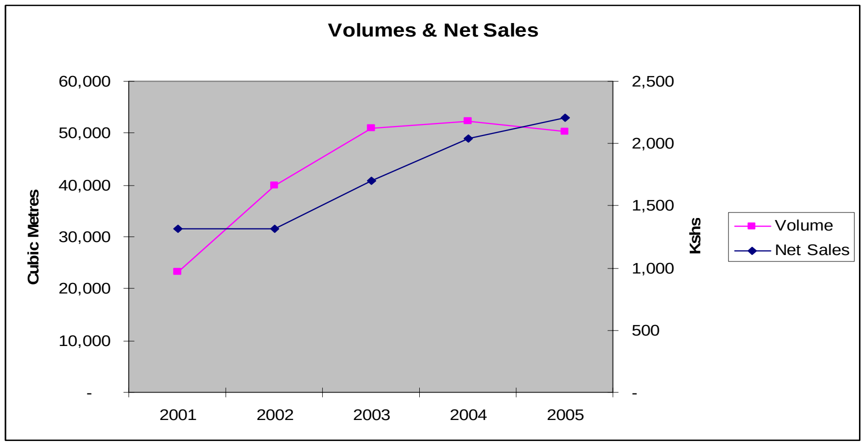


Volume growth has been at an annual rate of 20% between 2003 and 2005 and is forecast at 61% for the year ended 30 September 2006.
Volume growth in all sectors is expected for 2006.

SEGMENT INFORMATION - SUBSIDIARIES

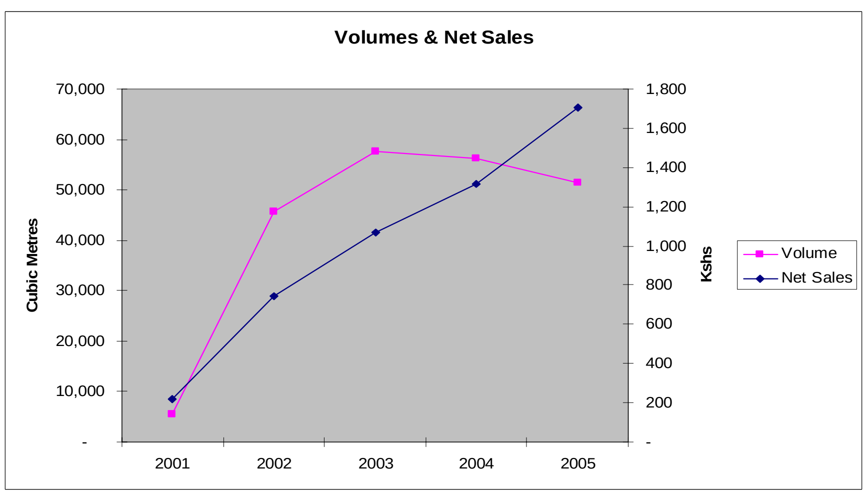
Kobil Uganda Limited

Kenol owns 100% shares in Kobil Uganda Ltd, which trades under the Kobil brand. The Company already has 58 service stations and a depot in Kampala since it opened shop five years ago. The Company's operations account for an estimated 12% of the local market share. Kobil Uganda sales are mainly in the retail sector. The business has been profitable with net sales growing by 10% year on year from Kshs 1.3 billion in 2001 to Kshs 2.2 billion in 2005. This trend is expected to continue with plans to add six more retail outlets in the next financial year.



Kobil Tanzania Limited

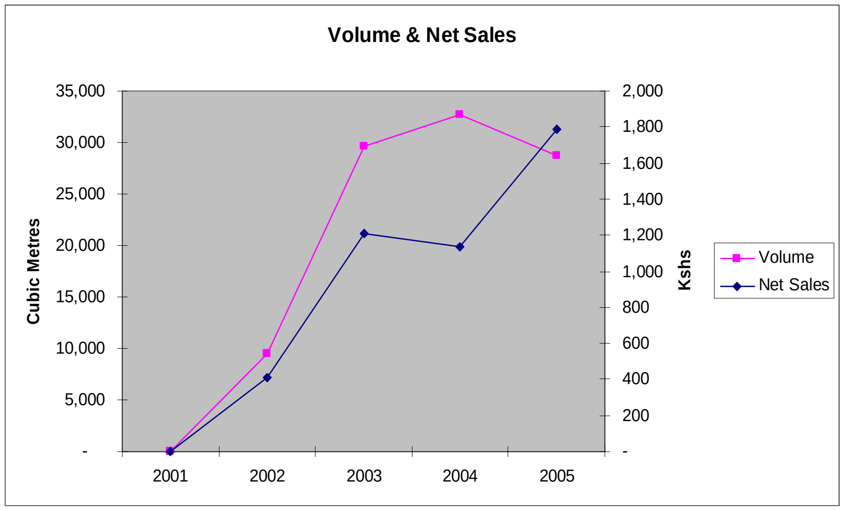
Kobil Tanzania Limited, a wholly owned subsidiary of Kenol, started operations in May 2001 and sells both fuel and lubricants. It currently operates 15 services stations commanding a 6% local market share. The Tanzanian petroleum industry, though very competitive, is a strategic market place for the Group as it is the fastest growing economy in East Africa. Tanzania has become a major artery for product supplies to Zambia and has enhanced its exports to Malawi and Southern DRC (Lubumbashi). Gross profit margins have been growing by about 15% per annum over the last four years, a trend which is expected to continue into the near future.



SEGMENT INFORMATION - SUBSIDIARIES

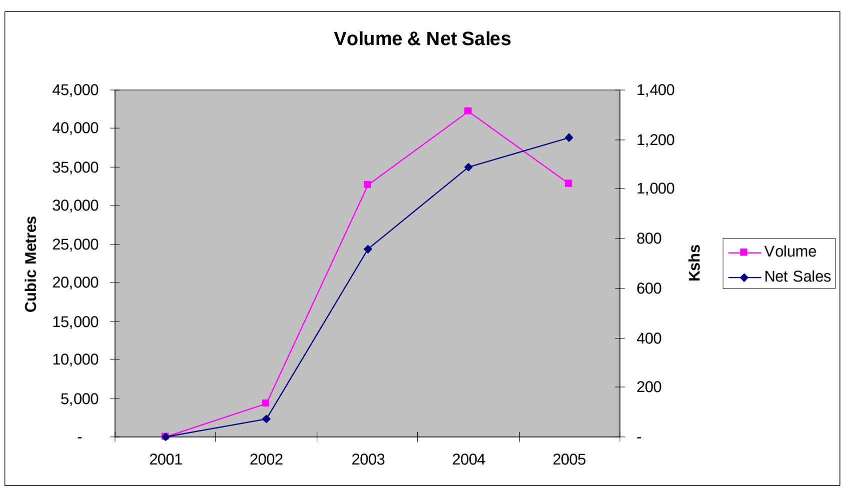
Kobil Zambia Limited

Kobil Zambia has been operating in Zambia for three years and has a network of 16 service stations with plans to open six more stations in 2006. It also has depot facilities in Lusaka and Ndola. Current market share stands at 8.5% and is expected to increase to 10% in 2006. Further, net sales have been consistently increasing over the last four years and are expected to almost double for the year 2006. The market, which is dominated by multinational companies, is stable, profitable and well regulated by government.



Kobil Rwanda SARL

Kobil Rwanda is a 100% Kenol owned subsidiary incorporated in May 2002. Starting with one service station, they have gained a 30% market share of the wholesale fuel market in the country. Given Kenol's recent acquisition of Shell Rwanda (comprising 17 Service Stations and a 16,000m^3 depot, the largest in Rwanda) which commenced operations on 1 February 2006, market share is expected to grow with volume growth forecast at over 50%. Kobil Rwanda also sells lubricants, fuel oil and bitumen in the region and in 2005 introduced its K-Gas LPG brand becoming the only major oil company trading in this segment in Rwanda.



SEGMENTAL INFORMATION - SUBSIDIARIES

Kobil Ethiopia Limited

Kobil Ethiopia commenced operations in March 2005 opening a flagship service station principally to facilitate the marketing of lubricants. Plans are already underway to acquire a multinational's assets which would significantly increase market share in the country. Gross profit for the year 2006 is forecast at Kshs 20 million.

CURRENT OPERATING ENVIRONMENT

Higher international oil prices

In the past twelve months, the price of Murban crude per barrel has risen by approximately 35%. Higher international oil prices have a direct affect on the working capital financing and borrowing costs of the company. However, prices have been largely stable since the beginning of 2006.

Public sensitivities

In as much as the price of crude is still on the rise, this increase in price cannot be immediately passed on to the local consumer at the pump. Kenol has to take into consideration the sensitivities of the public and the political establishment at large before effecting any price change at the pump. Consequently, retail pump prices typically rise more slowly than international oil prices. Over time however, retail prices catch up and margins revert to the norm.

KPC - inadequate storage space

The oil marketing industry in general has been suffering from inadequate storage and distribution facilities at the Kenya Pipeline Company ('KPC'). KPC has been experiencing supply problems into the market, being unable to efficiently cope with the growing demand for fuel in Kenya and the surrounding region. Almost all fuel supplies for Uganda, South Sudan, Rwanda, Burundi and Eastern DRC are imported via Mombasa, Kenya.

.....but KPC investing in storage and transport infrastructure

KPC is however planning to upgrade and double the capacity of the pipeline to Western Kenya from $440m^3$ to $880m^3$, and also later extend the pipeline to Kampala, Uganda. This would greatly relieve the current storage constraints in Western Kenya and particularly benefit Kenol which has been expanding operations in Uganda, Rwanda, Burundi and Eastern Congo.

KPC - unfair industry practices

Further and more recently, KPC has been accused of unfair practices and favouritism with regard to offering storage space to certain players in the industry. KPC has limited storage space at its depot in Mombasa. Each of the major oil companies has a contractually agreed storage space at the Kenya Oil Storage facility (KOSF). However, recently KPC has been accused of letting out additional storage space to a number of independent oil outfits at the expense of the major players. The problem is currently being resolved between KPC and the major industry players.

KRA - payment of 50% fuel tax upfront

In the past, oil companies first collected taxes at the *point of sale* for onward submission to the Kenya Revenue Authority ('KRA'). In August 2005, the KRA decreed it government policy to pay 50% of fuel taxes upfront within four days of purchase with the remaining 50% to be paid within 30 days when collecting oil from KPC. This adds more strain on working capital financing requirements with the consequence that the company has to go out into the market to borrow more. This tax rule change adversely affected Kenol's recent results.

FUTURE OUTLOOK

Continued regional expansion

Currently, Kenol's subsidiaries account for 22% of net profits. With the on-going aggressive regional expansion of its subsidiaries, we expect this figure to increase to over 40% for 2006 and quickly become the major contributor to net profits. The recent acquisition in Rwanda will serve to enhance profits and further facilitate expansion plans into the surrounding region.

Multi-Nationals divesting

Kenol is taking advantage of the opportunities arising due to the pull out of major multi-nationals corporations ('MNC') from the African market. Mobil recently closed shop in 14 countries across the African continent. BP is currently in the process of pulling out of Kenya. Shell and Caltex have already divested out of western Kenya. Not too long ago, Agip pulled out of Kenya completely selling its stake to Shell Kenya. It is rumoured that MNCs are planning to exit from other Eastern African markets as the small sizes of these markets do not justify the overhead costs of each operation. It would appear that MNCs do not have the critical mass required to service country wide operations in countries across Africa. The additional costs associated with setting up stations to international standards and the hiring of expensive expatriates cannot sustain such operations. Kenol leverages off its local expertise trained to international standards and its knowledge of the local market to garner a foothold and succeed in African markets. Furthermore, these small African retail markets are generally not considered "core" businesses for the large, global oil companies. Kenol's core business is exactly oil marketing in Eastern Africa. Therefore it plans to continue to benefit from the exits of MNCs from this region.

K-Gas

K-Gas continues to show tremendous growth. The recent commissioning of the Kshs 150 million LPG storage and filling plant will serve to increase margins both in Kenya and the region with net sales expected to improve by over 70% in 2006.

Growing economies in the region

While the first half of the 2006 financial year has proven difficult, primarily due to industry wide problems, the outlook for the remainder of 2006 appears brighter. The country has registered a GDP growth rate of 5.8% on the back of a number of prudent fiscal and macroeconomic measures. We expect this trend to continue in the near term with knock on effect on industries countrywide.

Similarly with the regional economies of Uganda (5.3%), Tanzania (6.8%), Zambia, Rwanda and Ethiopia all showing signs of increased growth, the outlook for the regional subsidiaries is looking increasingly optimistic.

We also expect the growing investments in the road transportation networks in Kenya and around East Africa to support future sales growth.

FINANCIALS

Income Statement

Kshs million	1H 2006	2005	1H 2005	2004
Gross Turnover	25,066	41,745	18,720	34,479
Indirect taxes	(2,294)	(4,208)	(2,217)	(4,064)
Net Turnover	**22,772**	**37,537**	**16,503**	**30,415**
Cost of sales	(21,645)	(34,754)	(14,992)	(28,090)
Gross Profit	**1,128**	**2,783**	**1,511**	**2,325**
Other income	40	29	(9)	40
Operating income	**1,168**	**2,812**	**1,502**	**2,365**
Operating expenses	(566)	(1,203)	(564)	(1,180)
Operating profit	**602**	**1,609**	**938**	**1,185**
Finance costs	(16)	(235)	(97)	8
Profit before tax	**586**	**1,374**	**841**	**1,193**
Taxation	(181)	(458)	(270)	(362)
Minority interests	-	-	-	-
Exceptionals	-	-	-	8
Profit after tax	**404**	**916**	**571**	**838**
EPS	4.01	9.09	5.66	8.32
DPS	-	2.25	-	2.00
Profit margins				
Gross profit margin	5.0%	7.4%	9.2%	7.6%
Op profit margin	2.6%	4.3%	5.7%	3.9%
Pretax profit margin	2.6%	3.7%	5.1%	3.9%
Net profit margin	1.8%	2.4%	3.5%	2.8%