KENOLKOBIL LIMITED

Recommendation: BUY

The Next Big Dividend-Paying Stock?

We maintain our BUY recommendation, based on a fair value of KES 13.43 per share, representing a potential upside of 16.8% from the current share price of KES 11.50. The stock trades on a FY16E P/E of 6.8x and EV/EBITDA of 4.2x.

While we do foresee a requirement for further investment in working capital as crude oil prices recover and trading volumes increase, the company's cashflows should benefit from earnings growth resulting from strong sales volumes, exit from loss making Tanzania and lower interest expenses, together with an asset light expansion model, all of which will result in higher cashflow generation and dividend pay-outs, as per our forecasts.

KenolKobil has been paying out 25.0-30.0% of its earnings in dividends since 2013 (from a high of 45.0% in 2011). We expect this to be maintained and cash dividends to increase to KES 0.45 and KES 0.75 per share in FY16E and FY17E, respectively, compared to KES 0.35 per share in FY15. This translates in to a dividend yield of 3.9% in FY16E and 6.5% in FY17E. The increment in cash dividends is on the back of a stable total debt level (KES 4.0bn) in FY16E and FY17E. As the company approaches the end of its restructuring and turnaround, we expect the dividend pay-out to be maintained (or increased) going forward.

KES millions	2012	2013	2014	2015	2016E	2017E
Change in Operating Working Capital	(11,812)	(1,162)	(3,460)	(2,309)	2,443	3,405
Cash Flow from Operations	2,956	1,297	5,455	5,224	2,736	2,746
Capital Expenditure	854	790	429	396	1,200	800
Free Cash Flow to Firm	1,793	827	4,468	5,893	509	839
Net Borrowings	(2,290)	(1,238)	(4,879)	(5,836)	(658)	-
Dividends	596	9	191	478	515	669
DPS (KES per share)	-	0.10	0.20	0.35	0.45	0.75
Dividend yield (%)	-	0.9	1.7	3.0	4.0	6.5

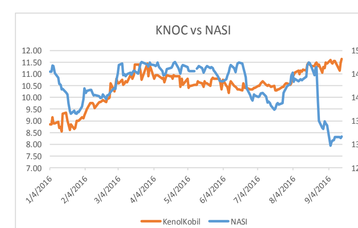
	2012	2013	2014	2015	2016E	2017E
Gross profit (KES m)	4,288	4,265	5,052	5,837	7,428	8,542
Contribution margin per liter (KES)	1.25	2.50	4.42	3.71	3.50	3.50
Sales Volume (liters m)	2,626	1,400	1,144	1,572	2,122	2,440
Provisioning-KPRL receivable (KES m)	-	-	-	-	(900)	(200)
EBITDA (KES m)	(1,498)	2,380	4,347	4,333	4,869	6,916
EBITDA margin (%)	-0.78	2.17	4.82	5.01	4.88	4.84
EPS (KES)	(4.27)	0.38	0.74	1.29	1.68	2.59
DPS (KES)	0.00	0.10	0.20	0.35	0.45	0.75
Pay-out ratio (%)	0.0	26.3	27.0	27.1	27.0	29.0
ROaE (%)	-69.46	8.52	20.33	23.89	25.63	31.24
Net debt (KES m)	14,424	13,602	9,447	3,926	3,932	3,763
Net working capital (KES m)	12,856	11,694	8,234	5,925	8,367	11,772

Bloomberg Ticker :	KNOC KN
Reuters Ticker:	KENO NR

Share Statistics

Price Target (KES)	13.43
Current Price (KES)	11.50
52 week range (KES)	10.20-11.65
Issued shares (m)	1471.8
Market cap (USD m)	169.3
Year end	December
Free Float (%)	56.1
Av daily trading value (USD)	158,063

Price Trend



Source: NSE

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Investment Thesis

Strong Operating Cash Flows

We expect strong EBITDA growth (12.4% to KES 4.9bn in FY16E and 42.0% to KES 6.9bn in FY17E), despite the provisioning for the KPRL yield shift receivable (KES 1.1bn in total over FY16E and FY17E). EBITDA will benefit from higher sales volumes (+35.0% in FY16E and +15.0% in FY17E) across all subsidiaries and segments, focus on margins, exit from loss making Tanzania and operational efficiencies from "right-sizing".

We foresee a margin dilution, as the company is predominantly increasing its volumes in lower margin segments. Contribution margin per litre is expected to reduce to KES 3.50 in FY16E and FY17E as compared to KES 3.71 and KES 4.42 in FY14 and FY15, respectively. However, the gross profit is nonetheless expected to grow 27.0% to KES 7.4 bn in FY16E and 15.0% to KES 8.5 bn in FY17E.

Operating costs increased 21.4% y/y (or KES 543.9m) in FY15, we expect the operating costs to increase to KES 3.5bn in FY16 before stabilising from FY17 onwards. This is primarily due to one-off operating costs in FY15 and FY16E which we estimate to be around KES 300.0m e.g. - relocation of the headquarters (The company has currently put its plans to build its own 10-12 floor headquarters as previously announced on hold, and is instead moving in to new rented commercial space in 4Q16).

Tax losses accumulated by the Kenyan business after 2012 will be fully utilised by 2017, as per our forecasts, and this will cause a drag on cash flows from 2018 onwards as the Company starts to pay full taxes.

Sale of Kobil Tanzania and Depot in Congo

The sale of Kobil Tanzania and the depot in Congo is a positive development for KenolKobil. This was expected as part of the restructuring exercise started in 2013. Tanzania was an underperforming subsidiary and consistently under pressure given the high level of competition, inefficiencies and a difficult market environment. We view it as an earnings accretive outcome because Tanzania was a loss making subsidiary (FY15 Loss after tax - KES 464.6m; FY14 Loss after tax – KES 331.7m) and the sale proceeds of KES 1.6bn have been used to further de-lever the balance sheet.

Both Tanzania and DRC operations were fairly small, Tanzania had 17 retail stations and a terminal on a long term lease; Congo had one storage depot. Therefore we do not expect a major impact to the top line resulting from the exit from these markets.

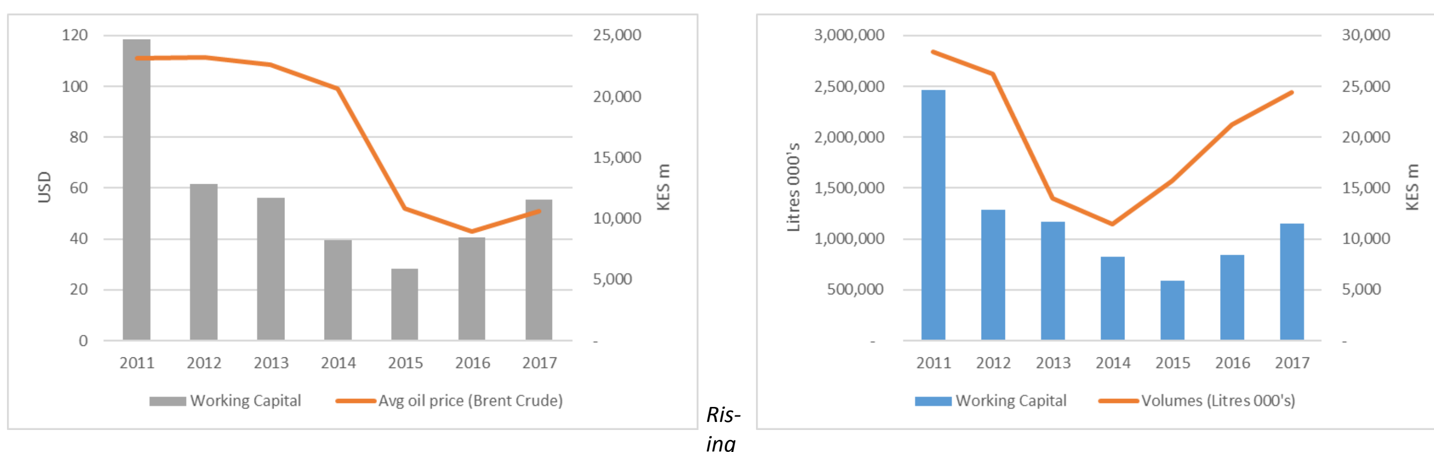
In terms of logistics, the restructuring should have no impact on other subsidiaries as KenolKobil could either use third party storage in Tanzania or supply product via Kenya to ensure uninterrupted supply to the landlocked regional subsidiaries i.e. Rwanda and Burundi.

Provisioning for the KPRL Yield Shift Receivable

KenolKobil took a step to provide for the KPRL yield shift receivable with an impairment provision of KES 400.0m in 1H16. We expect a further impairment of KES 500.0m in 2H16 (KES 900.0m in FY16E) and will write down a further KES 200.0 million in 1H17. The total value held on the books was KES 1.1bn and this is expected to be fully provided by end of 1H17.

Working capital requirements

The rise of crude oil prices and strong volume growth have necessitated higher working capital requirements.



Ris-ing oil prices and growing volumes are expected to increase the working capital requirements. Source: Company, Kestrel estimates

We forecast a continued need for working capital investment as oil prices are expected to climb higher (Brent crude is expected to average $43 in FY16E and $51 in FY17E) and sales volumes are expected to increase by 35.0% in FY16E and 15.0% in FY17E. We expect working capital to increase by KES 2.4bn in FY16E and KES 3.4bn in FY17E. We would like to highlight that efficient inventory management has been key to driving margins and staying ahead of competition in the past. We believe inventory management will continue to be a key focus for the company going forward.

KES m	Total Kenya	Total Kenya	KenolKobil	KenolKobil
	2014	**2015**	**2014**	**2015**
Net Sales	155,102	120,254	90,210	86,558
Gross Profit	6,750	6,990	5,052	5,837
Gross Margin (%)	4.35%	5.81%	5.60%	6.74%
Other Income	488	766	852	830
Operating expenses	(4,549)	(4,905)	(2,543)	(3,087)
Net foreign exchange loss	(149)	(320)	(288)	(232)
EBITDA	2,540	2,531	4,347	4,333
EBITDA margin (%)	1.6%	2.1%	4.82%	5.01%
Operating Working Capital	14,167	9,496	8,234	5,925
Working capital/Sales (%)	9.13%	7.90%	9.13%	6.84%
Net debt	6,841	1,453	9,447	3,900
Cash Conversion Cycle (days)	34	29	33	25

A comparison of the working capital and working capital intensity between Total Kenya and KenolKobil. Source: Company annual reports, Kestrel estimates

Pay-down of debt

Net debt at 30th June 2016 stood at KES 3.6bn. This is higher than the level in March 2016, when management stated net debt to be c. KES 2.3bn, driven primarily by the need to support higher volumes and as a result of the rally in oil prices (c. 15% rise in Brent crude over the period). We forecast debt to remain stable at the KES 4.0bn level over the FY16-FY17E period (based on the current oil price and volume forecasts) and therefore assume that the growing working capital investments will be primarily financed by internally generated cash flows.

The company is expected to have paid down all local currency debt by year end (FY16E) and therefore remain with US Dollar denominated debt only from 2017 onwards. This debt is assumed to be purely for working capital financing requirements. We note that the company is currently able to borrow at favourable rates in US Dollars, hence interest expenses are expected to be minimal.

Credit Metrics	2012	2013	2014	2015	2016E	2017E
Net debt (KES m)	14,424	13,602	9,447	3,926	3,932	3,763
Net operating working capital (KES m)	12,856	11,694	8,234	5,925	8,367	11,772
(EBITDA - Capex) to total interest expense (x)	-0.3	1.9	3.9	7.3	29.6	95.7
(EBITDA - Capex - WC changes) to total interest expense (x)	4.7	2.6	6.8	10.8	17.7	53.5
EBIT to interest expense (x)	-0.9	0.9	2.8	5.5	18.1	69.0
Net debt to EBITDA (x)	-9.6	5.7	2.2	0.9	0.8	0.5
Net debt to total capitalization (%)	44.1	48.4	39.5	22.6	18.7	14.1
Net debt to shareholder equity (x)	223.8	204.0	128.9	45.9	36.4	27.6
Current ratio (x)	1.0	0.9	1.0	1.2	1.4	1.5

Source: Company, Kestrel estimates

Asset Light Approach to Expansion of Operations

Since 2013, the new management has adopted an asset light approach for network expansion. The company has been adding new stations to its network via long term leases (typically >25 years tenor) as opposed to outright acquisition of stations. This reduces the upfront capital requirements to add a new station as the upfront expenditures are reduced to re-branding, minimal capital expenditure to improve the physical state of the site (if required) and new fittings. The leasing method creates a better cash flow system and allows for faster expansion.

Capital expenditure is expected to be contained at KES 1.2bn in FY16E and KES 800.0m in FY17E, in the absence of any unforeseen opportunities. Management has stated that they don't require any further investment in storage capacity (14 terminals across 6 countries). The company added 20 service stations in 1H16 and plans to add 15 more in 2H16 (363 active stations as at 30th June 2016). We expect general expansion of c.20 stations per annum across all countries post 2016. Additionally, non-fuel income is expected to grow as the company invests in constructing rental spaces in 2 to 3 stations every year from FY17E onwards (Rental spaces will be added in 5-6 stations in FY16E).

No of Active Stations	Kenya	Rwanda	Burundi	Uganda	Zambia	Ethiopia
Service stations	178	58	42	36	26	23

As at 30th June 2016, Source: Company

Management has mentioned various countries such as Djibouti, Mozambique and South Africa as potential countries for expansion in the past but we don't expect any expansion into new countries in the near term. Additionally, the company is looking to build a filling plant (LPG) in Kisumu, Kenya (KES 100.0m capital outlay; 300MT capacity). Furthermore, recent press articles report a possible investment in a blending plant (in joint venture with BP) in Mombasa, Kenya (KES 1.0-1.5bn total capital outlay; 1,000 tons per month capacity). The timing of the blending plant is unknown, and therefore excluded from our FY16-FY17E capital expenditure budget.

Dividend History

Dividend History	2009	2010	2011	2012	2013	2014	2015	2016E	2017E
Dividend per share	0.325	0.520	1.000	0.000	0.100	0.200	0.350	0.450	0.750
Pay-out ratio	25%	40%	45%	0%	26%	27%	26%	27%	29%

**2016 includes interim dividend only*
Source: Company

The table above highlights the dividend history of KenolKobil since 2009. The company re-initiated paying an interim dividend in 2015, the first time since 2011. We would like to highlight that the highest pay-out ratio in the past was 45% in 2011 and should the company face a favourable market environment in 2017/18 or thereafter, the company could look to increase its pay-out ratio to these levels which is much higher than the 30% we have forecasted.

Company	Industry	Current dividend yield
Safaricom	Telecoms	7.2%*
EA Breweries	Alcoholic beverages	4.3%*
BAT Kenya	Tobacco	6.0%
Bamburi Cement	Cement	7.9%
Nation Media	Media	9.1%
KenolKobil	Oil (downstream)	6.5%**

Comparison of KenolKobil's dividend yield to the dividend yield of Kenya's "blue-chip" dividend paying stocks
**Includes special dividend*
***FY17E dividend yield*
Source: Kestrel Capital

Risks to our Rating and Recommendation

Exchange rate volatility – KenolKobil is exposed to volatility in exchange rates. The Company mitigates exchange rate risk via timely conversion of currencies and careful management of inventory. Additionally, the pricing controls allow for adjustments relating to exchange rates, slightly cushioning the effects. Furthermore, due to the fall in the level of debt from previous years, cash flows are now better matched and therefore reduce exposure. KenolKobil recorded a net foreign exchange loss of KES 367.6m in FY14 and KES 232.1m in FY15. Management stated that c. 30% of forex losses in 2015 were from Tanzania, which has been sold. Going forward, we do not expect exchange losses to have a large significance as it has in the past.

Commodity price cycle - KenolKobil is exposed to commodity price cycles which affects its working capital requirements and in turn, capital structure. Should oil prices recover significantly, the company will have to increase its working capital and this may affect its ability to pay dividends. A very sharp increase in oil prices may even require KenolKobil to draw on its debt facilities, causing an increase in interest expenses.

Kenya Pipeline Company ("KPC") litigation - The KPC litigation still remains outstanding and we do not expect a big impact from the litigation. We have not included the potential impact of any settlement in our forecasts given the uncertainty around the timing and settlement amount.

Valuation

We maintain our BUY recommendation, based on a fair value of KES 13.43 per share, representing a potential upside of 16.8% from the current share price of KES 11.50. The stock trades on a FY16E P/E of 6.8x and EV/EBITDA of 4.2x. We derive our price target by applying the EV/EBIT and P/E multiples of comparable companies to our FY16E forecasts and then applying a 50% weight to each methodology to attain our price target.

Name	Mkt Cap (KES m)	Country	P/E	P/B	EV/EBITDA	EV/ EBIT
Conoil	8,014	Nigeria	8.34	1.33	-	-
Total Nigeria	33,199	Nigeria	9.37	4.89	-	3.06
Capital Oil	942	Nigeria	-	1.63	-	-
Total Kenya	11,331	Kenya	1.95	0.18	2.87	1.63
Mobil Nigeria plc	21,575	Nigeria	10.51	3.90	-	6.00
Afriquia Gaz	86,602	Morocco	19.45	4.14	-	12.43
Eterna plc	1,237	Nigeria	3.01	0.40	3.09	3.80
Puma Energy Zambia	4,480	Zambia	6.09	0.80	5.62	6.93
Total Petroleum Ghana	6,250	Ghana	7.77	1.62	-	9.08
Ghana Oil	12,141	Ghana	7.22	1.62	5.66	7.03
Average			**8.19**	**2.05**	**4.31**	**6.24**
KenolKobil	**16,925**	**Kenya**	**7.80**	**1.83**	**4.07**	**4.89**

Source: Bloomberg

P/E Method	
Comparable Companies average P/E multiple	8.19x
KenolKobil FY16E	1.68
Fair Value per share	**KES 13.80**

EV/EBIT method	
KenolKobil's FY16E EBIT	3,706.9m
Comparable companies average EV/EBIT multiple	6.24x
EV	20,993.4,m
Less: net debt	3,932.4m
Equity value	17,060.9
No. of shares	1471.8
Fair value per share	**13.06**

Blended Value	KES per share
P/E method	13.80
EV/EBITDA method	13.06
Blended value	**13.43**

Model Assumptions

- Oil prices average US$ 43 and US$ 51 per barrel in FY16E and FY17E, respectively. We use the EIA (www.eia.gov) October 2016 average Brent crude price forecasts for our valuation.
- Foreign exchange rates are not volatile and do not affect the Company in an adverse manner.
- Full use of deferred tax assets in the Kenyan subsidiary.
- Capital expenditures of KES 1.2bn and KES 800.0m in FY16E and FY17E, respectively. The timing of the filling and blending plant is unknown, and therefore excluded from our FY16-FY17E capital expenditure budget.
- Total debt is expected to remain stable, and the increased working capital requirements are financed by internally generated cash flows. All outstanding debt is denominated in US Dollars post FY16E i.e. all local currency debt is paid down in FY16E.
- We have not included the potential impact of any settlement from the outstanding KPC litigation in our forecasts given the uncertainty around the timing and settlement amount. Management estimates present value of any receipts to be zero in a worst case scenario.

Financial Summary

Summary Income Statement

KES m	2012	2013	2014	2015	2016E	2017E
Sales	192,527	109,687	90,210	86,558	99,696	142,779
Volumes (Liters 000 ‘s)	2,626,335	1,400,030	1,144,000	1,572,000	2,122,200	2,440,530
% change y/y	-7.55%	-46.69%	-18.29%	37.41%	35.00%	15.00%
Gross profit	4,288	4,265	5,052	5,837	7,428	8,542
Gross margin (%)	2.23%	3.89%	5.60%	6.74%	7.45%	5.98%
Other income	483	1,403	852	830	762	839
Administrative expenses	(5,860)	(3,369)	(2,543)	(3,087)	(3,532)	(3,565)
Provisioning - KPRL receivable	-	-	-	-	(900)	(200)
Net forex losses	(4,606)	(105)	(288)	(232)	(50)	(50)
EBITDA	(1,498)	2,380	4,347	4,333	4,869	6,916
EBITDA margin (%)	-0.78%	2.17%	4.82%	5.01%	4.88%	4.84%
Depreciation	(188)	(264)	(317)	(259)	(270)	(318)
Amortization	(398)	(578)	(670)	(493)	(892)	(1,032)
EBIT	(2,084)	1,537	3,360	3,581	3,707	5,566
EBIT margin (%)	-1.08%	1.40%	3.72%	4.14%	3.72%	3.90%
Interest income	78	44	68	84	40	20
Interest expense	(2,351)	(1,672)	(1,213)	(651)	(205)	(81)
Profit/(loss) before tax	(8,965)	564	1,995	2,782	3,542	5,455
% change y/y	-281.70%	-106.29%	253.72%	39.49%	27.29%	54.03%
Profit/(loss) for the year	(6,285)	558	1,091	2,015	2,479	3,819
Net margin (%)	-3.26%	0.51%	1.21%	2.33%	2.49%	2.67%
EPS	-4.27	0.38	0.74	1.37	1.68	2.59

%	2012	2013	2014	2015	2016E	2017E
Gross margin	2.23%	3.89%	5.60%	6.74%	7.45%	5.98%
EBITDA margin	-0.78%	2.17%	4.82%	5.01%	4.88%	4.84%
EBIT margin	-1.08%	1.40%	3.72%	4.14%	3.72%	3.90%
Net profit margin	-3.26%	0.51%	1.58%	2.19%	2.49%	2.67%
ROE	-97.50%	8.38%	19.41%	22.18%	22.98%	27.96%
ROaE	-69.46%	8.52%	20.33%	23.89%	25.63%	31.24%

Summary Statement of Financial Position

KES m	2012	2013	2014	2015	2016E	2017E
Total equity	6,446	6,666	7,330	8,556	10,789	13,657
Non-current liabilities						
Borrowings	668	523	88	0	0	0
Total non-current liabilities	898	717	286	211	211	211
Current liabilities						
Payables and accrued expenses	9,113	5,591	5,633	3,696	5,056	7,355
Borrowings	15,947	14,854	10,410	4,662	4,031	4,031
Total current liabilities	25,341	20,739	16,299	8,611	10,022	12,903
Total equity and liabilities	**32,684**	**28,122**	**23,915**	**17,377**	**21,021**	**26,771**
Assets						
Non-current assets						
Property, plant and equipment (net)	4,284	4,668	4,648	3,544	4,475	4,957
Prepaid operating lease rentals	609	601	735	887	1,027	1,107
Deferred tax asset	2,358	2,595	2,180	1,420	782	0
Total non-current assets	8,144	8,740	8,427	6,722	7,150	6,925
Current assets						
Inventories	8,884	6,529	4,141	3,096	5,056	7,355
Trade and other receivables	13,085	10,757	9,726	6,525	8,367	11,772
Cash and cash equivalents	2,191	1,775	1,051	762	99	268
Total current assets	24,540	19,382	15,488	10,655	13,872	19,846
Total assets	**32,684**	**28,122**	**23,915**	**17,377**	**21,022**	**26,771**

Summary Statement of Cash flows

KES m	2012	2013	2014	2015	2016E	2017E
Cash flows from operating activities						
Cash generated from operations	6,087	3,123	6,978	5,852	3,326	3,661
Interest received	78	44	69	84	40	20
Interest paid	(2,351)	(1,672)	(1,340)	(651)	(205)	(81)
Income tax paid	(858)	(198)	(252)	(60)	(425)	(854)
Net cash generated from operating activities	2,956	1,297	5,455	5,224	2,736	2,746
Cash flows from investing activities						
Prepayment for operating lease rentals	(379)	(562)	(817)	(773)	(1,027)	(1,107)
Purchases of property, plant and equipment	(854)	(790)	(429)	(396)	(1,200)	(800)
Proceeds from sale of property, plant and equipment	9	881	260	214	-	-
Net cash used in investing activities	(1,163)	(470)	(987)	669	(2,227)	(1,907)
Cash flows from financing activities						
Net repayments of borrowings	(2,290)	(1,238)	(4,879)	(5,836)	(658)	-
Dividends paid	(596)	(9)	(191)	(478)	(515)	(669)
Net cash used in financing activities	(2,886)	(1,247)	(5,070)	(6,314)	(1,173)	(669)

Recommendation guide

STRONG BUY:	Highly undervalued/ strong fundamentals
BUY:	Good value/ strong fundamentals
ACCUMULATE:	Buy on price dips
HOLD:	Correctly valued with little pricing upside or downside
LIGHTEN:	Overvalued by the market/ Reduce exposure/Declining fundamen tals/industry concerns
SELL:	Weak fundamentals and challenging operating environment/Highly overpriced

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