KenolKobil Update - Cautionary Statement on Potential Take-over

Bloomberg Ticker :	KNOC KN
Reuters Ticker:	KOCL.NR

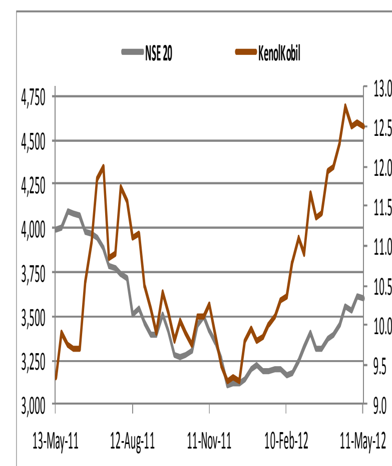
Share Statistics

Current Price (KES)	12.50
Issued shares (m)	1,471.8
Market cap (KES m)	18,397
Market cap (USD m)	220.0
Av daily trading vol (USD)	69,908
Free Float (%)	31.4
Year end	Dec

Price Return

	Absolute	Excess
3m	20.8	6.0
6m	22.0	15.9
12m	33.7	42.8

Price Trend



Source: NSE

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KenolKobil released a fairly detailed statement last week cautioning shareholders and investors that the company's key shareholders had signed an agreement with Puma Energy for the sale of their majority shareholdings in KenolKobil. The contemplated sale of shares is subject to due diligence, regulatory approvals and price confirmation. Should the transaction proceed, Puma Energy would comply with the requirements of the regulations under the Capital Markets Act, and contemplates making a Take-Over offer to acquire all the shares in the Company in accordance with those regulations. Following the announcement, the stock was indefinitely suspended from trading at the Nairobi Securities Exchange.

We address the key concerns as follows:

- **Timeline for the contemplated transaction**– The key determinants for progress on consummating a transaction include (i) Puma Energy's due diligence on KenolKobil which is expected to take approximately two months, (ii) regulatory approvals from the Energy Regulatory Commission ("ERC") and the Competition Boards in the several jurisdictions where KenolKobil operates, and (iii) final price confirmation after the various regulatory approvals are obtained. Puma Energy would trigger the Capital Markets (Take-overs and Mergers) Regulations, 2002 when the Board of Directors of Puma Energy resolve to acquire effective control of KenolKobil. Pursuant to this resolution, Puma Energy (the "Offerer") would be required to serve a notice of intention in writing to KenolKobil (the "Offeree") and various regulators within twenty four hours. Puma Energy would then follow a series of Take-over procedures mandated by the Take-over and Mergers Regulations. Note that Puma Energy could not legally take-over KenolKobil without ERC and Competition approvals in any case. Assuming that regulatory approvals are obtained in a timely fashion, we expect that a full take-over could be effected as early as September 2012.

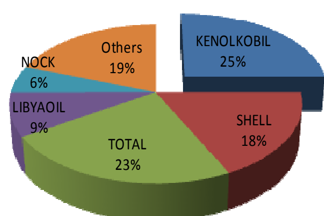
- **Potential deal size and expected take-over premium** - Assuming Puma Energy will launch a Take-over bid for the entire shareholding of the company, the deal size could be more than USD 300m in absolute terms versus KenolKobil's current market value of approximately USD 220m. Our expectation is that all shareholders of the company would be offered the same Take-over price on substantially the same terms. Our most recent fair value estimate on KenolKobil was KES 17.50, and consensus estimates are also around this level. Applying an estimated take-over premium of between 15-20% over fair market value for a controlling interest in the firm points to an offer price between KES 20.13- KES 21.00. This would imply a maximum exit P/E ratio of 9.5x and a P/B ratio of 2.7x, which in our view are unlikely to be achieved in the near-term assuming the status quo remains. We reckon that the stock has been historically undervalued, which could also affect the dynamics of setting the acquisition multiples. We also contend that KenolKobil has been undervalued relative to other sub-Saharan Oil and Gas players, and the acquisition multiples would also attempt to capture the hidden value in the company. Overall, from our preliminary analysis of the contemplated transaction, shareholders would benefit significantly, with an upside of between 61.0% and 68.0% to the current price if the transaction was to materialize.

- **Puma Energy profile** - Puma Energy is one of the fastest-growing oil storage, distribution and marketing companies in the world, and continues to invest heavily in Africa, strategically partnering across the continent with key emerging African players. Puma Energy was formed in 1997 focusing on emerging markets. Puma Energy is an integrated midstream and downstream oil company focusing on supply, storage, and transportation of petroleum products. Headquartered in Switzerland, Puma Energy now operates in 30 countries around the world, including eleven countries across North and

South America. Puma Energy has been operating in Africa for a decade, and now operates in twelve countries across West, Central and Southern Africa. The company has oil storage terminals in northern Europe, the Middle East and South East Asia, with planned developments in India. Puma Energy is the 80% owned oil storage and distribution subsidiary of Trafigura Baheer BV, one of the largest independent commodity traders in the world, and is 20% owned by its African strategic partner Sonangol, the Angolan national oil company.

Our views on KenolKobil - Following our report titled "Fuelling Profits", and subsequent updates we have maintained our **BUY** recommendation on KenolKobil, notwithstanding the current suspension of its share trading on the NSE. Our positive view on the company is informed by growth in profitability driven by a gradual medium term rise in margins, significant improvement in sales volumes, a growing portfolio of strategic fuel storage assets across greater Eastern Africa, and continued growth opportunities as a result of increased acquisitions in sub-Saharan Africa. Further, on a relative basis, trading at a 30.0% discount (on P/E basis) to our sub-Saharan peer group, the company is significantly undervalued vis-à-vis other downstream oil marketers in Africa. In summary, KenolKobil's key growth drivers are:

Market Shares (2011)



Source: Petroleum Institute of East Africa

- margin expansion;
- volume upside from combined mid-stream and downstream activities;
- growing portfolio of strategic storage assets; and
- increased acquisitions in Africa downstream markets.

KenolKobil as an attractive takeover target - As the largest independent downstream oil marketer in greater East Africa, KenolKobil has been a prime take-over target or candidate for a strategic partnership for several years now. The valuations have been compelling, given the company's expected medium term ROE expansion and increased acquisitions in Sub–Saharan Africa that has been a key growth driver for the last three years. KenolKobil's rapid growth (3yr CAGR in revenues: +32.0%) has been supported by accumulation of strategic midstream and downstream oil assets through continued participation in acquisitions and buyouts. The company's strategic intent is to grow its presence further in new markets by participating actively in the buyout of downstream oil assets in Sub-Saharan Africa. KenolKobil's strategy for sub-Saharan Africa appears to offer a good strategic fit with Puma Energy, and synergies are likely to culminate to the latter with increased critical mass capabilities for mid-stream and downstream activities in the East African region. Puma Energy is particularly strong in the greater West Africa region while KenolKobil's strengths lie in the greater East Africa region. KenolKobil would also offer a large outlet for Puma Energy parent company Trafigura's oil supply and trading activities in the greater East Africa region. KenolKobil is also the industry leader in Kenya with a combined market share of 21.2% (including export sales). The table below shows KenolKobil's market shares across the various countries where it has operations.

Country	No. of Stations	Market Share (%)
Kenya	156	25
Ethiopia	65	6
Uganda	64	10
Rwanda	46	32
Tanzania	26	11
Zambia	26	11
Burundi	18	15
Total	**401**	

Source: Company, Petroleum Institute of East Africa

Comparable transactions in sub-Saharan Africa

The largest downstream transaction in Africa (in terms of disclosed deal size) is the acquisition of Shell's downstream business in 14 African countries for USD 1.0bn by Vitol and Helios Investment Partners. While "deal sizes" are disclosed, it is difficult to ascertain specific, comparable and reliable valuation multiples for the various transactions. Aside from the buyers listed below, other large oil companies which have made oil related acquisitions and investments in the greater Eastern Africa region include Libya Oil, Engen Petroleum, Essar Oil and Reliance Petroleum.

Year	Buyer	Seller	Nature of Asset	Value (USD m)
2011	Helios Investment Partners LLP; Vitol Group	Royal Dutch Shell	Africa downstream business	1,000
2010	Puma Energy International	BP	Southern Africa marketing business	296
2009	Total Outré Mer	Chevron	Kenya and Uganda business	150

Source: Companies, various

FY11 earnings review

Income statement (KES m)	FY10	FY11	y/y ch%
Sales	**101,650**	**222,441**	**118.8**
Cost of sales	94,053	210,107	123.4
Gross profit	**7,597**	**12,333**	**62.3**
Other operating income	104	281	170.6
SGA expenses	3,690	5,152	39.6
EBITDA	**3,437**	**6,307**	**83.5**
Operating profit	3,233	6,080	88.1
Interest paid	(544)	(1,413)	159.6
Profit before tax	**2,836**	**4,934**	**74.0**
Taxation	(921)	(1,660)	80.2
Profit before minority interest	1,915	3,274	71.0
Attributable income	**1,915**	**3,274**	**71.0**
Earnings per share (KES)	1.30	2.22	71.0
Dividend per share (KES)	0.52	1.00	92.3

Source: Company reports, Kestrel estimates

KenolKobil released its 1H11 results, posting a 71.0% y/y growth (on restated 2010 earnings) in net earnings to KES 3,274m (against our target of KES 3,225m). In addition to an interim dividend of KES 0.57, the Board of Directors also recommended a final dividend of KES 0.43. We discuss the key highlights from the results below:

- Sales surged 118.8% y/y (+67.0% h/h) to KES 222.4bn, mainly driven by a significant y/y improvement in volumes. The increase in volumes was supported by the company's continued investments in downstream assets, including storage facilities that allow the company to manage inventory more efficiently. According to the Petroleum Institute of East Africa (PIEA), KenolKobil registered a 2011 market share of 25.0%, ahead of other major oil marketers such as Total Kenya and Shell Kenya at 23.3% and 17.8% respectively. The company also notes a positive contribution to sales by the Africa trading desk, Liquefied Petroleum Gas (LPG), fuel oil, and Non-fuel business.
- KenolKobil recorded a 52.5% increase in volumes to 3.0m metric tonnes, out of which 49.6% of the volume was attributable to the trading desk. The significant increase in volumes was also supported by fuel oil contracts from thermal power producers. The retail network accounted for 19.4% of the volumes, but contributed 23.0% to gross profits due to better margins realized on this segment. KenolKobil currently operates a retail network of 401 service stations, and plans to increase the total number of stations to 413 in 2012 through organic growth.
- We note that gross margins declined 193bps y/y to 5.5% mainly on account of increased trading desk business, which generally generates thinner margins although on large volumes. The trading desk, which mainly operates on the African East coast has provided opportunities for the company to participate in non-speculative bulk cargo originating from the Arab Gulf.

KenolKobil Limited (cont'd)

- SGA expenses grew 39.6%, implying faster growth in EBITDA, which grew by 83.5% y/y to KES 6.3bn. Administrative expenses increased 49.2% y/y to KES 3.9bn, partly impacted by provisions taken by the company against some trade receivables. Notably, the company changed its accounting policy on the valuation of its fixed assets from a revaluation values to a historical cost model. The net effect of this change was a decrease in depreciation charges by KES 139.0m. According to management, this change in policy has been mainly motivated by the rapid rise in the values of fixed assets in recent years, while management want to maintain a more conservative stance.
- The company was negatively impacted by a KES 1.2bn foreign exchange loss, out of which KES 982m was attributable to Kenya. We also note a negative movement of KES 1.5bn in the hedge reserve on the Statement of Comprehensive income as a result of losses on forward positions taken on the USD. This was indeed our key downside risk on 2011 earnings – currency risk for KenolKobil arises as a result of the large mismatch between USD denominated contract liabilities, and receivables denominated in domestic currencies. The company's policy is to hedge 50% of its USD liabilities which invariably leads to forex losses as a result of currency volatility on KES (and other regional currencies) vis-à-vis the USD.
- Net finance costs were substantially higher at KES 1.2bn compared to KES 397.0m in the previous year as a result of higher interest costs, coupled with increased borrowing. In addition to the short term borrowings obtained by the company to finance inventory, KenolKobil obtained medium term borrowings amounting to USD 17.0m for capex to finance various acquisitions during the year. The company invested in various terminals in Dar-es Salaam, Bujumbura, Lubumbashi , Jinja, and Lusaka. KenolKobil also bought the assets of Phoenix Petroleum (U) Ltd in Uganda.
- Although no specific plans were mentioned, the company also revealed the possibility of bringing on board a strategic investor/partner to bridge the company to the next level of growth. KenolKobil has been investing aggressively in downstream oil assets, which has provided new growth opportunities for the company. Acquiring diverse and adequate storage facilities is a capital intensive but strategic exercise, giving KenolKobil a competitive advantage over its competitors.
- We remain positive on the company; our view is informed by the expected growth in profitability driven by a gradual medium term rise in margins, significant improvement in sales volumes, and continued growth opportunities as a result of increased acquisitions in sub-Saharan Africa.
- We reiterate our **BUY** recommendation for KenolKobil.

Peer Comparables: Oil and Gas companies in Africa (2011)

Name	Country	P/E (x)	P/B (x)	Did Yield (%)	ROE (%)
KENOLKOBIL	**Kenya**	**5.6**	**1.6**	**8.0**	**28.1**
TOTAL KENYA	Kenya	-	0.3	-	(1.8)
SASOL LTD	South Africa	8.0	2.0	4.4	24.4
OANDO PLC	Nigeria	2.6	0.4	13.9	19.7
TOTAL GABON	Gabon	8.0	2.0	7.5	16.6
TOTAL NIGERIA PLC	Nigeria	13.3	4.9	6.6	40.2
CONOIL PLC	Nigeria	6.3	1.2	7.9	19.4
TOTAL PETROLEUM GHANA LTD	Ghana	14.9	4.6	5.0	32.4
GHANA OIL CO LTD	Ghana	10.8	2.2	3.4	21.7
ENGEN	Botswana	9.7	3.4	13.3	39.9
	Mean	**7.9**	**2.3**	**7.0**	**24.1**
	Median	**8.0**	**2.0**	**7.0**	**23.0**

Source: Bloomberg

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 fundamentals/ industry concerns
SELL:	Weak fundamentals and challenging operating environment/Highly overpriced

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