KESTREL CAPITAL

Member of the Nairobi Stock Exchange

21 September 2011

KenolKobil Limited

Recommendation: BUY

Following our report titled “Fuelling Profits”, we maintain our **BUY** recommendation on KenolKobil and upgrade our fair value estimate to **KES 17.50**. Our positive view on the company is informed by more aggressive 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. On a relative basis, trading at a 24.4% discount to our sub-Saharan peer group, the company is significantly undervalued vis-à-vis other downstream oil marketers in Africa.

- **Margin expansion to drive long term profitability** – We hold the view that margin expansion will be the key long term driver for sector profitability. Our revenue model for KenolKobil assumes that gross margins will gradually improve over the medium term, conditioned upon rationalized sector pricing. On a gross margin basis, we think oil marketers will benefit from reduced price undercutting in a price-regulated market. We have assumed that margins will rise by 33bps y/y in FY11 and 93bps till FY13 as a result of improved margins in its niche operations such as the African trading desk, exports, Liquefied Petroleum Gas (LPG), fuel oil, and non-fuel business.
- **Mid-stream business development offers profit growth opportunities** - The trading desk, which mainly operates on the African East-coast has provided opportunities for the company to participate in non-speculative bulk cargo sales originating from the Arab Gulf market. We expect that the company will benefit on margins generated from this niche market with relatively low operating risk since the fuel volumes are pre-contracted. The trading desk currently accounts for approximately 11% of group pre-tax profitability.
- **Group sales remain strong** – KenolKobil’s inland sales are estimated to grow by 24.7% y/y in FY11F to 2.5m metric tonnes, and our forecasts suggest that this will improve to a 3yr CAGR of 26.5% till FY13. We expect this growth to be driven by fuel demand from thermal power producers, and an enhanced distribution and storage network in the country. We note that KenolKobil currently has the leading market share for Kenya inland sales at 23.8% (from January to June 2011), supported by its wide distribution network of 156 fuel stations and strategic assets such as depots and blending plants. Export volumes are also on the rise as a result of increased demand from growing regional economies. KenolKobil is also the industry leader in Kenya with a combined market share of 21.7% (including export sales).
- **Forex losses remains our key risk -** Aside from the risks of margin volatility and infrastructure inefficiency costs, our key risk to KenolKobil’s near term performance is the risk of currency depreciation. Currency risk for KenolKobil arises as a result of the large mismatch between USD denominated contract liabilities, and receivables denominated in domestic currencies. While the company is 50% hedged on its USD liabilities, we hold the view that there is high likelihood of significant forex losses in FY11 as a result of the depreciation of the KES and other domestic currencies vis-à-vis the USD.

Key Statistics	FY10	FY11F	FY12F	FY13F
EPS (KES)	1.21	2.19	3.44	4.04
Growth (%)	37.2	81.5	56.9	17.6
DPS (KES)	0.52	1.00	1.25	1.50
Growth (%)	60.0	92.4	40.3	13.9
EV/EBIT (x)	7.3	4.0	3.1	2.7
EV/EBITDA (x)	6.2	3.8	2.9	2.6
P/E (x)	8.6	4.7	3.0	2.6
P/B (x)	1.2	1.1	0.8	0.7
Div Yield (%)	5.0	9.6	13.5	15.4
ROaA (%)	5.6	9.1	12.1	12.7
ROaAE (%)	14.7	23.9	30.6	28.8

Source: Company, Kestrel estimates

Bloomberg Ticker :	**KNOC KN**
Reuters Ticker:	**KOCL.NR**

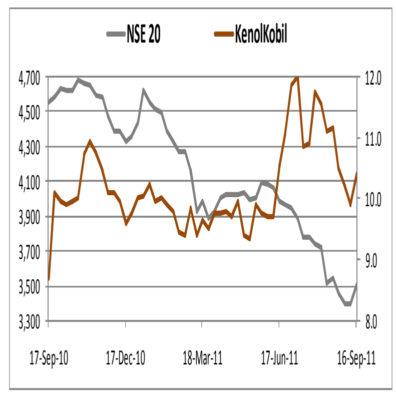
Share Statistics

Fair Value (KES)	17.50
Current Price (KES)	10.40
Issued shares (m)	1,471.8
Market cap (KES m)	15,306
Market cap (USD m)	162.6
Av daily trading vol (USD)	147,047
Free Float (%)	34.0
Year end	Dec

Price Return

	Absolute	Excess
3m	5.2	5.5
6m	-0.5	-5.8
12m	118.3	74.2

Price Trend



Source: NSE

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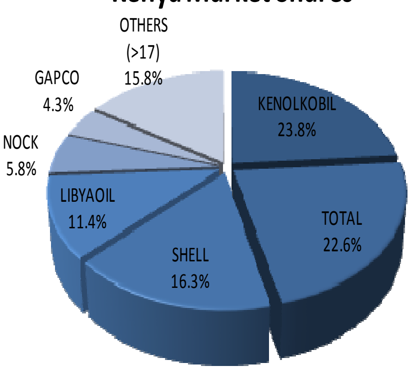
Acquisitions: the new growth frontier - With an enhanced capex programme, the company intends to grow its presence further in new markets by participating actively in the buyout of downstream oil assets in Sub-Saharan Africa. Management estimates that subsidiaries will account for about 45.0% of the company's operating profits in FY11, which we think is plausible given the company's growing presence in Sub-Saharan downstream markets. KenolKobil's rapid growth has been supported by accumulation of strategic midstream and downstream oil assets through continued participation in acquisitions and buyouts.

The company has outlined a capex programme of USD 17m (financed through medium term loans) to participate in the acquisition of downstream assets in sub-Saharan Africa as Multinational Oil Corporations (MNC's) exit downstream markets in Africa. Assets already acquired during FY11 include: a terminal in Tanzania; depots in Burundi and Uganda; and the acquisition of assets from Phoenix Petroleum (U) Ltd in Uganda. Other projects slated for FY11 include a terminal in Lubumbashi, DRC, and construction of new storage facilities in Lusaka and Bujumbura. Acquiring diverse and adequate storage facilities is a capital intensive but strategic exercise, giving KenolKobil a competitive advantage over its competitors.

Kenya Market Shares



Source: Petroleum Institute of East Africa

KenolKobil remains an attractive takeover target - As the largest independent downstream oil marketer in East Africa, we view KenolKobil as a possible take-over target (or candidate for a strategic partnership) in future. Further, trading at FY11F EV/EBIT and EV/EBITDA multiples of 4.0x and 3.8x respectively, the valuations are compelling coupled with the expected medium term ROE expansion and sustained high dividend yield.

Earnings drivers

Metrics	FY10	FY11F	FY12F	FY13F
Total volume (MT)	2,002,016	2,496,779	2,746,457	3,158,425
% y/y	(22.2)	24.7	10.0	15.0
Sales (KES m)	101,761	150,606	173,197	190,517
% y/y	5.2	48.0	15.0	10.0
SG&A expenses (KES m)	3,347	4,183	4,685	5,388
% y/y	1.5	25.0	12.0	15.0
Gross Margin (%)	7.6	7.9	8.3	8.5
EBITDA margin (%)	4.3	5.1	5.6	5.7
Net Margin (%)	1.7	2.1	2.9	3.1

Source: Company, Kestrel estimates

Country	No. of Stations	Market Share (%)
Kenya	156	24
Ethiopia	65	6
Uganda	64	10
Rwanda	46	32
Tanzania	27	11
Zambia	25	11
Burundi	17	15
Total	**400**	

Source: Company, Petroleum Institute of East Africa

1H10 earnings review

Income Statement (KES m)	1H10	1H11	y/y ch%
Sales	**60,350**	**83,313**	**38.1**
Cost of sales	56,085	76,571	36.5
Gross profit	**4,264**	**6,742**	**58.1**
SGA expenses	1,887	2,312	22.6
Operating profit	**2,378**	**4,510**	**89.6**
Finance income/costs	(646)	(1,291)	100.0
Profit before tax	1,732	3,218	85.8
Taxation	(553)	(1,061)	92.0
Attributable income	**1,179**	**2,157**	**82.9**
EPS (KES)	**0.80**	**1.47**	**82.9**

Source: Company

KenolKobil released its 1H11 results, posting an 82.9% y/y growth in EPS to KES 1.47. The board of directors also recommended an interim dividend of KES 0.57. Below are some highlights from the results:

- Sales increased 38.1% y/y to KES 83.3bn and the company realized a gross margin of 8.1% compared to a gross margin of 7.1% in 1H10. We observe that margin upside, in addition to growth in volumes has resulted in the 58.1% growth in gross profit for the company. We think price controls have resulted in stability in gross margins for oil marketers due to significant elimination of price undercutting in the sector.
- SGA expenses increased 22.6% y/y mainly as a result of provision for a doubtful debt and higher operating expenses. However, distribution costs declined 4.0% to KES 527.2m.
- Finance costs were substantially higher compared to the previous year (+100.0% to KES 1.3bn). The company indicated that forex losses accounted for 65.0% of total finance costs while interest costs were higher as a result of increased borrowing. The company also announced the continuance of its KES 1.5bn Commercial Paper programme to finance working capital requirements.
- Despite the current under-investment and inefficiencies associated with petroleum storage and transportation infrastructure in Kenya, we believe that ongoing sector reforms and privatization plans for state corporations in the petroleum supply chain will provide a more favorable environment for oil marketers in Kenya.
- We remain positive on KenolKobil's opportunities to grow profitability in FY11, and in the medium term. Our view is further supported by margin stabilization in the sector, expected significant volume upside, and growing profitability from subsidiaries.

Valuation of KenolKobil and Peer Comparables

Discounted Cash Flow Method (DCF)

We have used Discounted Cash Flow valuation to derive our fair value per share over the forecast period. Our discount rate (cost of equity) assumption of 22.2% was based on a Risk Free Rate of 14.0%, Market Risk Premium of 8.5%, a Beta of 0.95, and a long term sustainable growth rate of 3.0%.

Our DCF model discounts Free Cash Flows over a 3 year period (until 2013) and thereafter derives a value based on the perpetuity method. Our estimated Free Cash Flows were discounted using the Weighted Average Cost of Capital (WACC) using a cost of debt of 12.0% and a tax rate of 30.0%.

DCF Valuation	
Sum of discounted free cash flows (KES m)	9,076
Terminal value (KES m)	30,334
Total intrinsic value (KES m)	39,410
Net debt/ (cash) (KES m)	13,647
Total equity value (KES m)	25,763
No. of shares (m)	1,472
Per share value (KES)	**17.50**

Source: Kestrel estimates

Peer Comparables: Oil and Gas companies in Africa (2010)

	Country	P/E (x)	P/B (x)	Div Yield (%)	ROE (%)	ROA (%)	EV/EBIT (X)	EV/EBITDA (x)
ENGEN	Botswana	11.7	4.1	3.9	39.9	22.5	4.9	4.7
TOTAL GABON	Gabon	12.5	1.9	7.1	16.6	10.6	6.1	2.3
GHANA OIL	Ghana	11.9	2.2	3.0	19.6	5.4	4.1	3.7
TOTAL GHANA	Ghana	28.2	6.1	2.3	22.4	8.7	10.8	6.1
KENOLKOBIL	**Kenya**	**8.6**	**1.2**	**5.0**	**14.7**	**5.6**	**7.3**	**6.2**
TOTAL KENYA	Kenya	4.9	0.4	5.4	7.4	3.0	2.8	4.0
TOTAL COTE D'IVOIRE	Cote d'Ivoire	8.3	1.7	-	20.7	10.6	6.6	-
SHELL COTE D'IVOIRE	Cote d'ivoire	11.1	1.1	-	8.4	4.1	-	-
AFRIQUIA GAZ	Morocco	18.4	3.6	-	20.7	6.0	13.6	9.8
OANDO PLC	Nigeria	4.1	0.6	0.1	19.7	4.5	8.9	7.2
CONOIL PLC	Nigeria	8.2	1.5	6.1	19.4	6.9	4.5	3.1
TOTAL NIGERIA PLC	Nigeria	17.0	9.9	4.2	55.7	8.7	8.3	6.9
MOBIL NIGERIA PLC	Nigeria	35.8	6.3	0.8	43.1	7.5	3.8	3.2
SASOL	South Africa	10.2	2.1	3.8	17.9	11.8	8.0	-
	Mean	**13.6**	**3.1**	**3.8**	**23.3**	**8.3**	**6.9**	**5.2**
	Median	**11.4**	**2.0**	**3.9**	**19.6**	**7.2**	**6.6**	**6.1**

Source: Bloomberg

Financial summary

Income statement (KES m)	FY10	FY11F	FY12F	FY13F	y/y ch%	3yr CAGR %
Sales	101,761	150,606	173,197	190,517	48.0	23.2
Gross profit	7,708	11,898	14,375	16,194	54.4	28.1
EBITDA	4,354	7,715	9,690	10,806	77.2	35.4
Operating profit	3,667	7,257	9,165	10,214	97.9	40.7
Finance cost/income	(971)	(2,650)	(1,936)	(1,711)	173.0	20.8
Profit before tax	2,698	4,607	7,229	8,503	70.8	46.6
Taxation	(921)	(1,382)	(2,169)	(2,551)	50.0	40.4
Profit after tax	1,777	3,225	5,060	5,952	81.5	49.6
Balance sheet (KES m)						
Fixed assets	4,595	6,125	7,025	7,925	33.3	19.9
Other non-current assets	1,560	1,560	1,560	1,560	-	-
Current assets	26,062	31,161	35,925	39,861	19.6	15.2
Total Assets	32,217	38,845	44,510	49,345	20.6	15.3
Shareholders equity	12,706	14,326	18,753	22,639	12.8	21.2
Non current liabilities	632	632	632	632	-	-
Current liabilities	18,879	23,887	25,125	26,074	26.5	11.4
Total equity and liabilities	32,217	38,845	44,510	49,345	20.6	15.3
Cash flow statement (KES m)						
Cash generated by operations	3,487	5,065	7,754	9,095	45.2	37.7
Working capital (Increase)/Decrease	(12,552)	(2,098)	(3,099)	(2,386)	(83.3)	(42.5)
Operating Cash Flow	(9,065)	2,967	4,655	6,709	(132.7)	(190.5)
Net interest received/(paid)	397	1,650	1,436	1,411	315.1	52.5
Cash taxes	(634)	(1,382)	(2,169)	(2,551)	117.9	59.0
Net cashflow before investing	(9,699)	1,585	2,486	4,158	(116.3)	(175.4)
Net cash invested	(896)	(1,988)	(1,425)	(1,492)	121.9	18.6
Free cash flow	(10,595)	(403)	1,061	2,666	(96.2)	(163.1)
Net financing cash flow	10,595	403	(1,061)	(2,666)	(96.2)	(163.1)
Net cash flow for the year	(1,582)	(507)	428	601	(67.9)	(172.4)
Opening cash balance	3,678	2,133	1,626	2,054	(42.0)	(17.7)
Closing cash balance	2,133	1,626	2,054	2,655	(23.8)	7.6

Source: Company, Kestrel estimates

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

Disclaimer