

Company Research Update (CRU)



Kenya Airways Limited

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Verdict: UNDERVALUED

We undertake an analysis of Kenya Airways (KQ), Kenya's national flag carrier and one of Africa's top airlines. Our analysis has been prompted by recent events that may influence the company's performance in the medium-to-long term.

Despite the current global economic downturn, its hedging contracts and staff cost challenges; we opine that the significant improvement in the global fuel price, the aggressive drive to expand its route network and improvements in its on-time flight policy could see the company register a material improvement in its FY performance for the year to March 2010.

Valuation verdict

We value the KQ share at Kshs. 34.64 (US\$0.45), 53.95% above the current price*. We see the airline markedly cutting its loss after tax figures by about 60% in FY10 and it re-bounding to profitability in FY11, provided the global recession dissipates. Indeed, we feel that the worst in global recession is now behind us, which means that tourism and international traveler numbers will be picking up, in addition to the international fuel price registering significant gains thus cutting KQ's hedging exposure. The Airline's trailing EPS stands at Kshs. -8.84 per share, with fair prospects of a reduction in Loss per Share to Kshs. -3.50 per share in FY2009 and a full recovery to about Kshs. 1.10 per share in FY2011.

Other factors going for the company include the company having a potential to expand to other routes both in Africa and to the rest of the world, the use of the internet which presents a convenient flight booking tool and the planned procurement of more Aircraft which could see more cargo space, greater comfort and lower fuel use for the airline. The airline however also faces some challenges that include, unpredictable fluctuations in international fuel price, obstacles to market access, Airport safety and security challenges, staff wage increase agitation, Exchange rate fluctuations, stiffening competition and political risk.

Business Model & Strategy

KQ's business model revolves around increasing its number of flight destinations especially within Africa, higher frequencies to some destinations, taking shorter routes (where possible), implementing tactical cut-backs on some routes, increasing cargo volume uptake and procuring and using new modern Boeing 787 Dreamliners which have more cargo space, greater comfort and lower fuel use. E – Ticketing, a convenient tool not only to market the airline but also to cut on time and money cost of going through agents for flight bookings has also been adopted by the company.

Company financials

We expect the company's top-line to remain above Kshs.70bn (-US\$ 933 Mn) in FY2010, with the bottom-line registering some improvement in FY2009/10, owing to some recovery in the price of jet fuel and the resultant reduced hedging risk exposure. On the flipside, expect staff costs to rise by about Kshs. 900m, in addition to a rise in direct costs as fuel price improves. In the interim, the company is likely to continue to rely on its revenue reserves if and when it declares dividends.

Conclusion

For KQ, we are anticipating a significant improvement in performance from the Kshs. 5.6bn loss registered in FY2008/09 mainly as a result of marking oil price to market (at about US\$ 50 per barrel in March 2009 and now at above US\$ 70 per barrel), and passing the unrealized losses as a result of hedging (at US\$ 110 per barrel) through its income statement. Also, we opine that the upside factors outweigh the challenges. The foregoing, added to our valuation points to a likely rebound for the airline which would ensure shareholder value creation in the medium-to long term.

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Management Opinion

The company's board recognizes that the company's loss after tax in FY2009 compares unfavorably with prior years' results. It however notes that there is a likely improved performance in FY2010 on the back of increased passenger numbers, better yields and improved exchange rate. KQ also anticipates increased competition and is increasing its investments in its airline fleet, people and systems to match competition.

Dividend Policy

In the 3 years prior to FY2009, the company's payout ratio averaged 18%. However, in the medium-term (1-1.5years), it is unlikely that this payout ratio would be maintained without eroding retained earnings. We anticipate a modest 5-10% payout ratio in the foreseeable future.

Performance of the global airline industry

The global airline industry performance has been bad with over 40 airlines suspended from the IATA settlement system in the last 15 months for non payments. IATA opines that demand will continue to improve, with fares stabilizing, but at profitless levels. Meanwhile, cost pressures will continue to mount from reduced aircraft utilization and rising oil prices. The global aviation body reckons that the industry is not out of the woods just yet.

Competition on African routes

Kenya Airways, Ethiopian Airlines and South African Airways are the major players in Africa. Kenya Airways leads the pack with 36 African routes that now account for more than half of its annual revenues. Following KQ is Ethiopian Airlines which flies to 34 destinations and South African Airlines which plies 30 destinations on the continent.

Africa remains a key focus region for the airlines as the aviation following effects of global financial crisis that saw traveler numbers drop by as much as 30 per cent. Kenya Airways which commands about 67 per cent of the Africa route network plans to open three additional routes by the end of 2009, after launching four new routes.
10,386.35

Ticker.....	KQ	Issued & Fully paid shares.....	461,615,483
Current price.....	20.50*	DPS (Kshs. per Share).....	1.00
Market Cap (Kshs Mn).....	10,386.35	Dividend yield.....	4.81%
Historical EPS (Ksh.).....	(8.84)	Historical P/E.....	-
Par value (Ksh.).....	5.00	Forward (2010) P/E.....	-

* Price as at Week ended October 16 2009.

Introduction

KQ is an aviation industry player and is engaged in international, regional and domestic carriage of passengers and cargo by air, the provision of ground handling services to other airlines and the handling of import and export cargo. The Company flies to several destinations in Africa, Middle East, Asia and Europe.

Key recent developments

3rd February 2009: KQ issues a profit warning for FY2008/09, attributing the likely fall in profits to the global economic crisis, high fuel prices, post election violence experienced in Kenya at the beginning of 2008, a strong Kenyan Shilling against the US Dollar, the aviation industry's continuing decline in passenger numbers and a hedge of a part of its fuel prices at higher than the market.

15th July 2009: Kenya Airways in partnership with Air Botswana announces plans to launch flights to Gaborone in September 4 2009, under a code share arrangement with Air Botswana.

20th July 2009: Kenya Airways announces extensive enhancements to its Mombasa flight schedule, including increasing its weekly flights from the current 27 to 58 flights per week, beginning July 2009.

28th July 2009: Kenya Airways unionisable workers issue a 21-day strike notice to the airline, and the Labour ministry, due to what they say are stalled salary negotiations.

16th August 2009: KQ unionisable workers call off a 2-day strike after agreeing to a return-to-work formula. The pay plan included among other things, an interim wage award of 10 per cent for the first year and 10 per cent for the second year - total of 20 per cent for the review period.

19th August, 2009: Kenya Airways announces plans to launch direct flights to Ndola – the second largest city in Zambia on September 17, 2009. Ndola becomes the 36th African destination in the KQ network with recent additions being to Congo-Brazzaville and Libreville; launched in March and June this year respectively.

11th September 2009: Kenya Airways moves to bolster its presence in the Seychelles in a pact that will see the two countries market tourism through a twin destination concept, months after Kenya Airways signed a deal with KTB and other Kenyan sectors such as hoteliers and the media to grow arrivals from African countries to boost tourism and increase the airline's revenues.

Company Board

KQ's board of directors is composed of a Chairman (Mr. Evanson Mwaniki), Group MD& CEO (Mr. Titus Naikuni), Finance Director (Mr. Alex Mbugua) and 8 Non-Executive Directors (Mr. Dinesh Kaplila, Eng. Abdulazaq Adan Ali, Mr. Peter Hartman, Mr. Ron Schipper, Mr. Denis Afande, Mr. Joseph Kinyua, Mr. Ayisi Makatiani and Mr. Jos Veenstra).

The Kenya government is represented by Cyrus Njiru who comes from the transport ministry. KLM nominee Micah Cheserem resigned during the 2008 when he was appointed chairman of Kenya's Capital Markets Authority.

Corporate Actions

KQ has been consistent in paying dividends in the past few years, paying a DPS of between Kshs. 0.50 and Kshs. 1.75. In the latest FY announcement, the company's DPS was 32.65% down, as a result of significantly lower earnings figures.

Recent Corporate actions

Corporate Action	Amount (Kshs)	Ann. Date	Bk Cls. Date	Payment Date
1ST& FINAL DIVIDEND	1.25	27/05/05	12/8/05	14/9/05
1ST& FINAL DIVIDEND	1.75	30/05/07	24/8/07	28/9/07
1ST& FINAL DIVIDEND	1.75	5/05/08	26/09/08	24/10/08
1ST& FINAL DIVIDEND	1.00	05/06/09	25/09/09	23/10/09

Source: Nairobi Stock Exchange

Shareholding

As at March 2009, most (74.27%) of KQ's issued and fully paid shares were held by local (41.15%) and foreign (33.12%) institutions. The company was cross-listed in Uganda and Tanzania in March 2002 and October 2004 respectively.

Also, a majority (about 63.38%) of the total issued shares are held by large shareholders who hold at least 1 million shares and above.

The KQ-KLM Partnership: One of the main shareholders of KQ – KLM (through KLM-Koninklijke Luchtvaart) acquired a 26 percent stake in Kenya Airways in 1996 for US\$26 million. This KQ-KLM relationship continues to date, with the two companies sharing codes, and Kenya Airways implementing KLM's customer service procedures. As a result, benefits from economies of scale in purchasing and other areas have been accruing.

The shareholders' agreement reached at in December 1995, between the Kenya government and KLM, stipulates that the Dutch airline has the power to nominate candidates for the positions of Managing Director and Finance Director of Kenya Airways for Board approval. Also, according to the agreement, as long as the Co-operation Agreement remains in force, the Board of Kenya Airways may not make any major strategic decisions, such as new aircraft acquisitions or material changes to Kenya Airways' route network, without the prior approval of the KLM-appointed Directors.

Name of Shareholder	No. of Shares	% of Issued Shares
KLM-Koninklijke Luchtvaart	120,020,026	26.00%
PS Treasury	106,171,561	23.00%
Stanbic Nominees Kenya Ltd A/C NR70001	11,525,200	2.50%
Mansukhlal Khetshi Shah	6,515,378	1.41%
Barclays (Kenya) Nominees Limited a/c 9318	4,715,917	1.02%
Paul Wanderi Ndungu	4,356,544	0.94%
Apa Insurance Limited	4,055,592	0.88%
Kenya Commercial Bank Nominees Ltd A/C 769G	3,554,300	0.77%
Khetshi Dharamshi And Company	3,289,371	0.71%
Stanbic Nominees Kenya Ltd A/C NR13001	3,000,000	0.65%
Subtotal	267,203,889	57.88%
Others (7,6693)	194,411,594	42.12%
Total	461,615,483	100.00%

Source: KQ

Kenya's Airline Industry

Kenya's airline industry is regulated by the Kenya Civil Aviation Authority. The domestic civil and cargo air transport market is composed of several players that include; 748 Air Services, African Express Airways, Airkenya Express, ALS - Aircraft Leasing Services, Astral Aviation, Blue Bird Aviation (Kenya), CMC Aviation, Delta Connection (Kenya), East African Safari Air, Fly540, JetLink Express, Kenya Airways and Safarilink Aviation.

Pertinent Information

Jet Price Sensitivity: KQ has increasingly become sensitive to fuel price changes and less sensitive to currency fluctuations – a 1% increase/decrease in fuel price impacts the profit by Kshs. 269 million (\$3.6 million). In addition, as of March 2009, fuel cost excluding hedge cost accounted for 32% of operating cost (2008 – 29%). This cost will most likely remain above 30% and continue to significantly influence the company's earnings.

Fuel Hedging: In compliance with fuel hedging accounting rule (IAS 39) that requires changes in fair value balances of outstanding derivatives to be passed through the income statement, KQ charged an unrealized hedge loss of Kshs 7.5bn through the FY2009 income statement. The unrealized hedge loss relates to future fuel consumption up to December 31 2010. Although the company is in the process of reviewing the hedging policy through a committee of the company's board, we reckon that the item will continue to affect the company's bottom-line in the medium-term.

KQ's Historical fuel price hedge Receipts and Payments [2004 – 2009]

Year	Kshs. '000'
2004	1,499
2005	3,416
2006	-1,814
2007	-2,808
2008	1,888,052
2009	-1,372,003
Cumulative position	516,342

Source: KQ

Routes & Revenue: KQ flies to 37 African cities, 5 Asian and 3 European destinations. Revenue comes from Kenya (4%), Africa (46%), Middle East & Asia (22%), and Europe (29%). The 3 European destinations and 5 Middle East & Asia seem to contribute more significant revenue per destination. Therefore, in addition to expanding its Africa network routes, the Airline should also consider increasing the number of European, Middle East & Asia destinations and new previously unexplored routes.

Investment in African Airlines: KQ's 49% investment in Tanzania's Precision Air brought in Kshs. 62 million in profit. The company needs to actively participate in buying stakes in select African Airlines to firm-up its foothold in Africa, but also diversify its risk exposure.

Currency transfer restrictions: KQ has 58 million (\$763,000) in Seychelles that they could not repatriate due to funds transfer restrictions. However, the Seychelles government has allowed the company to utilize the funds to procure services

Borrowings: As of March 2009, the airline had a loan amounting to Kshs 32 billion (with 23 billion or ~\$303 million) owed to Barclays Bank plc, also from ABN Amro and EXIM Bank USA –repayable over periods of 12 years from the dates of disbursement of the loans and at rates between 4.5% and 6.6%.

Employee relations: As of March 2009, KQ had 4,240 employees. Among these employees are 340 pilots and 850 cabin crew. The airline plans to hire 68 pilots in 2009 and another 23 over the next 5 years to replace retiring pilots. Recently, the company signed a Collective Bargaining Agreement with the Aviation and Allied workers union (AAWU), which saw AAWU members receive a 20% salary increase spread over 2 years. The amount applies to basic salary and allowances of the 3,500 flight attendants, cargo handlers, engineers and ground crew of Kenya Airways employees. The pay increase was backdated 18 months from August 2009 and will add about 900 million shillings to the airline's five billion shillings (\$65.95 million) wage bill.

Pertinent Information Cont'd

Aircraft Fleet: KQ owns Boeing 777-200, 737-300, 737-700 aircraft. The company leases Boeing 737-800s and 767s, as well as Embraer 170s (it paid 4.9 billion in leases in FY2008/09). The airline paid deposits of Kshs. 1.65 billion (\$21.7 million) to Boeing for the yet to fly Dreamliner B787 whose deliveries they expect between 2013 and 2015. However, given that there have been some delays in this delivers and the fact that some leases on the company's planes are about to expire, KQ is discussing the purchase of 6 to 9 Airbus A330-200s.

Passenger services: For KQ, the busiest passenger months are July to August (~270,000 passengers p.m.) while lowest is February (~200,000).

Performance comparison (in capacity and Passenger uplift) between Q12008/09 and Q12009/10

Capacity		Passenger Uplift	
Region	Performance	Region	Performance
European region	Up 20%	European region	At par
Middle, Far East & Asia	Down 3%	Middle, Far East & Asia	Down 25%
Northern Africa	Up 7%	Within Africa but excluding Kenya	Up 3%
Southern Africa	Up 7%	--	--
Kenya	Down 2%	Kenya	Down 3%
Total	Up 10%	Total	Down 4%

Source: KQ

On time flights: Kenya Airways' punctuality is now on a 4 year high after an 86 percent on zero minute performance. This means that nearly all of Kenya Airways flights are punctual; on time at all times – the best record for the airline. This performance implies a 95% performance when measured by International Air Travel Association (IATA) standards that define on-time as within 15 minutes after scheduled departure time.

KQ (2009) performance comparison with peers: The recent FY2009 loss figures for KQ seem to have significantly affected its profitability ratios, excepting operating margins which though positive were lower compared to selected peers Emirates Airways and South African Airways (SAA).

Emirate Airways seems to have a relatively better ROE, a lower debt ratio and a lower debt to equity ratio. SAA seems to have a relatively better ROA, a lower direct cost margin and compared to the other two.

Kenya Airways seems to be doing better than Emirates in terms of direct cost margins as far as the selected indicative ratios is concerned, but worse in all the other selected indicator ratios. It is however expected that these some of these ratios will most likely improve in the medium-term, thanks to a recovery in global markets.

Selected indicator Ratios for KQ, Emirates & South African Airways (SAA)

	KQ	Emirates	SAA
ROA (%)	(5.45%)	12.85%	29.95%
ROE (%)	(23.77%)	19.87%	7.76%
Debt Ratio (%)	77.08%	35.32%	50.78%
Debt to Equity	3.36	0.55	1.03
Current ratio	0.90	3.36	6.97
Direct cost margin (%)	(66.54%)	(85.91%)	(60.70%)
Operating profit margin (%)	5.63%	14.78%	39.29%
LBT/PBT margin (%)	(7.89%)	16.36%	20.00%

Source: Various

KQ Financials

Comment on Consolidated Income Statement

Over 6 years between 2003 and 2009, total turnover has been on an uptrend, registering a compounded cumulative growth rate (CAGR) of 17.4%. In the last 4 years, gross profit margins have been in the 22% to 32% range. Pre-tax profit has fluctuated within the -7.89% and 13.18% range over the same period. In 2009, the LBT/PBT margin slipped into negative territory as a result of a fuel derivative unrealized loss of Kshs 7.53bn. We expect the company to bounce back in the medium-to-long term, in line with a recovery of international fuel price and a review of the company's hedging policy from 2010.

Direct Costs

Direct sales cost that includes Aircraft fuel oil, Aircraft landing, handling and navigation costs and aircraft maintenance costs, which together accounted for 76.52% of the total direct cost in 2009, (2008 – 72.38%) was at an average of 68% as a ratio of turnover. Fuel cost incurred in generating sales accounted for 36.22% of total operating cost. Given this challenge, short-term hedging 6-9months could help smooth out the cost of fuel whilst making it more predictable.

Realized and Unrealized losses/gains on fuel derivatives

Given that the cost of fuel is unpredictable, it is prudent to hedge. However, as has been indicated by recent hedging risk exposure(s), it can be a costly undertaking. In 2009, KQ paid Kshs. 1.3bn as hedging cost. In 2010 and 2011, we anticipate that the airline will pay about Kshs. 985m and Kshs. 1bn respectively in hedging cost. Also, unrealized losses on fuel derivatives (which were marked to market in 2009 leading to the significant LBT) could markedly reduce from 2010 as the price of fuel improves and as the company reviews its hedging policy, leading to a return to profitability in the medium term.

Comment on Balance Sheet

KQ's shareholder funds have fluctuated in the past, registering a 22.84% growth in 2008 and a 35.38% drop in 2009. In 2010, we expect a marginal 1.09 drop as the company pays the Kshs. 462m from its revenue reserve.

The company's gearing which measures the percentage of capital financed by debt and long-term finance stands at an average of 66%. Conventionally, a gearing ratio of 15% would be considered prudent while anything over 100% would be considered risky. KQ'S rate is well within the acceptable conventional range.

Selected indicator Ratios for KQ

	2011F	2010F	2009	2008	2007
ROA (%)	0.65%	-2.12%	-5.45%	5.88%	5.30%
ROE (%)	2.87%	-9.51%	-23.77%	17.22%	18.94%
Debt Ratio (%)	77.22%	77.72%	77.08%	65.85%	72.00%
Debt to Equity	3.39	3.49	3.36	1.93	2.57
Direct cost margin (%)	-67.46%	-66.18%	-66.54%	-64.19%	-70.31%
Operating profit margin (%)	4.51%	4.84%	5.63%	7.11%	12.99%
LBT/PBT margin (%)	3.84%	-2.71%	-7.89%	10.79%	10.16%
Payout ratio (%)	90.91%	-28.57%	-11.31%	17.66%	19.73%

Source: Sterling

Assets

The company's assets registered a 3.73% drop in 2009 after a long growth span, due to decreases emanating from liquidation of held-to-maturity assets, negative fuel derivative figures and a fall in cash and bank balances among others.

INCOME STATEMENT	2011F	2010F	2009	2008	2007
	Kshs. M	Kshs. M	Kshs. M	Kshs. M	Kshs. M
Turnover	94,376.75	82,730.19	71,829	60,471	58,792
Direct Costs	(63,662)	(54,751)	(47,792)	(38,814)	(41,335)
Fleet ownership costs	(8,474)	(8,054)	(7,994)	(7,388)	–
Gross profit	22,241	19,925	16,043	14,269	17,457
Overheads	(17,984)	(15,924)	(12,001)	(9,968)	(9,818)
Operating Profit	4,257	4,002	4,042	4,301	7,639
Other Income	855	720	658	760	71
Other gains/losses	98	80	72	(218)	–
Associated company results share	67	63	62	65	185
Realised (losses)/gains on fuel deriv.	(1,078)	(985)	(1,372)	1,888	–
Unrealised (losses)/gains on fuel deriv.	(2,045)	(3,287)	(7,532)	1,403	–
Finance Costs	(1,449)	(2,837)	(1,594)	(1,673)	(1,920)
LBT/PBT	705	(2,244)	(5,664)	6,526	5,975
Taxation Credit/Charge	197	628	1,581	(1,948)	(1,877)
(Loss)/Profit for the year	508	(1,616)	(4,083)	4,578	4,098
EPS - Basic and Diluted	1.10	(3.50)	(8.84)	9.91	8.87
DPS	1.00	1.00	1.00	1.75	1.75

Source: KQ/Sterling

BALANCE SHEET	2011	2010	2009	2008	2007
	Kshs. M	Kshs. M	Kshs. M	Kshs. M	Kshs. M
ASSETS					
Non-current assets					
Property, plant and equipment	52,679	51,828	51,051	52,518	54,106
Intangible assets	502	510	550	301	248
Prepaid operating lease rentals	175	390	1,662	116	118
Investment in associated company	568	510	449	387	322
Deferred expenditure	-	-	-	146	84
Aircraft deposits	2,792	2,652	2,532	1,879	2,106
Deferred tax asset	541	791	26	45	-
Fuel derivatives	-	-	-	323	-
	57,257	56,680	56,270	55,715	56,984
Current assets					
Inventories	1,698	1,605	1,474	1,258	962
Trade and other receivables	10,943	10,325	8,997	6,831	6,477
Due from related companies	8	6	3	-	41
Taxation recoverable	782	750	737	712	639
Fuel Derivatives	-	-	-	1,080	-
Held to maturity investments	-	-	-	7,747	2,407
Deposits with financial institutions	5,450	5,285	5,077	1,812	-
Bank and cash balances	3,005	2,679	2,373	2,683	9,777
	20,193	19,575	18,661	22,123	20,303
TOTAL ASSETS	77,550	76,255	74,931	77,838	77,287
EQUITY AND LIABILITIES					
Capital and reserves					
Share capital					
Share Capital	2,308	2,308	2,308	2,308	2,308
Revenue reserve	16,030	15,630	16,069	20,960	17,190
Hedge reserve	(675)	(950)	(1,201)	3,314	2,142
Shareholders' funds	17,663	16,988	17,176	26,582	21,640
Non-current liabilities					
Borrowings	30,226	29,123	28,257	25,190	31,287
Deferred tax liability - net	6,220	6,178	5,871	9,540	7,210
Fuel derivatives	585	560	714	-	-
Deferred income	1,495	2,245	2,239	2,413	2,587
	38,526	38,107	37,081	37,143	41,084

Source: Sterling

In 2010, we expect the company's asset strength to improve on the back of an improved performance.

Liabilities

KQ's biggest liability is in the form of borrowings from a number of lenders, chief among whom is Barclays Bank PLC which has lent 72% of the loan at 4.5% interest. The loan matures in 2014. The company's liabilities are generally likely to be on an uptrend as it takes measures to procure more assets to replace ageing ones. The company's debt ratio is likely to remain in the 42% to 45% band.

Equity

Owing to proposed dividend payments and hedge payments, the company's net worth is likely to register a marginal drop, with a recovery expected in 2011.

Non-current liabilities	2011	2010	2009	2008	2007
Current liabilities					
Fuel derivatives	2,150	3,720	5,415	-	-
Sales in advance of carriage	5,980	5,837	5,098	4,640	4,156
Trade and other payables	6,835	6,495	5,339	5,344	6,299
Accruals for staff leave entitlements	754	745	741	738	530
Deferred income	174	174	174	174	174
Unclaimed dividends	40	40	40	40	40
Corporate tax payable	16	16	16	-	18
Borrowings	5,411	4,133	3,851	3,177	3,346
	21,361	21,160	20,674	14,113	14,563
EQUITY AND LIABILITIES	77,550	76,255	74,931	77,838	77,287

Source: KQ/Sterling

Valuation Indicators

Between 2000 and 2009 KQ's average end-year price fluctuated between Kshs. 7.30 and Kshs. 105.00, with its P/E oscillating between Kshs. 1.28X and 10.71X.

Shareholders have in the past paid as low as 0.36X the book value (2003) and as high as 2.81X the book value. In March 2009, they were paying 0.52 times the book value, a substantial discount on the share price.

Over the 10-year period, the company's payout ratio has averaged 23.85%, with the latest positive payout standing at 17.66%. In addition, KQ's average dividend cover stands at 2.9X, well above the conventional threshold of 1.5 times - in the sense that the company can well afford the dividend. KQ's earnings yield average 21.17% over the 10-year period, well above 13.75%, the current 20-year bond rate.

Selected value indicators (2000 – 2009)

Year (31 mar.)	Mkt. Price	Value Ratios			Earnings		Dividends	
		P/E Ratio	P/B Ratio	Div. Yield	12 Month EPS	% Change	% Payout Ratio	12 Month DPS
2000	7.75	1.28	0.51	16.13%	6.05	-	20.66%	1.25
2001	7.55	2.01	0.45	16.56%	3.75	-38.02%	33.33%	1.25
2002	7.30	3.88	0.45	8.22%	1.88	-49.87%	31.92%	0.6
2003	5.8	7.73	0.36	8.63%	0.75	-60.11%	66.72%	0.5
2004	10.65	3.39	0.58	7.04%	3.14	318.67%	23.89%	0.75
2005	24.00	3.67	0.90	5.21%	6.54	108.28%	19.11%	1.25
2006	105.00	10.05	2.81	1.67%	10.45	59.79%	16.75%	1.75
2007	95.00	10.71	2.03	1.84%	8.87	-15.12%	19.73%	1.75
2008	52.00	5.25	0.95	3.37%	9.91	11.72%	17.66%	1.75
2009	17.75	--	0.52	5.63%	-8.84	-189.20%	-11.31%	1.00

Source: Sterling

Price trend and Company Valuation

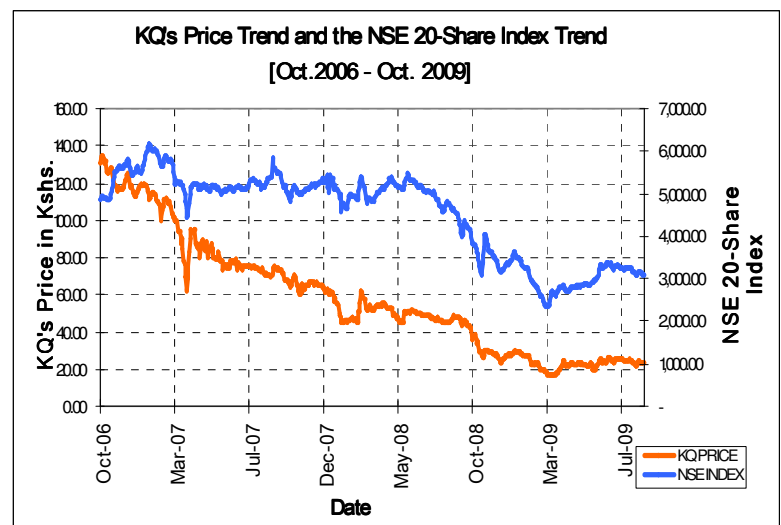
The lowest price that KQ has traded at in the last 12 months is Kshs. 16.00, while the highest price is Kshs. 51.00. In the period between January 2008 and October 2009, the company's average price per share was Kshs. 36.12. KQ's price has generally been tracking the market as indicated by the NSE 20-share index.

Valuation

i. DCF

Assuming a 2% economic growth rate for Kenya, a 0.80 beta coefficient and a 14.75% cost of equity and a 10.50% post-tax cost of debt, we arrive at Kshs. 33.67 per share for the KQ share.

Value of KQ using DCF Approach	Kshs.m
Value of the firm	40,202
+ Cash and marketable securities =	7,450
- Value of Debt	32,108
Value of Equity	15,544
- Value of Equity options issued by firm	-
Value of Equity per Share (Kshs.)	33.67



Source: Sterling

ii. Book Value

KQ's current book value is at Kshs. 34.14 per share, implying that as at October 6 2009, prospective investors were paying 0.61 times the book value of the company.

Weighted price: A weighting of the company's share price using the DCF, book value and average market price yields Kshs. 34.64, 66% above the current* share price of Kshs. 20.75 per share.

Upside Potential

- **Expansion:** Kenya Airways has a huge potential to expand to other routes both in Africa and to the rest of the world where there are no direct flights to Nairobi. The launch of direct flights into even more of these routes could significantly improve the airline's capacity to improve its earnings.
- **Economy:** Given the fact that there is correlation between economic performance and national and international travel, the slow growth being experienced in the East African region could present a challenge. However, there is an opportunity for KQ to conduct more business and shore up its earnings after these economies improve.
- **E – Ticketing:** The internet presents KQ with a convenient tool not only to market itself but also to cut time and money cost of going through agents for flight bookings. By aggressively marketing its website, KQ can substantially improve service delivery to its prospective clients.
- **Management:** KQ is managed by efficient staff dedicated to overseeing its long term growth. Additionally, no material changes have been effected in the company's board of directors. This assures investors about the company's long term stability moving forward.
- **Cargo Volumes:** Cargo freight volumes appear low for the time being. Over time, the company will have to consider expanding and creating more cargo space to serve the rising demand for cargo transportation both to the region and the rest of the world.
- **Procurement of more Aircraft:** The planned use of the new aircraft (probably Airbus or Dreamliner) which could see more cargo space, greater comfort and lower fuel use as compared to their predecessor counterparts could help the airline deliver more efficient service to its clients and in the process help it become the preferred airline of choice for air travelers and tourists.
- **Market:** Demand for international travel is down. However, given that this is part of the business cycle, in the long term demand especially to the Far East destinations could rise. KQ can take advantage of the increased demand to improve and retain its market share in international travel by offering seamless efficient service to its clients.

Downside Challenges

- **Fuel Prices:** The unpredictable nature of fluctuations in international fuel price presents the company with one of the biggest challenges as it strives to improve its earnings.
- **Market Access:** Bilateralism and protectionism has been identified as one of the major impediments to market access in the African Continent. There also are cases of persistent postponement of appointments to conclude new or revised air transport agreements and/or cases of difficulties in securing permission to increase frequencies even where agreements exist.
- **Terrorism Threats and Passenger Safety:** Given the global village concept, airline passengers are increasingly putting their safety first. Airlines that have put in place strict measures to prevent threats to life or personal security have been preferred. Although not a major threat to the African region, terrorism is worldwide phenomenon and KQ needs to continuously review its services to mitigate against any such threats.
- **Airport Safety and Security:** The coordination of activities at the airport to ensure seamless service while emphasizing on quality and safety is pertinent. The status of the JKI A runway has been a subject of debate. With rebuilding the airport on-going however, it is anticipated that this issue will be addressed satisfactorily.
- **Travel Advisories:** Travel warnings that stay for long without being lifted even with no threat to passenger and tourist security continue to depict a twisted image about Kenya. The Kenya government needs to be reviewing its security operations more often, whilst re-assuring international travelers about Kenya's safety to mitigate against such advisories if and when they are issued.
- **Staff Costs:** It is only recently that the company signed a collective bargaining agreement with the Aviation and Allied Workers Union (TAWU), which saw KQ TAWU members receive a 20 salary increase to be implemented over the next two years at about 10% per year. Staff costs present a challenge because staff agitation if not kept in check can lead to significant contraction of a company's earnings due to a ballooning wage bill.
- **Exchange rate fluctuations:** Short term currency fluctuations that may translate into variations in KQ's trading results should be monitored. KQ has been using futures and options contracts to mitigate against these unpredictable fluctuations.
- **Competition:** Competition is increasingly becoming visible in the airline industry. As KQ management lays strategies for the future, Airlines like Qatar Airways, Emirates, Ethiopian Airlines and South African Airways among others, should be put in the serious competitor basket and appropriate strategies put in place to stem competition. Uganda has also launched a new airline.
- **Political uncertainty:** political upheavals that affect air travel have dogged Kenya at times of electioneering. It is however hoped that reforms currently being undertaken will stop a repeat of this cycle.
- **Global recession:** As observed by IATA, airlines are now recovering from the worst financial crisis since the great depression. Significant profits are however some distance away.

Conclusion

Given our foregoing analysis and the current market price, an UNDERVALUED verdict for KQ has been passed. The company is on an ambitious route expansion and renewal mode in readiness for a recovery of the global economy and this signals a potential for significant future cash flow growth. We opine that despite the hedging challenges, KQ is on the path to creating more shareholder value in the long run.