KENGEN AND THE PUBLIC INFRASTRUCTURE BOND OFFER (PIBO)

STERLING INVESTMENT BANK
Members of the Nairobi Stock Exchange

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Verdict: BUY

We initiate an analytical review of KenGen's Public Infrastructure Bond Offer (PIBO), to support planned construction and /or development of earmarked power generation projects with a "BUY" Verdict.

Our opinion has been informed by the fact that KenGen requires significant additional capital to finance its business plan and in particular, capacity expansion projects that will in turn help the company to meet its long term financial and operational objectives, yielding higher returns not only for the company, but also for all the other stakeholders (including prospective debt holders).

Rationale for the verdict

The PIBO's Upside

- **Peak demand:** In the 2008/09 financial year, there already are electricity installed capacity challenges, with reserve capacity getting into relatively low levels against the standard 15% reserve capacity. If KenGen's investment strategies come to fruition, this could see adequate reserve capacity getting restored, with a likely translation of the demand into higher earnings for the company.
- **Senior Unsubordinated note:** The corporate bond ranks above other loans or securities with regard to claims on assets or earnings of KenGen.
- **Collateral for borrowing:** The corporate bond can be used as collateral for borrowing loans from banks.
- **Electronic trading and Liquidity:** With electronic trading in bonds set to start soon, bond liquidity will most likely improve, with improved turnover and ease of transfer generating more activity.
- **Tax Exemption:** Interest earned on the KenGen bond will for the time being, be exempt from tax, subject to any changes in law.
- **Relatively lower default risk:** Given the nature of demand of KenGen's business product (electricity), added to the fact that the company is a virtual monopoly, although a default risk exists in any corporate debt security offers, the chances of the company defaulting on its obligations are remote.
- **Market Yield:** the current market yield for a 10 year government bond is around 11.80%. The KenGen bond has an average maturity of 6.25years and a similar bond in the market is trading at 11.40%. This is over 100 basis points compensation to the inherent risk in the KenGen bond.

The PIBO's Downside

Liquidity: Corporate bond liquidity is just picking up at the Nairobi Stock Exchange. Before liquidity markedly improves, some investors could find themselves holding the bond for a while before finding a buyer, in case they would wish to redeem it before it matures.

- **Interest rate risk:** Given the fact that the bond's interest rate is fixed, a significant variation in market interest rates could lead to either of the parties to the offer getting dismayed. However, there are options for both, with the investor having the option of selling it at the NSE. KenGen can also go for early redemption, upon 30 days of a written notice.
- **Default risk:** The default risk for a corporate bond is usually higher than that of a Treasury bond. However, the return on a corporate bond is higher than that of a Treasury bond of a similar tenor.

Subscription Categories

Pool	Category	Without Green Shoe		With Green Shoe	
		% of total %	Bond Value (Kshs.bn)	% of total %	Bond Value (Kshs.bn)
A	Retail Investors	20%	3.0	20%	5.0
B	Institutional Investors*	80%	12.0	80%	20.0
	Total	**100%**	**15.0**	**100%**	**25.0**

Introduction

KenGen is a public company listed on the Nairobi Stock Exchange with the Government of Kenya owning 70% shareholding and the public 30%. It is the main generator of electric power in the country with an installed capacity of 1,022 Megawatts made up of hydropower, geothermal, thermal and wind. KenGen controls about 75% of the electric energy sales market in Kenya.

Brief historical profile

1954: Kenya Power Company (KPC) is registered as a company and commissioned to construct the transmission line between Nairobi and Tororo in Uganda as well as to develop geothermal and other generating facilities in the country. In 1997, the management of KPC was formally separated from KPLC as a direct result of the new reforms being undertaken in the energy sector and the entire economy. The terms of restructuring of the power sector effectively resulted in a separation of functions, with KPC responsible for power generation and KPLC for Transmission and Distribution.

1998: KPC is re-launched under a new name and corporate identity as KenGen. KenGen, at its launch hence takes charge of all publicly owned power generating plants.

Business Model

KenGen's power generation model revolves around a strategy to be a market leader in the provision of reliable, safe, quality and competitively priced electric energy in the region, producing more than 2000MW of power by 2018 through aggressively increasing power generation capacity via capacity expansion horizons. Currently, the company has a capacity of 1,022MW. In the period between 2013 and 2018, the company plans to add about 500MW of electricity, with about 1500MW being added after 2018. By 2030, the company is targeting a total of 9,000MW of electricity. This business strategy will be implemented through power generation horizons I, II and III.

Management Opinion

Managaement is upbeat about the company's persuance of a Good to Great (G2G) transformation strategy, a plan anchored on three planks of capital planning and execution, regulatory management and operational excellence. The company is also in the final phase of connecting its power stations to Supervisory Control and Data Acquisition (SCADA) - a system that collects data from various sensors at a plant or in other remote locations and then sends this data to a central computer which then manages and controls the data. Management opines that it remains optimistic about the years ahead and is confident of making further progress towards its long term financial and operational objectives.

Latest results – H1 2008/09

Non-fuel revenue increased marginally by 1.6% as a result of increased generation from geothermal and hydro sources. Fuel revenue was up by 180% due to increased thermal generation because of low hydrology associated with current drought in the country. Other revenue included compensation by Government of Kenya for the administrative costs of the emergency Power Project (EPP). Net profit for the period was Ksh.1,174 million down from Ksh.1,748 million in a similar period in 2008 due to an increase of 10% of operational costs attributable to increased thermal generation and higher financing costs.

Basic Company Statistics

Year Listed.....2006
Current Share Price.....Kshs. 12.60
Share Capital: Authorized Shares.....2,215,927,528
: Issued Shares.....2,198,361,456
Trailing EPS.....Kshs2.19
Historical P/E ratio.....5.75X
DPS.....Kshs.0.90
Projected (2009) EPS.....Kshs.1.20
Projected (2009) P/E.....10.50X
Market Cap.....Kshs.27,699.35m

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Critical Information on the PIBO

KenGen is seeking to raise Kshs15bn (US$202m) to finance the construction of a thermal plant - Kshs12bn (US$ 156M) and the re-development of Tana hydro-power project at Kshs3bn (US$46m).

If there is an oversubscription, there will be a *green shoe* option in which the company will absorb up to Kshs 10bn (US$ 130m) and use the amount to fund the following projects;

- Kindaruma 3rd unit Kshs3bn (US$46m),
- Kiambere upgrading Kshs1.15bn (US$15m),
- Others' upgrading (Sang'oro and raising masinga dam potential) - Kshs 4.62bn (US$60m) and developing Eburu Geothermal Kshs847m (US$11m).

Summary of Key PIBO information

- *Amount to be raised*: Kshs15bn (with an option of raising an extra of up to Kshs. 10bn if there is oversubscription (*i.e green shoe option*).
- *Type:* The bond is unsubordinated (ranks above other loans or securities with regard to claims on assets or earnings) and unsecured.
- *Offer Price per bond:* At par
- *Indicative coupon:* to 12.5%.
- *Maturity:* October 31 2009.
- *Redemption:* 16 semi-annual payments from April 30 2012 following a 2-year grace period.
- *Interest payment:* Semi-annual.
- *Minimum Amount:* Kshs100,000
- *Minimum Amount required (60% of Kshs. 15bn):* Kshs9bn
- *Principal redemption (without green shoe) – semi-annual:* Kshs. 0.9375bn
- *Principal redemption (with green shoe) - semi-annual:* Kshs1.5625bn.

Subscription Categories

Pool	Category	Without Green Shoe		With Green Shoe	
		% of total %	Bond Value (Kshs.bn)	% of total %	Bond Value (Kshs.bn)
A	Retail Investors	20%	3.0	20%	5.0
B	Institutional Investors*	80%	12.0	80%	20.0
	Total	**100%**	**15.0**	**100%**	**25.0****

*Licensed/Registered in EAC partner states i.e Commercial Banks, National Pension Funds and other statutory type funds, Collective Investment Schemes, Life Insurance Companies, Investment Banks and Foreign Institutions.
**Assumes that the Green Shoe option will amount to Kshs. 10bn

Use of raised funds

- KenGen's current total generation capacity is 1,022MW, composed of 749MW (Hydro), 115MW (Geothermal), 152MW (Thermal) and 5MW (Wind). The company is seeking to raise its generation capacity by about 528.6MW in the next 4 years (Horizon I expansion) through the expansion of specific generation projects.

All figures in US$	Capacity (MW)	Total project Cost funding	Funded/Committed	Balance (to be funded)
Hydros	86.0	188.4	54.6	133.8
Geothermal	317.5	1,103.0	91.8	1,011.2
Thermal	120.0	200.0	0.0	200.0
Wind	5.1	18.9	15.1	3.8
Subtotal	528.6	1,510.3	161.5	1,348.8
RIGS	N/A	167.1	-	167.1
Total Horizon I Projects	**528.6**	**1,677.4***	**161.5**	**1,515.9**

*The project costs above exclude interest capitalized during construction calculated at US$231.9m

- The Kshs15bn (US$202m) to be raised shall be used to finance the construction of a thermal plant at Kshs12bn (US$ 156M) and the re-development of Tana hydro-power project at Kshs3bn (US$46m).
- If there is an oversubscription, there will be a *green shoe* option in which, up to Kshs 10bn (US$ 130m) will be absorbed. The funds to be raised from the *green shoe option* will be used to fund the following projects; Kindaruma 3rd unit Kshs3bn (US$46m), Kiambere upgrading Kshs1.15bn (US$15m), Others' upgrading (Sang'oro and raising masinga dam potential) to the tune of Kshs 4.62bn (US$60m) and developing Eburu Geothermal Kshs847m (US$11m).

Justification of the bond offer

- Under Kenya's Vision 2030 National Development Plan, electric power provision is highlighted as a major pillar in the realization of national development. Development projects recommended under this Vision will increase demand on Kenya's energy supply.

- The country must, therefore, generate more energy and increase efficiency in its consumption. Currently, demand for power supersedes supply and this has resulted in the Government of Kenya putting stop-gap measures to prevent load-shedding by inviting emergency power supply. Specifically, it is estimated that, peak electricity demand will rise from about 1,153 in 2007/08 to about 3,400MW by 2017/18.

- Currently, the economy is servicing 150 MW of emergency power to fill the supply gap. KenGen's challenge therefore is to put up new capacity timely to meet this rapidly rising demand. KenGen plans to increase its installed capacity by over 500 MW by 2013 and over 2,000 MW by 2020. This relatively large expansion will require significant capital. It is estimated that the capacity expansion of 500 MW will require an investment of over US$ 1 billion, while the 2,000 MW increase will require an investment of over US$ 7 billion.

- It is for this reason that KenGen has therefore embarked on a financing plan for capacity expansion and the first phase will be the roll-out of a Kshs. 15 billion Bond.

KenGen's Debt Capacity

- As at December 31 2008, KenGen's debt was Kshs 27bn, mainly from JICA (76%), IDA (23%) and KfW (a German government-owned development bank, based in Frankfurt) (1%). This debt has some advantages (weighted cost of pre-tax debt a relatively low level -3.03% and a long average life – 22 years.

- Also, KenGen's long-term debt to Total Assets ratio stood at a relatively low level of 19%). The disadvantages of this type of debt include there being a long time of financial negotiations before financial closure of the project, leading to delays in project implementation and such debt being prone to foreign exchange fluctuations leading to high tariffs that are often passed-on to consumers.

Payment method

- Payment method- For those making payment trough bankers cheques on the closure date i.e 29th sep 09 they will lose on 4 days of interest since the bond starts accruing interest on the 2nd sep 09. We therefore advise clients to look at the cost of a bank guarantee versus the cost of loss of interest receivable.

Offer Timetable

Time/Date	Activity
T+0: Sep. 8 2009	Offer Opens
T+21: Sep. 8 2009	Offer Closes
T+50: Oct. 28 2009	Announcement of allocation results
T+52: Oct. 30 2009	Final date of payment against guarantees
T+55: Nov. 2 2009	Issue date – electronic crediting of CDS accounts, EFT refunding (if any).
T+59: Nov. 6 2009	Deadline of collection of refund cheques and bond certificates
T+62: Nov. 9 2009	Listing and commencement of trading on NSE

Source: KenGen

Kenya's Power Sub-sector

- Prior to 1997, the Electricity Power Act allowed independent power producers to supply electricity to the National Grid. At the time, there was approximately 96 percent of rural Kenya which was not connected to electricity. In June 1999, the Electricity Regulatory Board was formed and in August the same year, the Interim Power Purchase Agreement (IPPA) between KenGen and KPLC that set the base bulk tariff at 2.36Ksh/kWh was signed.

- In 2003, the government converted some Kshs. 12.3 billion that KPLC owed KenGen into preference shares with a five year period of dividend payment. The government also converted Kshs. 15.5 billion that KenGen owed into preference shares. In 2006 the Energy Regulation Commission (ERC) was established under the Energy Act, 2006 as the sector's regulatory agency, with the responsibility of setting and reviewing issues of tariff, licensing, enforcing standards, dispute settlement and approval of power purchase and network service contracts.

- Currently, the energy sub-sector is dominated by 6 major players namely: Ministry of Energy, the Electricity Regulatory Commission (ERC), KPLC, KenGen, Rural Electrification Authority (REA) and Independent Power Producers (IPP's). An additional 2 players (Kenya Electricity Transmission Company and Geothermal Development Company have been established).

- The Ministry of Energy is involved in the formulation of requisite policies that are in line with the national development objectives. KPLC is engaged in the transmission, distribution and retail of electricity purchased in bulk from Kenya Electricity Generating Company Limited (KenGen) – which has 75% installed capacity, while Independent Power Producers (IPPs) are private investors who generate power.

- Among these IPPs are Iberafrica Power (K), Westmont Power (K), Orpower 4 and Tsavo Power Company Ltd. The Rural Electricity Authority (REA) implements rural electrification projects on behalf of the government. Power from Emergency and independent Power Producers (EPPs) is about 60 per cent more expensive than that which KenGen sells to KPLC.

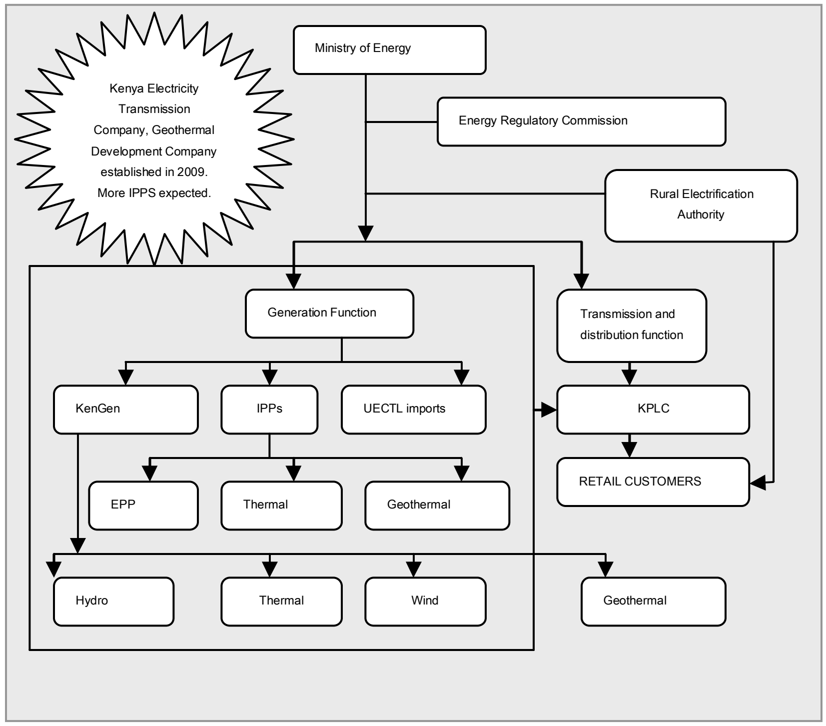
Kenya's electricity needs

- The national electricity access rate is currently about 15%, with access in rural areas estimated at 4%. This means that there is a significant demand growth potential. As a result, the Government of Kenya has been putting stop-gap measures to prevent load-shedding by inviting emergency power supply. The economy currently services 150 MW of emergency power to fill the supply gap.

The tariff structure and Power Purchase Agreement

- Since August 1999 KenGen and KPLC have been having a formal Interim Power Purchase Agreement (IPPA) that specifies the tariff and trading arrangement which is regulated by the Electricity Regulatory Commission (ERC).

- In 2003, the IPPA was varied, reducing KenGen's bulk tariff by 60 cents from 2.36 Ksh/kWh to 1.76 Kshs/kWh for a period of three years from 1st July 2003 to June 30 2006.



Major players in Kenya's power Sub-sector

Power Producer	Type of Source	Amount produced (in MW)
KenGen (75% inst. cap)	Hydro	749.28
	Thermal	152.2
	Geothermal	115
	Wind	5.45
IPPs* (24% inst. cap)	EPP**	150
	Thermal	132
	Geothermal	48

*More IPPs are planned for 2009.
**140MW of EPP is planned for December 2009.

Kenya's power capacity challenge

Indicator	2005/06	2006/07	2007/08*
Peak Demand (MW)	916	987	1,153
Installed Capacity (MW)	1,177	1,186	1,238
Effective Capacity (MW)	1,135	1,144	1,185
Reserve Capacity Margin (MW)	19%	14%	3%

*estimate
Source: KPLC

The tariff structure and Power Purchase Agreement cont'd

- From July 2006, the Kenya government started to subsidize KPLC power purchase rates from KenGen by paying the 60 cents per unit of electricity supplied by KenGen on behalf of KPLC. However, this subsidy ended on 30th June 2009.

- On June 4th 2009 KenGen and KPLC signed a hybrid 20-year PPA. Under the new PPA, KenGen shall be paid Sh2.42 a unit of yield, with each of the five models of power generations having a different PPA. The PPA models take into account factors such as operation and maintenance of respective power plants, capacity and energy payment, terms to regulate testing and commissioning of plants among others. The deal took effect on July 1.

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Kenya Electricity Generating Company (KenGen)

KenGen develops, manages and operates power generation plants to supply electric power to the Kenyan market. It generates and sells electricity mainly to the authorized distributor, (KPLC).

Shareholding

The Kenya government is the majority shareholder in KenGen. Individual shareholders do not make it to the list of the 10 major shareholders. The implication of this is that daily liquidity of the share is determined by the extent of participation of the smaller shareholders who hold 26.90% of the total shares, and the participation of the larger shareholders who rarely participate in daily trading.

As of June 2008, the government's shareholding in KenGen stood at 70%, with about 19.16% being held by smaller shareholders who hold at least 100,000 shares and below. The rest of the shares are held by middle tier shareholders. It is instructive therefore, that retailers with small share lots (about 219,725 shareholders) are the ones who have been responsible for providing daily share liquidity, contributing to share price and volume movements on a daily basis. In the coming days, we expect this shareholding structure to continue to influence the liquidity of the share, dictating the daily price and volume movements. Also, given the company's share register which stood at 220,099 shareholders as of June 2008, the logistics and financial implications of managing the register will continue to be a major challenge for the company. Allowing an electronic format of some of the basic disclosure documents could help mitigate against the challenge.

Corporate Actions

Traditionally, KenGen has been announcing end-year results in late September or mid-October. Despite the operational challenges, we expect the company to announce some dividend payout in FY09.

Competition

i. Product (electricity generation) competition

KenGen is a virtual monopoly in electricity generation, and in effect electricity consumption, accounting for about 83.26% of the total power purchased by KPLC. KenGen's competition emanates from Independent Power Producers (IPPs). Among these are Iberafrica Power (K) – 5.29%, Westmont Power (K) whose supply contract was retired by KPLC upon expiry in 2004, Orpower4 - 1.69%, Tsavo Power Company Ltd – 9.61% and Mumias Sugar Company – 0.16%, who together generate about 16.74% of the total consumed electricity.

ii. Project Financing through bonds

Financing through bonds is not new in Kenya's capital markets. However, the KenGen Bond will be the corporate bond with the longest tenor in Kenya's capital markets. After it is listed, the bond will be competing with a number of other already listed corporate bonds.

Comment on Income Statement

KenGen has in the past recorded profitability, albeit, at a decreasing rate especially in the latest results. Given the projections up to 2010, the company's Compounded annual growth rate (CAGR) of total revenue will be 8%.

KenGen's 10 largest Shareholders as at 30 June 2008

Shareholder	No. of shares	%
PS, Treasury	1,538,853,019	70.00%
N.S.S.F	17,334,800	0.79%
Barclays (K) Nominees Ltd. – A/C 9230	10,175,300	0.46%
Barclays (K) Nominees Ltd. – A/C 1853	8,899,831	0.40%
Kenya Commercial Bank Nominees Ltd. – A/C 769G	7,667,592	0.35%
Jennid Trading Ltd.	5,455,794	0.25%
Alfaways Ltd.	5,000,000	0.23%
Lancaster Investment Ltd.	4,502,106	0.20%
Sandhurst Investments Ltd.	4,501,294	0.20%
Kesington Developers Ltd.	4,148,427	0.20%
Total	1,606,538,163	73.08%
Other Shareholders	591,823,293	26.92%
Grand Total	**2,198,361,456**	**100%**

KenGen's distribution of Shareholders as at 30 June 2008

Share Range	No. of shareholders	Shares	% Shareholding
1-500	90,653	25,115,319	1.14
501-1,000	46,776	37,2442,028	1.69
1,001-5,000	54,014	116,220,115	5.29
5,001 – 10,000	21,767	142,554,246	6.48
10,001 – 50,000	3,674	70,885,112	3.22
50,001 – 100,000	296	20,551,058	0.93
100,001 – 500,000	283	61,185,023	2.79
500,001 – 1,000,000	54	39,554,610	1.81
Above 1,000,000	51	1,685,053,945	76.55
Total	**217,658**	**2,198,361,456**	**100.00**

Source: KenGen Annual Report 2008.

Corporate Action	Amount	Date Announced	Register Closure	Payment Date
Final Div.	0.55	27/09/06	17/11/06	1/02/07
Interim Div.	0.40	28/02/07	22/3/07	30/5/07
Final Div	0.40	18/09/07	16/11/07	01/01/08
First & Final Div.	0.90	15/10/08	21/11/08	02/02/09

Source: NSE

Recent Corporate Bond Auctions and their Subscription Rates

	Iss. Date	Mat. Date	Iss. Val.	Coupon	Amt. Raised	Subsc. Rate
			Kshs 'm'	%	Kshs 'm'	%
INFRASTRUCTURE BOND						
IFB 1/2009/12YR	2/23/09	8/2/21	18,572.82	12.500	26,884.64	145%
EADB BONDS						
EADB FXT/2004/7YR	9/8/04	1/8/11	800.00	7.500	800.00	100%
FAULU KENYA LTD (FRN)						
FR(MTN)/2005/7YR	4/4/05	3/29/10	500.00	8.197	555.00	111%
PTA BANK LTD (FRB)						
FR(MTN)/2005/7YR	7/4/05	7/5/12	800.00	8.824	800.00	100%
FR(MTN)/2007/7YR	10/15/07	10/31/14	1,000.00	9.440	1,035.00	104%
ARM (MTN) FR						
FR(MTN)/2005/5YR	10/27/05	10/27/10	800.00	10.141	1,000.00	125%
BARCLAYS BANK (MTN) FR						
FR(MTN)/2007/7YR	11/19/07	11/19/14	1,500.00	7.757	1,725.00	115%
FX(MTN)/2008/7YR	7/14/08	7/14/15	2,000.00	8.700	--	--
SASINI LTD						
SASINI LTD (5YR)	12/4/07	11/27/12	600.00	11.750	620	103%
MABATI ROLLING MILLS (MRM)						
FR(MRM)/2008/8YR	10/27/08	1/3/17	1,378.50	10.190	2,000	100%
FXD(MRM)/2008/8YR	10/27/08	1/3/17	621.50	13.000	--	--
CFC STANBIC						
FR (CFC STANBIC) 2009/7YR	7/16/09	7/14/16	5,000.00	9.905	6,400	128%

Note: MTN= medium term note; FR= floating rate; FRN=floating rate note; FRB=floating rate bond; FXD=fixed
Source: KPLC

Financials

Comment on Income Statement Cont'd

Gross profit margins will be at an average of 43.94%, while Net profit margins will be at an average of 20.15%. In the short term, gains in revenue growth are likely to be affected by operating costs (due to the increased use of thermal power sources) and finance costs (mainly interest payments on borrowed funds).

In the 2009/10 period, the company's fuel revenue is expected to register significant growth. Increased sales emanating from the growth in demand for energy and the commissioning of new power generators will most likely continue to contribute to the growth of the company's revenue base. In the medium term therefore, revenue could get a boost as a result of the revision of the Power Purchase Agreement to Sh2.42 a unit of yield, effective July 1 2009, in addition to each of the five models of power generations having a different PPA, taking into account operating costs. Also, given the arrangement it has with KPLC where the company is able to re-coup all costs used in electricity generation as pass through costs, the company top-line is likely to be less volatile.

In the long term, it is anticipated that the cash flows that will emanate from the current and planned capital commitments will significantly increase KenGen's top and bottom-line, making it create value and meet its long term obligations to stakeholders.

KenGen Ratios

	2010F	2009F	2008	2007
Profitability (%)				
EBITDA on Sales Revenue	63.15%	69.57%	22.32%	22.40%
EBIT on Sales Revenue	34.17%	33.19%	17.36%	18.60%
Operating Return on Revenue	15.20%	19.21%	36.65%	9.56%
Pre-tax Return on Shareholders' Equity	4.98%	5.14%	4.52%	5.21%
Post-tax Return on Shareholders' Equity	3.73%	3.86%	8.66%	2.19%
Return on Total Assets	1.74%	1.98%	5.51%	1.36%
Gross profit margin	62.76%	69.44%	21.96%	21.59%
Net profit margin	15.20%	19.21%	36.65%	9.56%
Interest Coverage (%)				
EBITDA/Total Interest	225.53%	227.87%	1,334.39%	474.49%
EBIT/Total Interest	122.01%	108.71%	1,037.94%	393.89%
End period CASH Flow/Total Interest	-95.09%	-43.05%	1386%	267.69%
Leverage (%)				
Debt Ratio	53.51%	48.79%	36.33%	37.59%
Debt to Equity	115%	95%	57%	60%
Fixed Assets to worth Ratio	185.18%	178.02%	141.41%	144.79%
Liquidity Ratios (%)				
Current Ratio	178.60%	172.00%	134.45%	135.80%
Quick Ratio	163.93%	151.96%	122.02%	121.47%
Cash Turnover	186.63%	278.29%	589.39%	561.83%
Other Ratios (%)				
ROE	3.73%	3.86%	8.66%	2.19%

Source: KenGen PIBO Information Memorandum

Comment on the balance sheet

Going by the company's shareholders' funds, KenGen's total net worth is set to register a 10.52% growth in the 2009/10 period as a result of a 76% anticipated rise in share premium.

The company's debt ratio appears to be on an up-trend, with projected figures forecasting a 53.52% debt ratio in 2010. The company has a plan of maintaining a debt/equity ratio of 60:40, with a possibility of doing a rights issue worth Kshs. 10.2b to remain within the target capital structure after that target structure is violated if and when all horizon I projects are fully funded.

KenGen's income Statement

	2010F	2009F	2009A	2008	2007
	Kshs.'000'	Kshs.'000'	Kshs.'000'	Kshs.'000'	Kshs.'000'
Non-fuel Revenue	11,209,027	8,291,885	11,838,274	11,548,176	11,141,219
Fuel Revenue (pass- Thr.)	7,472,684	5,527,924	9,390,050	4,543,387	3,410,548
Total Revenue	18,681,711	13,819,809	21,228,324	16,091,563	14,551,767
Operating Cost	(6,957,182)	(4,222,714)	(18,092,700)	(12,557,479)	(11,409,594)
Gross profit	11,724,529	9,597,095	3,135,624	3,534,084	3,142,173
Interest Income	(2,596,700)	(1,047,182)	635,284	275,773	593,091
Other income	73,670	17,293	221,818	58,218	117,747
Operating Profit	9,201,499	8,567,206	3,992,726	3,868,075	3,853,011
Finance costs - forex adj.	-	-	42,282	8,764	13,804
- other	(5,415,331)	(5,027,539)	(898,904)	(798,073)	(553,706)
Profit Before tax	3,786,168	3,539,667	3,136,104	3,078,766	3,313,109
Tax - Current	(946,542)	(884,917)	-	-	(1,465,943)
- Deffered	-	-	(982,104)	2,818,113	(456,128)
Net Profit	2,839,626	2,654,750	2,154,000	5,896,879	1,391,038
EPS (Shs. Per Share)	1.29	1.21	0.98	2.68	0.63

Note: A – Annualized; F - Forecasted

Source: KenGen PIBO Information Memorandum

KenGen's Balance Sheet

	2010F	2009F	2008	2007
NON CURRENT ASSETS	KShs'000	KShs'000	KShs'000	KShs'000
Property,plant and equipment	105,354,238	90,557,250	91,822,390	87,357,082
Prepaid leases on land	-	-	1,475	1,504
Work in progress	27508548	27,827,521	-	
Deffered income tax	4,004,313	162,332	-	-
Intangible assets	-	-	303,721	215,664
Amount due from KPLC-deferred debt	-	-	701,704	627,072
Treasury bonds	3,936,420	3,936,420	3,509,123	3,941,294
	140,803,519	**122,483,523**	**96,338,413**	**92,142,616**
CURRENT ASSETS				
Inventories	1,868,171	1,381,981	985,013	1,036,841
Trade and other receivables	9,212,898	6,815,248	735912	1,618,707
Amount due from KPLC	-	-	4,677,895	4,129,247
Tax recoverable	-	-	-	73,190
Treasury bonds	-	-	427,297	1,200,322
Geothermal development funds	-	-	25,551	-
Term deposits	-	-	30,926	89,794
Bank and cash balances	11,664,835	3,666,212	3,699,354	1,749,334
	22,745,904	**11,863,441**	**10,655,138**	**9,824,245**
CURRENT LIABILITIES				
Borrowings due within one year	-	-	1,531,116	1,023,189
Trade and other payables	5,852,046	4,881,686	5,649,563	3,444,905
Overdraft	6,690,191	1,849,685	-	-
Leave pay provision	-	-	119,252	120,095
Amount due to KPLC	-	-	7,471	2,433
Geothermal development funds	-	-	-	1,443,030
prepaid operating lease	-	-	2,000	2,000
Dividend payable	-	-	615,542	-
Tax payable	193,544	166,116	-	1,198,537
	12,735,781	**6,897,487**	**7,924,944**	**7,234,189**
NET CURRENT ASSETS	10,010,123	4,965,954	2,730,194	2,590,056
NON-CURRENT LIABILITIES				
Borrowings	61,145,562	47,870,827	19,466,078	16,040,695
Prepaid operating lease	-	-	13,000	15,000
Retirement benefits liability	-	-	-	-
Deferred tax	13,630,331	10,777,250	11,464,355	15,038,788
	74,775,893	**58,648,077**	**30,943,433**	**31,094,483**
Share capital	6,045,495	5,495,904	5,495,904	5,495,904
Share premium	8,886,952	5,039,818	-	-
Reserves	61,105,303	58,265,677	60,650,745	57,262,942
Proposed dividends	-	-	1,978,525	879,343
TOTAL EQUITY	76,037,750	68,801,399	68,125,174	63,638,189
TOTAL EQUITY &LIABILITIES	**163,549,424**	**134,346,963**	**106,993,551**	**101,966,861**

Source: KenGen PIBO Information Memorandum

The effect of the bond offer on KenGen's balance sheet

If the bond offer (including the green shoe option) is fully subscribed to, then KenGen's balance sheet will have a higher financial leverage in the form of Kshs. 25b in long term borrowings. If the proceeds of the offer are invested as planned, the resulting effect will depend on whether the firm's rate of return on assets (ROA) will be higher than the rate of interest on the borrowings. Leverage will allow greater potential returns to the investor that otherwise would have been unavailable but the potential for loss would also be greater if the investment does not go as planned. In the case of KenGen the plans appear to be on course.

Comparison with other Power generators (2008)

Profitability – KenGen's return on equity was lower than that of Maharashtra of India and National Grid of UK, but above that of ESKOM because it was in loss making territory. However, the company's gross and net margins were higher, indicating better earnings per unit of sales revenue.

RATIOS	MAHARASHTRA (INDIA)	NATIONAL GRID (UK)	ESKOM (S. AFRICA)	KenGen (KENYA)
Profitability (%)				
Pretax Return on Shareholders' Equity	17.18%	35.11%	-0.36%	4.52%
Post-tax Return on Shareholders' Equity	10.82%	23.85%	-0.27%	8.66%
Return on Total Assets	4.11%	2.13%	-0.10%	5.51%
Pretax Profit Margin	7.27%	8.92%	-0.50%	10.12%
Net Margin	4.57%	6.06%	-0.37%	36.65%
Interest Coverage (%)				
EBITDA/Total Interest	768.23%	352.97%	-	1,334.39%
EBIT/Total Interest	596.97%	247.22%	-	1,037.94%
End period CASH /Total Interest	11.04%	67.86%	-	1,386%
Leverage (%)				
Debt Ratio	57.55%	60.25%	41.19%	36.33%
Debt to Equity	151.38%	674.89%	111.98%	57%
Fixed Assets to worth Ratio	156.91%	949.92%	193.74%	141.41%
Liquidity Ratios (%)				
Current Ratio	113.62%	96.14%	157.08%	134.45%
Cash Turnover	619.54	21.7	4.12	5.89

Source: Various

Interest coverage – All the three considered companies' ratios indicate that the made sufficient earnings, able to cover interest payments.

Leverage - In 2008, most of KenGen' leverage ratios compared favourably with some of the power generators in the world. Maharashtra of India had a 58:42 debt ratio, while National Grid of UK had a 60:40 ratio. ESKOM's was 41:59. KenGen's stood at 36:62.

Liquidity – KenGen's liquidity position appears sound, with current assets able to sufficiently cover current liabilities. National Grid appears to be behind it in terms of the current ratio.

Cost of power and vision 2030

Even as the KenGen lays strategies to make power available in Kenya, a major challenge is to reduce the average cost of power which statistics show is one of the highest in the region. Manufacturing cost will continue to be high if this cost is maintained at the current levels, leading to lower aggregate production and consumption and therefore a challenge to the attainment of Vision 2030.

Kenya needs to model its power generation structure along the South African model which is one of the world's cheapest power producers due to its ability to generate power from a variety of sources, mainly coal. Uganda's is the most expensive producer of fuel in east Africa whilst Egypt subsidizes its power to protect consumers.

Country	Equivalent of US$ Per kWH
Uganda	24.35
Kenya	20.55
Egypt	20.00
Israel	16.00
UK	11.16
Thailand	10.30
USA	9.28
China	7.10
Australia	6.55
South Africa	5.34

Sources: Power Engineering International, East African Standard, I-net Bridge

Expectations about the PIBO's trading in the Secondary Market

Market outlook:

- The fixed income market has been on a stable and active trend this year as a result of CBK's market stabilization strategies and a re-opening of a number of previously issued bonds. Interest rates are expected to remain stable for the rest of the year and are expected to drop marginally in the longer term as the economy recovers from the slump.

Liquidity:

- Activity is expected to improve in the fixed income market as the number of players increase and interest rate stability is achieved. The fixed income secondary market is on year to year expansion as the market becomes a preferable tool of relatively less risky investments.

- Through its diverse presence in the market, Sterling Investment Bank (SIB) has strategically placed itself in this market and has been able to achieve a 15% market share and is currently ranked number 3 for the first eight months of the year 2009. SIB will be able to provide secondary liquidity for the KenGen bond as investors can sell part or whole of the bond at the best prevailing market rates.

Buying of a bond at fixed rate Vs at a discount rate:

- The KenGen bond is offered at fixed rate and this means that the bond will be offered to all clients at a price of 100. Unlike the government bonds where the investor gets to bid a price for the bond and the bond is offered at a discounted price, the investor's chances of success depend on the price they bid. This creates different prices that the bond is held at. When listed.

- KenGen's fixed rate issue will increase the chances of success as KenGen will only start to pro-rate as soon as the received amount surpasses Kshs.25bn. The fixed rate will also provide a systematic pricing in the secondary market as the bond will trade at more predictable prices since the bond was purchased initially at the same price by all investors. This will reduce the volatility in price in the secondary market as soon as a government bond is issued and will therefore create a stable portfolio valuation basis.

Critical Investment Information

The KenGen PIBO presents yet another opportunity for investors to diversify their portfolio into corporate bond investment, in addition to investment in equities and Treasury bonds. Below are some of the factors going for and against KenGen as a company and its PIBO.

The Upside

- **Transformation:** In an attempt to meet the rapidly rising demand, KenGen has been implementing a transformation strategy oscillating around capital planning and execution, regulatory management, operational excellence and organizational effectiveness. It is anticipated that, when it is complete, the transformation will lead to increasing efficiency, yielding higher returns not only for the company, but also for all the other stakeholders.
- **Diversification:** The Company has been pursuing a strategy that emphasizes diversification of power generation sources to geothermal, thermal and wind to complement hydro. Increasingly, KenGen has been laying focus on Geothermal and thermal power generation, in line with the increasing power demand in the country. The diversification could provide essential support at times of extreme weather (drought) conditions and help support the top and bottom-line.
- **Peak demand:** In the 2008/09 financial year, there are expectations that there will be capacity challenges, with reserve capacity getting into relatively low levels, against the standard 15% reserve capacity. It is however anticipated that if KenGen's concerted efforts and investment strategies come to fruition, this could see adequate reserve capacity restored with a likely translation of the demand into higher earnings for the company.
- **Government Shareholding:** KenGen is 70% owned by the Kenya government. The company is therefore in a unique position of being able to advocate for and seek supportive power generation policies from the government. Also, even though it is a corporate organization, this equity stake improves the perception of investors about the company's ability to meet its debt obligations.

The PIBO Upside

- **Senior Unsubordinated note:** The corporate bond ranks above other loans or securities with regard to claims on assets or earnings of KenGen.
- **Collateral for borrowing:** The corporate bond can be used as collateral for borrowing loans from banks.
- **Tax Exemption:** Interest earned on the KenGen bond will for the time being, be exempt from tax, subject to any changes in law.
- **Relatively lower default risk:** Given the nature of demand of KenGen's business product (electricity), added to the fact that the company is a virtual monopoly, although a default risk exists in any corporate debt security offers, the chances of the company defaulting on its obligations are remote.
- **Market Yield:** the current market yield for a 10 year government bond is around 11.80%. The KenGen bond has an average maturity of 6.25years and a similar bond in the market is trading at 11.40%. This is over 100 basis points compensation to the inherent risk in the KenGen bond.

Recent 10-year T-Bond characteristics

Issue Number	Issue Date	Bond Type	Volume ('M')	Coupon Rate (%)	Average Yield (%)
FXD1/2009/10	27-Apr-09	Fixed	10,000.00	10.75	11.72
FXD1/2009/10	27-Apr-09	Fixed	10,000.00	10.75	11.72
FXD3/2008/10	29-Sep-08	Fixed	8,000.00	10.75	11.76
FXD2/2008/10	28-Jul-08	Fixed	8,000.00	10.75	11.42
FXD1/2008/10	25-Feb-08	Fixed	7,000.00	10.75	11.27
FXD1/2007/10	29-Oct-07	Fixed	9,000.00	10.75	11.32

Source: Central Bank of Kenya

The Challenges

- **Single Customer:** KenGen sells all electricity to KPLC and is KPLC's preferred supplier. If KPLC were unable to meet its obligations, under the terms of the contract between the two parties, the KenGen's ability to service its obligations would be put in jeopardy.
- **Market risk:** Changes in market prices such as interest rates and foreign exchange rates will affect the company's income or the value of its holdings of financial instruments.
  - KenGen is exposed to interest rate risk with regard to fluctuations in banks' interest rates in the market as this affects its borrowings.
  - The company has exposure to fluctuations in foreign exchanges with respect to foreign borrowings that are revalued at year-ends and also through purchases of goods and services that are done in currencies other than the local currency.
- **Latest financial results & projections:** Latest HY09 results and projections contained in KenGen's IM show a likelihood of the company registering a drop in earnings.
- **Fuel Cost:** The success of KenGen's operations and ability to rapidly expand generation capacity largely depends on the unconstrained availability of fuel at competitive prices during the critical life-cycle stages of planned power stations installation(s) and/or re-development. Further, the oil market is liberalized, meaning, with the unpredictability of price change, a challenge of fuel sourcing at competitive rates looms large. Additionally, even if some or all the cost of such fuel can be passed through to the final consumer, such pass-through can only be absorbed up to a certain level.
- **Over-reliance on hydro generation/weather:** Periods of unfavorable hydrological conditions affect the availability of electricity, as about 73% of its power is hydro-based

Challenges related to the PIBO

- **Liquidity:** Corporate bond liquidity is just picking up at the Nairobi Stock Exchange. Before liquidity markedly improves, some investors could find themselves holding the bond for a while before finding a buyer, in case they would wish to redeem it before it matures.
- **Interest rate risk:** Given the fact that the bond's interest rate is fixed, a significant variation in market interest rates could lead to either of the parties to the offer getting dismayed. However, there are options for both, with the investor having the option of selling it at the NSE. KenGen can also go for early redemption, upon 30 days of a written notice.
- **Default risk:** The default risk for a corporate bond is usually higher than that of a Treasury bond. However, the return on a corporate bond (just as has been indicated above) is higher than that of a Treasury bond of a similar tenor.

Conclusion

- KenGen requires significant additional capital to finance its business plan and in particular, capacity expansion projects. If the funds being raised are actually raised, then the company will be able to meet the rapidly rising demand for electricity, become more efficient and further its progress towards its long term financial and operational objectives, yielding higher returns not only for the company, but also for all the other stakeholders (including prospective debt holders).

- Given our foregoing analysis, we opine that the corporate bond will be a worthwhile investment that will not only help investors to diversify their investment, but also ensure a relatively high return to their investment.

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