Utilities
KEGOC

KEGOC – Recommendation downgrade

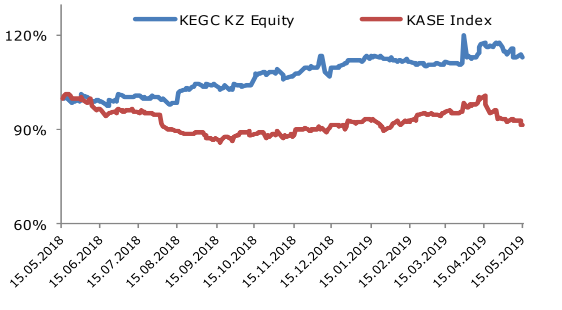
Altynay Ibraimova
a.ibraimova@halykfinance.kz

May 16, 2019

Ticker	KEGC KZ
Recommendation	**SELL**
Current price, KZT/share	1615
12M target price, KZT/share	1337
Upside/Downside	**-17%**
No. of ordinary shares (mn)	260
3M av. daily turnover (KZT mn)	22
Free float (%)	10%
Market capitalisation ($bn)	420
Major shareholders:	
Samruk-Kazyna	90%

Financials (KZT bn)	2018A	2019F	2020F
Revenues	175.8	181.6	186.1
EBITDA	81.4	75.3	73.2
Net profit	40.0	38.8	37.7
EPS	154.0	149.2	144.9
Equity	472.7	444.3	462.6
Net debt	114.5	143.0	-5.3
Valuation	**2018A**	**2019F**	**2020F**
Net Debt/EBITDA (x)	1.4	1.9	-0.1
Debt/Equity	0.4	0.3	0.4
EV/Sales	3.0	3.1	2.2
EV/EBITDA (x)	6.6	7.5	5.7
P/E (x)	10.5	10.8	11.1
P/B (x)	0.9	0.9	0.9
RoE	8.5%	8.7%	8.1%
Dividend yield	n/d	5.5%	8.4%

Price dynamics	Abs.	Relative KASE
1M	-3.2%	2.3%
3M	1.2%	1.5%
6M	4.9%	1.9%
52-week high	1 713	
52-week low	1 395	



Sources: Bloomberg, расчеты Halyk Finance

Capital-intensive projects funded through new borrowings in addition to the uncertainty about the increase in tariffs form our opinion regarding the current overvalued KEGOC shares. The dividend yield of 8% as a short-term growth trigger has lost its relevance and with a new target price of T1337/share, implying a discount to the market price of 17%, we do not note significant triggers that can compensate for the ambiguous cash flow dynamics. We expect a weaker EBIT margin from 31% in 2018. up to 25.7% by 2026 and low return on capital at 3.8% against the current 9.3%. We downgrade our recommendation on KEGOC shares from Hold to ***Sell****.*

Neutral results for 2018. The results of 2018 met our expectations. Operating profit amounted to T8.9bn, having strengthened by 18% compared to 2017 due to an increase in gross profit by 11%. Deviation in operating profit is 2.3% of our forecast. Profit for the period amounted to T40bn, which is 22% higher than in 2017. The weakening of the tenge, as a result of which the loss from exchange rate differences increased by 35% to T5.9bn and the assets depreciation amounted to T2.9bn (+ 31% yoy), had a restraining effect on net income. Adjusted net income (excluding impairment) is also in line with our expectations (T42bn vs. T44bn).

The forecast for tariffs is saved. Despite the company's optimism regarding the cancellation of tariff freezing as early as next year, our forecast for tariff stagnation in 2019-2020 at levels accepted by the regulator remains unchanged. We still expect an increase in tariffs only after 2020 and we maintain the forecast for the growth of transmission and balancing tariffs by 5% (CAGR) and for dispatching - by 8%.

Capex growth may put pressure on dividend yields. At a meeting with investors, the Company announced plans to implement new investment projects. We increased capital expenditures in 2019-2025 from the previous range of T10-40bn (incl. maintenance investments) to T45-75bn. In light of the expected larger cash outflows, according to our forecasts, for servicing capital-intensive projects and because of groundlessness in conditions of debt load, the company will review the policy of paying high dividends and reduce the payout ratio to 50%. The dividend per share, according to our forecasts, will decrease from T135/share for 2018 to T40/share by 2026.

Recommendation downgrade from Hold to Sell, 12M TP of T1 1337/share. Our new 12M target price amounts T1337/share, the discount to market price exceeds 17%. We see no obvious growth catalysts capable of leveling the weak dynamics of cash flows due to the social importance of the source of income. Dividend payments have reached their peak and cannot act as a growth driver for share prices. We recommend to Sell KEGOC shares.

Fig. 1. Financial indicators

KZT bn	2017A	2018A	yoy
Revenues	152.4	175.8	15%
Cost of sales	67.1	79.8	19%
Gross profit	85.3	96.0	13%
SGA	12.6	14.3	14%
Selling costs	0.2	0.3	15%
EBITDA	72.5	81.4	12%
Depreciation	22.9	26.7	17%
EBIT	49.6	54.7	10%
(Financial income)	-3.6	-5.0	38%
Financial expense	4.5	3.9	-15%
(Other income)	-0.5	-0.3	-34%
Other cost	0.2	0.3	30%
Share in associates	-0.5	-0.3	-32%
Exchange rate (gain) loss	4.4	5.9	35%
Impairment costs	2.4	-0.7	n/a
EBT	**45.1**	**51.0**	**13%**
Income tax	9.8	11.0	13%
Net profit	**32.9**	**40.0**	**22%**

Source: Company Data

2018 results

The 2018 KEGOC results show an increase in revenue of 15% yoy to T176bn. The main share of revenue comes from power transmission (61%), revenues from which increased by 15% yoy. In general, for all types of services provided by KEGOC, in 2018, there is a positive trend, which is associated both with the growth of average tariffs relative to 2017 to a greater extent, and with the growth of physical volumes of electricity consumed, to a lesser extent.

We also observe a rise in the purchase electricity (+ 40% yoy) and an increase in the technological consumption of electricity (+ 12% yoy), which led to an increase in the total cost by 18% yoy to T89bn.

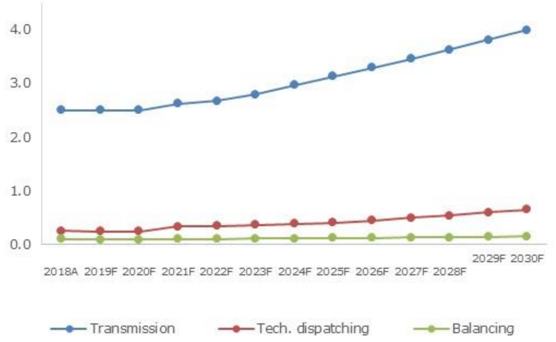
Operating profit amounted to T8.9bn, having strengthened by 18% compared to 2017. In addition to the 11% yoy growth in gross profit, the growth in operating profit was aided by the receipt of revaluation revenue of T3.3bn.

Profit for the period amounted to T40bn, which is 22% higher than in 2017. The weakening of the tenge, as a result of which the foreign exchange loss increased by 35% to T5.9bn and the assets depreciated in the amount of T2.9bn (+ 31% yoy), had a restraining effect on net profit.

KEGOC results for 2018 we estimate, as neutral, the deviation in operating profit is a reasonable 2.3% of our forecast. Adjusted net income (excluding impairment) is also in line with our expectations (T42bn vs. T44bn).

Tariff forecast is maintained

Fig. 2. Tariff forecasts



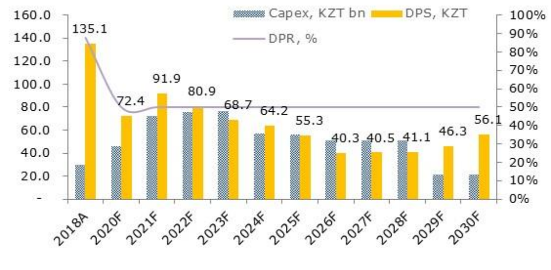
Source: Company Data

At the meeting with investors, KEGOC presented forecasts for tariffs for 2019-2020, which, despite the reduction and freezing of tariffs in 2019, show growth. In 2020, judging by the statements of KEGOC, tariffs for regulated services will increase: for electricity transmission by 12% yoy, for dispatching - by 29% and for balancing - by 11%.

We estimate the company's projections for tariffs too optimistic. We believe that the tariff freeze adopted by the Ministry of Energy for the next seven years will be relevant only until 2020, inclusive. We see the necessary prerequisites for the increase in tariffs after 2020, which will be more pronounced amid increased costs for energy producers. Our forecast for the stagnation of tariffs in 2019-2020 at the levels adopted by the regulator remains unchanged. The profit margin in KEGOC (about 14.8%) corresponds to the market. Based on the constant value of the profit margin of ~ 15% with full involvement of assets, we still expect an increase in transfer and balancing tariffs in 2021-2025 by 5% (CAGR) and in dispatching by 8%.

Capital costs will rise sooner than we expected

Fig. 3. Outflows on Capex and dividends

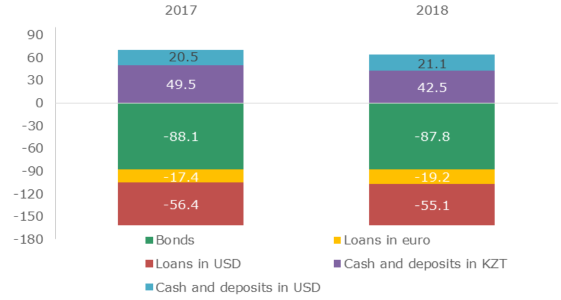


Source: Halyk Finance Forecasts

At a meeting with investors, the Company announced plans to implement new investment projects. In particular, the project on reconstruction of 220-500 kV overhead lines of KEGOC branches with a cost of T126bn planned for 2018-2028. KEGOC is going to sell at 70% through borrowing. The second project on Strengthening the electrical network of the Western zone of UES of Kazakhstan (2018-2023) is estimated by the company at T45bn and is also being considered for implementation mainly due to borrowed funds (80%). The company plans to borrow funds in tenge through the issuance of bonds. At the same time at the end of 2018 the company's debt amounted to T162bn and Debt/Equity at 0.34x.

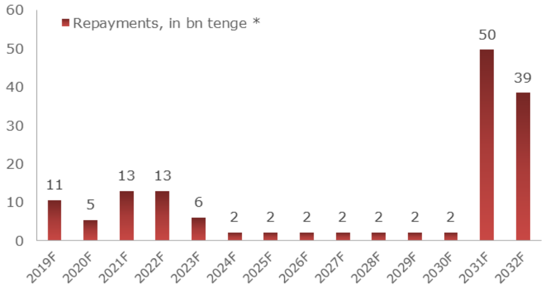
In connection with the completion of large projects, we expected the launch of the following capital-intensive programs only by

Fig. 4. Debt and cash by currency, tenge



Source: Company Data

Fig. 5. Repayment schedule



in terms of tenge at the rate of T384.2/$

Source: Company Data

2021. Assessing the scale of the already approved projects, we increased the capital costs in 2019-2025 from the previous range of T10-40bn (including maintenance investments) to T45-75bn. At the same time, we note that we classify capex in the amount of T126bn as Capex for maintenance and not for expansion, since we do not expect a net effect on cash flows, which is due to the nature of the planned costs. Thus, we consider capital expenditures for the restoration of the technical characteristics of power lines to extend the resource for more than 30 years more as a strategic Capex, the effect of which is eroded due to the periodic obsolescence of fixed assets.

In addition to new projects, starting from 2021 may come into effect a plan for the construction of lines 220 kV Uralsk-Atyrau and Kulsary-Tengiz, 500kV Nura-Zhezkazgan, 500kV Astana with the accession to the NES of Kazakhstan, the issuance of power Torgay WES and other new projects. The need for injections into these projects will be evaluated additionally. We lay the estimated cost of possible projects within no more than T41bn.

Dividends peak

At the AGM, the general meeting of shareholders decided on the results of 2018 send 87.7% of the net income for 2018 to dividend payment, which is T35.1 bn tenge or T135.06/share, of which T80.53/share has already been paid in 1H2018. The total amount of the dividend coincides with our forecast of T135/share.

Previously, we proceeded from the scenario that the company, due to the completion of the main phase of the project for the expansion and modernization of electrical networks, will significantly reduce capital investments until 2021. will be able to maintain a dividend payout ratio of 80%. However, in light of the expected cash outflows, according to our forecasts, to service capital-intensive projects and because of debt load, the company will reconsider the policy of paying high dividends and reduce the payout ratio to 50% and the size of the dividend will decrease to T40/share by 2026.

Discount Cash Flow Method (DCF)

The discount rate and the growth rate have not changed and are 14% and 3%, respectively.

We have significantly increased Capex in comparison with the previous assessment. A significant increase in capex attributable to 2020 is a consequence of the lower valuation of Capex before the company takes on two new projects for implementation in 2019-2028.

Fig. 6. Changes in the model

	unit	2019F	2020F	2021F	2022F	2023F	2024F	2025F
Before the revision								
Capex	KZT bn	14.6	9.8	35.2	37.4	38.6	39.4	40.0
Dividend	KZT/share	129	114	113	116	122	131	134
After revision								
Capex	KZT bn	29.9	45.7	72.5	75.4	76.9	57.3	56.2
Dividend	KZT/share	74.6	72.4	91.9	80.9	68.7	64.2	55.3
Change								
Capex	KZT bn	105%	367%	106%	101%	99%	46%	41%
Divivdend	KZT/share	-42%	-36%	-19%	-30%	-44%	-51%	-59%

Source: Halyk Finance Forecasts

We lowered the dividend forecast, noting the high advantage of servicing large projects and debt burden, a significant part of the repayments for which fall on 2031 and 2032:

Our new 12M target price is T1337/share, the discount to market price exceeds 17%. We see no obvious growth catalysts capable of leveling the weak dynamics of cash flows due to the social importance of the source of income. Dividend payments have reached their peak and have exhausted themselves as a driver to increase the value of shares. We recommend to **SELL** KEGOC shares:

Fig. 7. Target price calculation

KZT bn	2020F	2021F	2022F	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F
EBIT	50.3	63.9	62.1	63.2	67.2	67.8	71.2	74.7	78.5	82.4	86.5
D&A	22.9	25.6	29.3	33.9	39.0	48.1	50.6	53.1	55.7	58.5	61.5
EBITDA	73.2	89.6	91.3	97.2	106.2	115.9	121.7	127.8	134.2	140.9	148.0
Tax expenses	9.4	12.0	10.5	8.9	8.3	7.2	5.2	5.3	5.4	6.2	7.6
CapEx	45.7	72.5	75.4	76.9	57.3	56.2	51.1	51.1	51.1	21.1	21.1
Changes on working capital	3.4	6.1	4.3	5.3	5.8	7.5	6.9	9.0	8.5	7.0	7.1
Free cash flows	**21.4**	**11.2**	**9.8**	**16.6**	**46.4**	**60.0**	**72.3**	**80.5**	**86.3**	**120.7**	**126.4**

WACC	**14%**
First stage DCF	227
Terminal value	1 210
PV of terminal value	263
Enterprise value	491
Net debt	143
Equity value	348
Number of common shares (mn)	260
Fair price, ₸/share	1 337
Current price, ₸/share	1 615
Upside	17%
Rating	**SELL**

Source: Company data, HF calculations

Source: HF Calculations

Appendix 1. Forecasts of financial statements

KZT bn	2017A	2018A	2019F	2020F	2021F	2022F	2023F	2024F	2025F
P&L									
Revenues	152.4	175.8	181.6	186.1	209.7	218.1	230.8	246.7	263.6
Cost of sales	67.1	79.8	90.9	96.8	103.2	109.0	115.1	121.2	127.6
Gross profit	85.3	96.0	90.7	89.4	106.5	109.1	115.7	125.5	136.1
SGA	12.6	14.3	15.1	15.8	16.6	17.4	18.2	18.9	19.7
Selling costs	0.2	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.4
EBITDA	72.5	81.4	75.3	73.2	89.6	91.3	97.2	106.2	115.9
Depreciation	22.9	26.7	20.7	22.9	25.6	29.3	33.9	39.0	48.1
EBIT	49.6	54.7	54.6	50.3	63.9	62.1	63.2	67.2	67.8
(Financial income)	-3.6	-5.0	-0.8	-6.8	-5.1	-1.9	-1.5	-1.6	-1.7
Financial expense	4.5	3.9	7.2	10.4	9.7	11.1	18.7	25.1	31.1
(Other income)	-0.5	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.5
Other cost	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4
Share in associates	-0.5	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Exchange rate (gain) loss	4.4	5.9	0.1	0.0	0.0	0.7	1.9	2.5	3.0
Impairment costs	2.4	-0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EBT	**45.1**	**51.0**	**48.5**	**47.1**	**59.8**	**52.6**	**44.7**	**41.7**	**36.0**
Income tax	9.8	11.0	9.7	9.4	12.0	10.5	8.9	8.3	7.2
Net profit	**32.9**	**40.0**	**38.8**	**37.7**	**47.8**	**42.1**	**35.7**	**33.4**	**28.8**
Diluted number of shares	260.0	260.0	260.0	260.0	260.0	260.0	260.0	260.0	260.0
EPS	**135.9**	**154.0**	**149.2**	**144.9**	**183.9**	**161.8**	**137.5**	**128.3**	**110.7**
	2017F	**2018F**	**2019F**	**2020F**	**2021F**	**2022F**	**2023F**	**2024F**	**2025F**
Balance sheet									
Cash and its equivalents	47.6	19.1	36.3	37.2	41.9	43.6	46.2	49.3	52.7
Restricted cash	3.4	4.2	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Other financial assets	25.1	20.1	156.7	107.4	11.4	0.0	0.0	0.0	0.0
Trade receivables	7.8	9.3	19.5	20.0	22.5	23.4	24.8	26.5	28.3
Deferred taxes	1.0	0.8	0.7	0.7	0.8	0.9	0.9	1.0	1.0
Inventory	1.9	2.3	3.4	3.7	4.0	4.3	4.6	4.9	5.4
Deferred income taxes	1.6	1.5	2.3	2.3	2.6	2.7	2.9	3.1	3.3
Other short-term assets	0.7	0.5	0.6	0.7	0.7	0.8	0.8	0.9	0.9
Short-term assets	89.0	57.8	223.7	176.2	88.1	79.8	84.3	89.9	95.9
PPE	535.3	667.9	557.9	622.7	736.0	851.1	964.5	1035.4	1094.9
Intangible assets	1.0	1.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Advances provided	0.7	1.0	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Investments in associates	0.8	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Other financial assets	1.1	25.6	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Other long-term assets	1.0	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0
ASSETS	**628.9**	**755.9**	**786.6**	**803.8**	**829.1**	**935.9**	**1053.8**	**1130.2**	**1195.8**
Short-term debt	13.9	15.5	0.0	0.0	0.0	95.4	195.7	248.2	290.8
Trade payables	18.8	22.6	31.0	33.2	35.8	38.4	41.4	44.5	48.8
Advances received	2.0	1.7	2.4	2.5	2.7	2.9	3.1	3.4	3.7
Other short-term obligations	5.1	6.3	9.1	9.7	10.5	11.2	12.1	13.0	14.3
Short-term obligations	39.8	46.2	87.8	92.0	101.4	202.5	310.1	370.8	423.5
Long-term debt	148.2	146.5	187.7	182.4	169.4	156.9	152.5	152.8	153.5
Taxes payable	66.8	90.4	66.8	66.8	66.8	66.8	66.8	66.8	66.8
LIABILITIES	254.8	283.2	342.3	341.2	337.5	426.2	529.3	590.3	643.8
Chartered capital	126.8	126.8	126.8	126.8	126.8	126.8	126.8	126.8	126.8
Valuation reserve	220.9	310.8	263.2	263.2	263.2	263.2	263.2	263.2	263.2
Retained earnings	26.7	35.1	54.3	72.6	101.6	119.7	134.5	149.9	162.0
EQUITY	**374.2**	**472.7**	**444.3**	**462.6**	**491.6**	**509.7**	**524.5**	**539.9**	**552.0**
EQUITY AND LIABILITIES	**628.9**	**755.9**	**786.6**	**803.8**	**829.1**	**935.9**	**1053.8**	**1130.2**	**1195.8**
	2017F	**2018F**	**2019F**	**2020F**	**2021F**	**2022F**	**2023F**	**2024F**	**2025F**
Cash Flow Statement									
Operating Activities:	61.8	64.3	120.7	77.0	96.1	96.2	103.0	112.6	124.0
Investing Activities:	(9.3)	(52.4)	(181.6)	(51.4)	(59.5)	(152.8)	(173.5)	(141.7)	(144.2)
Financing Activities:	(37.1)	(40.6)	78.1	(24.6)	(31.9)	58.3	73.0	32.3	23.6
Net cash flow	**15.4**	**(28.7)**	**17.3**	**0.9**	**4.7**	**1.7**	**2.5**	**3.2**	**3.4**

Source: Company Data, Halyk Finance estimates

Research Department		**E-mail**
Stanislav Chuyev	Head	s.chuyev@halykfinance.kz
Dmitriy Sheikin	Macroeconomics	d.sheikin@halykfinance.kz
Asan Kurmanbekov	Macroeconomics	a.kurmanbekov@halykfinance.kz
Altynay Ibraimova	Equity	a.ibraimova@halykfinance.kz
Aliya Assilbekova	Equity	a.assilbekova@halykfinance.kz
Vladislav Turkin	Fixed income	v.turkin@halykfinance.kz

Sales Department		**E-mail**
Mariya Pan	Head	m.pan@halykfinance.kz
Aizhan Moldakhmetova	Institutional	a.moldakhmetova@halykfinance.kz
Shynar Zhakanova	Institutional	sh.zhakanova@halykfinance.kz
Dariya Maneyeva	Retail	d.maneyeva@halykfinance.kz
Aziza Ordabayeva	Retail	a.ordabayeva@halykfinance.kz
Aliya Abdumazhitova	Retail	a.abdumazhitova@halykfinance.kz

Address:
Halyk Finance
Abay av, 109 «В», 5th fl.
A05A1B9, Almaty, Kazakhstan
Contact: +7 727 357 31 77
www.halykfinance.kz

Bloomberg
HLFN
Thomson Reuters
Halyk Finance
Factset
Halyk Finance
Capital IQ
Halyk Finance