

KenGen | NSE | Energy | Medium Cap

Selected Financial Ratios

Year End (June)	08A	09E	10E	11E	12E	13E
Revenue (Kshs bn)	16.1	21.3	22.0	25.2	27.2	32.0
EBITDA (Kshs bn)	7.3	7.7	11.1	14.2	16.8	21.2
PBT (Kshs bn)	3.1	3.3	3.8	5.0	6.0	8.0
EPS	2.68	1.12	1.22	1.48	1.77	2.06
DPS	0.90	1.18	Nil	Nil	Nil	Nil
Revenue Growth	10.6	32.4	3.2	14.8	7.6	17.8
Debtors Growth	(14.7)	25.3	35.2	46.3	0.0	27.7
EBITDA Growth	(4.7)	6.3	44.1	27.5	18.3	26.5
EBITDA Margin	45.2	36.3	50.6	56.2	61.8	66.4
Net Margin	36.6	11.6	12.9	14.8	16.5	18.8
ROE	9.0	3.6	3.9	4.7	5.2	6.3
ROCE	5.1	2.0	1.4	1.6	1.9	2.4
Debt to Equity %	30.8	72.3	89.2	101.8	120.1	121.9
EBIT Coverage	4.8x	4.4x	2.1x	2.0x	2.0x	2.0x
Debt Service Cov.	15.9x	1.1x	1.0x	2.0x	1.2x	2.1x
P/CF	3.9x	5.3x	3.3x	2.4x	3.1x	2.6x
EV/EBITDA	6.5x	6.1x	4.2x	3.3x	2.8x	2.2x
Income items as percentage of total assets						
Revenue	15.1	15.9	13.4	13.2	12.3	11.9
EBITDA	6.8	5.8	6.8	7.4	7.6	7.9
Depreciation	3.2	2.6	2.5	2.3	2.1	2.0
Finance Costs	0.7	0.7	2.0	2.5	2.8	2.9
Pre-Tax Profit	2.9	2.4	2.3	2.6	2.7	3.0
Net Income	5.5	1.8	1.7	2.0	2.0	2.2

Source: Company data, FIB Research estimates

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Kenya Electricity Generating Company

Kenyan: Energy Sector – Electricity Generation

(pricing in this report is based on 28th September, 2009 closing prices)

Dim lights shine on power stocks. KenGen shares have taken a hit following the PIBO, but expected high (final) dividend yield for '09 may momentarily halt investor pessimism. Taking into account the cash flow constraints hinted through the bond prospectus, investor confidence in the future will be conditional on improvements in rain-fed generation and the fast execution of capacity expansion projects.

Revenue sources prove unreliable

Hostile climatic patterns stifle growth of traditional revenue sources which doesn't augur well for KenGen's EPS growth over the next two years. Electricity sales (non-fuel) are expected to recovery considerably as the weatherman's forecast promises to lift hydro generation.

Playing field becomes more crowded

Independent power producers (IPPs) are investing in more capacity to cater for the hungry demand for electricity (growing by 8% annually). These thermal producers will eat into market share in the short term and may cause more cash flow problems for KenGen's only customer.

Dividend growth prospects dwindle

KenGen's use of a higher financial leverage to raise asset returns may negatively impact market confidence as cash dividends disappear.

High bond and equity yields still give investors options

KenGen offers first-class yields for long term investors through the PIBO and current prices support a high ('09 estimated) dividend yield.

Stock Data

Price	11.35
52 week range	20.75-9.15
Market Cap.	KSh 24.9 bn
Market Cap.	US\$ 335 mn
Net Debt	KSh 22.1 bn
Free Float	30%
Issued Shares	2198 mn
EPS (09E)	1.12
P/E (09E)	10.1x
EV/EBITDA (09E)	6.1x
Div Yield (09E)	10.4%

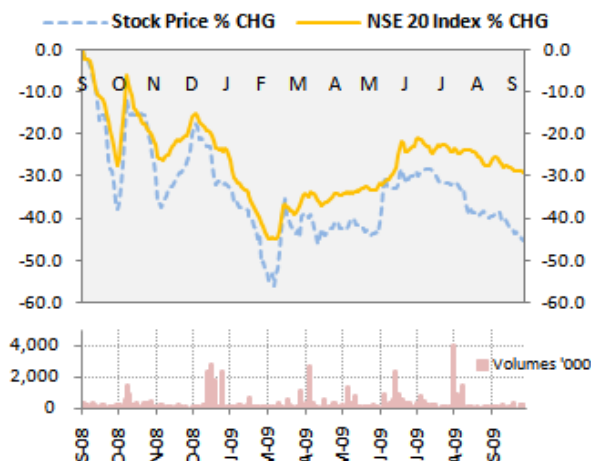


Exhibit 1: Forecasts and valuation

Year End (June)	Revenue (Kshs mn)	EBITDA (Kshs mn)	Pre-Tax Profit (Kshs mn)	EPS (Kshs)	EV/EBITDA (x)	P/E (x)
2008	16,092	7,272	3,079	2.68	6.5x	4.2x
2009E	21,310	7,728	3,264	1.12	6.1x	10.1x
2010E	21,982	11,133	3,767	1.22	4.2x	9.3x
2011E	25,244	14,192	4,998	1.48	3.3x	7.7x
2012E	27,152	16,783	5,980	1.77	2.8x	6.4x
2013E	31,993	21,229	8,031	2.06	2.2x	5.5x

Source: Company data, FIB Research estimates

Both short and long term expansion plans intended to provide stability

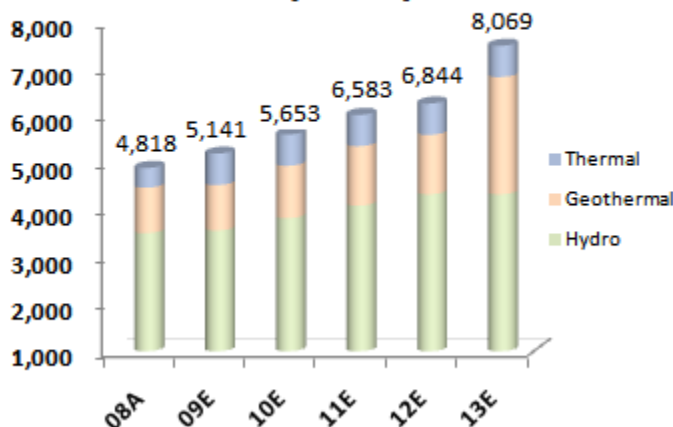
Despite being one of the best clean energy producing companies, it's diversification further into thermal generation plants mitigates the risks inherent in relying on one form of generation

We estimate sustainable medium-term (2009-13) EPS growth of 8.0% for KenGen largely dependant on the swift implementation of key expansion projects within 2011-13. Within the 2010 year expansion plans under the Horizon 1 projects include a 120 MW investment in thermal capacity and a 20 MW (minor) expansion of hydro capacity. To sustain long term growth the management team has to demonstrate the ability to negotiate better power purchase agreements (PPAs) with the regulatory authorities while avoiding the usual politics (associated with government owned firms) as well as other squabbles with local communities (during expansion efforts).

The short term capacity improvements are designed to bridge the current power supply deficit in the country although our estimates suggest that considerable improvements in ROA will be realized once more hydro projects go online. KenGen's tariff assumptions indicate that it will earn more from its thermal operations (about Kshs13.45 / kWh) against the average blended tariff on existing projects of Kshs2.42 / kWh. A good chunk of the capacity growth within 2010-13 will be added to KenGen's geothermal footprint which will boost units generated through the high load factor.

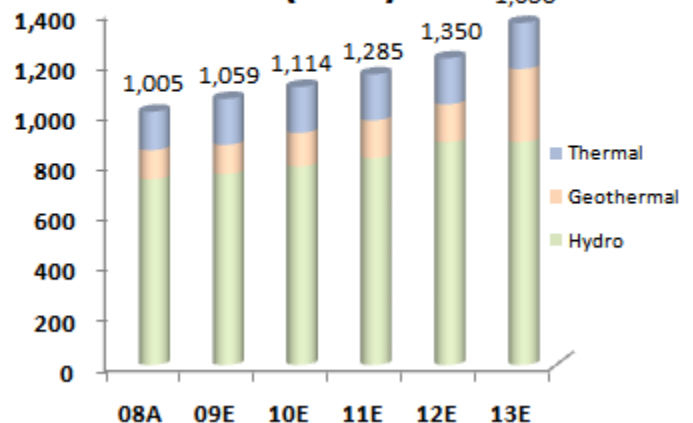
Exhibit 2: Expected Power Production and Capacity Expansion

KenGen Units Generated (GWh)



Source: Company data, FIB Research estimates

KenGen Installed Capacity (MW)



Source: Company data, FIB Research estimates

Brief valuation summary: Modest earnings growth but poor dividend profile

The power sector is general has been undervalued despite the fairly high barriers to entry and the high demand growth. We believe that the company will be able to improve its returns (capped by regulation) through increasing its financial leverage. We expect the company to generate predictable high cashflows but expect a large portion of the cash generated to be channeled into capex spend and used to service debts. The downside risk on the share is pegged on the management’s ability to commission new capacity swiftly and maintain a more balanced generation mix. A zero dividend policy within 2010-13 and the subsequent rights issues are not likely to settle well with shareholders. Using an average of DCF, EV/EBITDA, P/CF, and P/E, we arrive at a fair value of Kshs14.35, which is greatly higher than the current price.

Strategy based on using greater financial leverage to expand capacity

Geothermal investments promise to enhance energy unit sales

Based on the KenGen report ‘Geothermal Development in Kenya, 2006’ geothermal power occupies about 11% of the electricity sub-sector and has huge potential for growth (estimated at 2,000MW in Kenya). Kenya has emerged as one of the leaders in Africa in exploiting this form of renewable energy and the Geothermal Development Company was created in 2009 to explore, appraise and undertake steam production.

Horizon 1 projects target to increase geothermal capacity by 317.5 MW from the current 115.0 MW at a total investment cost of US\$1.3 bn

Exhibit 3: Geothermal Capacity (MW) – Kenya vs Global Leaders

World's Geothermal Producers				
COUNTRY		1995	2000	2005
USA	1	2,817	2,228	2,534
Philippines	2	1,227	1,909	1,931
Italy	3	632	785	790
Mexico	4	753	755	953
Indonesia	5	310	590	797
Japan	6	414	547	535
New Zealand	7	286	437	435
Iceland	8	50	170	202
El Salvador	9	105	161	151
Costa Rica	10	55	143	163
Kenya	11	45	57	129
Nicaragua	12	70	70	77

Source: Geothermal Development in Kenya, 2006 by KenGen

Geothermal Development Process

- Exploration
- Drilling (2000-3000m)
- Well testing
- Feasibility studies/EIA
- Power station construction

Geothermal projects set to be commissioned in the next two years will release about 297GWh in annual energy generation extra in addition to the current 966GWh resulting in a significant increase in electricity sales

This form of generation is crucial to the generation mix because of its high (94%) load factor (the ability to generate a consistent energy supply from installed capacity). The expected new tariffs on new geothermal projects are also considerably higher than hydro and ranging between Kshs7.00 to Kshs8.20 / kWh. However, despite the massive potential to impact KenGen’s top-line growth the ability to fund these projects (high upfront costs) as well as the complexity of the development process represents the biggest headaches. The management estimates that they could earn up to US\$1.29 mn (Kshs100 mn) in CDM revenue from the new projects (Olkaria II 3rd unit and Eburu) through the emerging carbon credits market. The carbon credit

market is ideal for power firms companies looking to benefit from the production of cleaner energy, and incentivizes further investment into future similar ventures.

Drought leaves hydro-electric power high and dry

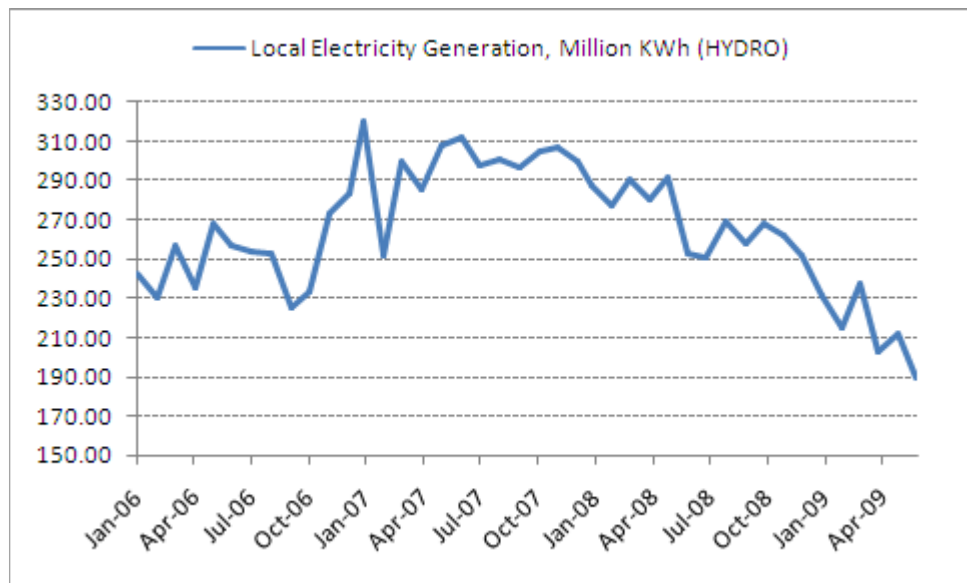
The majority of energy (60%) purchased by KPLC (the distributor) is derived from hydro-sources and production has proved to be highly volatile due to unpredictable weather patterns and lack of infrastructure development (and maintenance) over the last 40 years. The current year has proved to be particularly challenging due to the on-going drought. According to the Kenyan meteorological department most major rivers will register higher flows during the Q4 of 2009 (Oct-Dec) due to the El-Nino rains. The assumption being that hydro-generation will be the winner as catchment areas for major hydro dams will swell due to above-normal rainfall.

Horizon 1 projects target to raise hydro capacity by 86 MW from the current 758 MW at a total investment cost of US\$207 mn

Hydro-electric power projects set to be commissioned in the next one year will release generate about 190GWh in annual energy generation to the current 3,563GWh

Aside from the short term relief, long term projects target the Kiambere (large hydro) and Tana (small hydro) power plants whose the tariffs structures remain low (thus profitability is leveraged on units delivered). We believe within 2009-13 expansion of hydro capacity will result in only half the potential to raise unit sales as compared to the geothermal projects due to the existing tariffs. KenGen estimates that they could earn up to US\$1 mn (Kshs80 mn) in CDM revenue from the new hydro projects (through the emission reductions purchase agreement signed with the World Bank).

Exhibit 4: Local Electricity Generation, 2006 to June 2009



Source: KNBS, www.cbs.go.ke

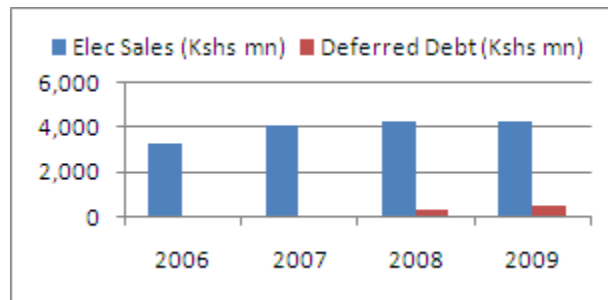
KenGen's financial year end closes in June and in the year to June 2009 electricity generation dropped 18% from 290 million KWh to 237 million KWh (on a 12 month rolling basis)

According to the statistics bureau in the year to June 2009 local electricity generated from hydro electric sources was down 24.8% against a 27.0%, 14.0% and 16.6% respective growth from geothermal, thermal (including IPPs) & EPPs sources. The poor contribution from rain fed generation coupled with the increased use of diesel plants is reflected in our lower gross margin projection, down 5% to 17% in '09 versus 22% in '08. We anticipate GWh unit sales to rise 4% in the first half of 2010 against 1% rise the previous year due to the impact of improved rainfall in Q2 (Oct-Dec).

Non fuel revenues have taken a back seat

In the recent past electricity sales accounted for 70%-75% of total revenues (the rest comprising fuel costs recovered and other revenues); however due to the persistent drought that percentage has dropped to 60%. We expect this percentage to remain fairly unchanged within 2009-13 as KenGen brings more thermal and a coal fire plant (that use fossil fuels) on board and we anticipate gross margins to remain lower in 2009-10 as fuel pass throughs continue to exert their influence. It is for this reason that the projection for electricity sales in 2009 is only 2% while projections for 2010 rise to 18% on account of revamped hydro operations. Due to the current regulatory framework KenGen’s only customer is KPLC and thus the company is exposed to KPLC’s inefficiencies. Recent figures suggest that receivables from KPLC have not risen dramatically since the new PPA (that changed tariffs) was signed in mid-2008.

Exhibit 5: Receivables from Related Party Transactions

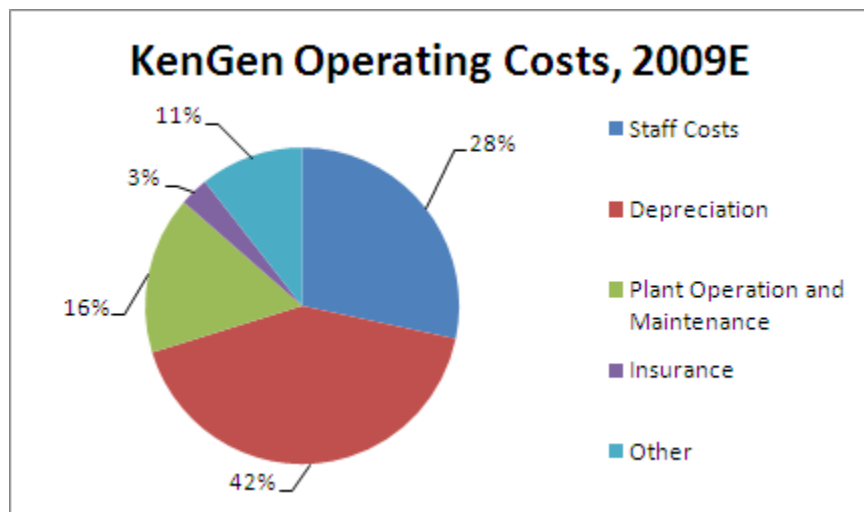


Source: Company data

The power firms operating leverage suggests costs remain contained

We do not anticipate major changes in fixed costs particularly depreciation costs (expected to remain at 17% of revenues) insofar as their ability to stifle growth in EBIT growth or EBIT margins within 2009-13 period. Although it is likely plant operation costs will rise as the company relies on more on its thermal power plants.

Exhibit 6: KenGen fixed costs



Source: Company data

Market share concerns as competition intensifies

With only 18% of the population having access to electric power, Kenya stands to gain from an influx of private players looking to profit from high demand. IPPs play a big role in bridging the power supply deficit particularly since KPLC started its campaign to sign up about 200,000 new customers every year

LTWP has entered into an agreement with KPLC to enable it to seek to funds to build a transmission network on a BOOT [Build Own Operate and Transfer] basis to which it can provide electricity to the national grid. These sort of agreements can assist power producers by enabling them not to rely solely on KPLC to build network infrastructure

As at 31 December 2008 about 75% of borrowings (advanced by the Japan Bank for International Cooperation) were guaranteed by the Government of Kenya

The barriers to entry into the local power generation business have been falling largely due to the growing domestic economy (i.e., power demand from sectors such as manufacturing). IPPs such as Iberafrica, Mumias Sugar, Aggreko (from whom KenGen earns the equivalent of 10% of energy generated) have been expanding their production capacity while market entrants like Rabai will drive total IPP capacity higher from 176MW to 339MW by June 2010. These players will continue to eat into KenGen's market share we estimate that KenGen's market share (in terms of Gwh produced) is expected to drop from the '08 full year figure of 75% to 68% as competitors take advantage of the deficiency in hydro-electric production. According to a new IPP entrant Lake Turkana Power Project (LTWP) in Kenya is ranked 5th worldwide and No.1 in Africa in Wind Power Generation Projects and the company plans to install 300MW of capacity by 2010 (through wind farms in Lake Turkana).

Credit risk rises through bond issue

To fund its expansion plans under the Horizon 1 project KenGen intends to utilize a funding mix that consists of a corporate bond, senior debt and various issues of stock. We expect the rights issues to negatively impact market confidence as free cashflows for dividends dry up while the issue of senior debt (representing 60% of debt financing) will worsen the debt service coverage and debt to tangible equity ratio.

Exhibit 7: Gearing Profile As At Half Year (HY) Periods (2009-10E)

Borrowing Profile (by type)				Gearing Profile		
KSh mn	HY 2009A	HY 2010E	%	KSh mn	HY 2009 Actual	HY 2010 Forecast
Bank loans	27,464	27,464	0.0	Short Term Borrowings	2,137	4,124
Corporate bonds	0	15,000	100.0	Long Term Borrowings	25,326	38,340
Bank overdrafts	0	0	-	Total Borrowings	27,464	42,464
Total	27,464	42,464	54.6	Less: Cash	5,369	11,569
Maturity Profile				Net Borrowings		
	HY 2009A	HY 2010E			22,095	30,894
> 1 Year	8%	10%	2%	Net Debt: equity	36%	41%
1 > 2 Years	8%	13%	5%	Gearing Ratio	31%	36%
2 > 5 Years	23%	44%	21%	Interest Coverage (x)	4.4	2.1
< 5 Years	61%	33%	-28%	% of government	75%	48%
Total	100%	100%		gauranteed borrowings		

Source: Company data, FIB Research estimates

Source: Company data, FIB Research estimates

Exhibit 8: KenGen's Debt Exposure

Debt exposure and comparison with set targets, 2009-13

Year	Debt Service Coverage (x)			Total Debt to Tangible Net Worth (x)	
	Company estimates	Target	Faida estimates	Company estimates	Target
2008A	15.9x	-	15.9x	0.3x	-
2009E	1.1x	-	1.1x	0.7x	2.3x
2010E	1.1x	1.0x	1.0x	0.9x	2.3x
2011E	1.2x	1.2x	2.0x	1.0x	2.3x
2012E	1.2x	1.5x	1.2x	1.2x	2.3x
2013E	0.8x	1.5x	2.1x	1.2x	2.3x

Source: Company data, FIB Research estimates

Credit risk exposure - peer comparison, 2009

Company	Country	Operating cashflow to Total Debt
National Grid Plc	UK	13%
Maharashtra State Power Gen. Co.	India	3%
Escom	South Africa	14%
Electricite de France [EDF]	France	20%
EON Germany	Germany	15%
KenGen ('09 estimate)	Kenya	10%

Source: Bond prospectus, FIB Research estimates

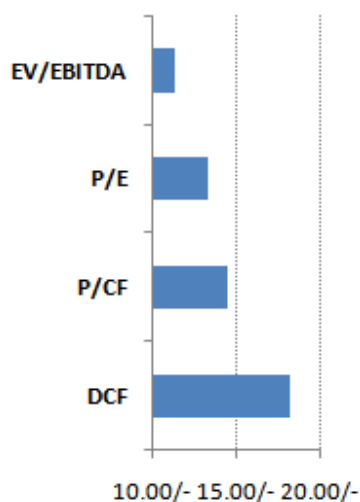
KenGen Profit Model	2007	2008	2009E	2010E	2011E	2012E	2013E
KShs mn							
Electricity Sales	10,853	11,372	11,615	13,679	15,931	16,563	19,526
Other Revenue	288	177	351	451	551	651	751
Fuel Revenue - Pass through	3,411	4,543	9,344	7,851	8,762	9,938	11,716
Total Revenues	14,552	16,092	21,310	21,982	25,244	27,152	31,993
Fuel Cost - Pass through	3,398	4,543	9,344	7,851	8,762	9,938	11,716
Staff costs	2,044	2,222	2,367	2,419	2,523	2,638	2,799
Depreciation	3,446	3,404	3,493	4,061	4,412	4,586	5,280
Plant Operation & Maintenance	1,080	1,199	1,356	1,516	1,585	1,649	1,724
Insurance	228	223	248	260	297	336	385
Other Expenses	1,213	966	884	1,368	1,593	1,656	1,953
Operating Costs	11,410	12,557	17,692	17,476	19,172	20,804	23,857
Gross Profit	3,142	3,535	3,618	4,506	6,072	6,348	8,136
EBITDA	7,634	7,272	7,728	11,133	14,192	16,783	21,229
Depreciation	3,446	3,404	3,493	4,061	4,412	4,586	5,280
EBIT	4,188	3,868	4,235	7,072	9,781	12,196	15,949
Pre-Tax Profit	3,313	3,079	3,264	3,767	4,998	5,980	8,031
Tax Charge/(Credit)	1,922	(2,818)	796	942	1,249	1,495	2,008
Minorities	0	0	0	0	0	0	0
Preferred Dividends	0	0	0	0	0	0	0
Net Income	1,391	5,897	2,467	2,825	3,748	4,485	6,023
EPS (Kshs)	0.63	2.68	1.12	1.22	1.48	1.77	2.06
DPS (Kshs)	0.80	0.90	1.18	0.00	0.00	0.00	0.00
Shares outstanding (mn)	2,198	2,198	2,198	2,527	2,527	2,527	2,926
Non Current Assets	91,516	96,339	122,578	140,898	159,144	182,382	216,685
Current Assets	10,451	10,582	11,771	22,652	32,061	37,817	52,644
Total Assets	101,967	106,921	134,349	163,550	191,205	220,200	269,329
Current Liabilities	7,234	7,852	6,899	12,736	20,765	26,971	38,826
Non Current Liabilities	31,095	30,943	58,648	74,775	87,004	104,373	128,436
Shareholders' Funds	63,638	68,125	68,801	76,038	83,434	88,855	102,066
Other financial ratios							
Gross Margin %	21.6	22.0	17.0	20.5	24.1	23.4	25.4
EBITDA Margin %	52.5	45.2	36.3	50.6	56.2	61.8	66.4
Return on Assets %	2.9	4.6	2.3	2.1	2.3	2.3	2.7
Return on Capital Employed %	3.2	5.0	2.0	1.4	1.6	1.9	2.4
Net Debt to Capital %	18.9	19.4	42.1	45.3	48.9	56.6	54.5
Other ratios for KenGen							
Electricity Sales to Revenue %	75	71	55	62	63	61	61
Depreciation Costs to Revenue %	24	21	16	18	17	17	17
Finance Costs to Revenue %	(0.3)	3.2	2.2	5.5	6.9	5.3	4.8
Installed Capacity (MW)	945	1,005	1,059	1,114	1,285	1,350	1,630
Growth in capacity %	3.9	6.3	5.3	5.2	15.4	5.0	20.7
GWh Produced (Generated)	4,599	4,818	5,141	5,653	6,583	6,844	8,069
Growth in unit sales %	1.3	4.8	6.7	10.0	16.5	4.0	17.9

Source: Company data, FIB Research estimates

Valuation: Kenyan power sector still retains low valuation multiples

We have valued KenGen at **Kshs14.35 per share** by using a weighted average of four valuations namely: DCF, EV/EBITDA, P/CF and P/E (where all metrics were given an equal weighting). We value KenGen at Kshs18.26 per share using a discounted free cashflow model and assuming a weighted average cost of capital of 10.6%. If a new PPA was agreed upon today between KenGen and KPLC that resulted in a 10% rise in the blended tariff earned (per kWh) for all existing projects then we believe the DCF would rise to Kshs25.00. Again assuming the above tariff scenario, we also estimate that KenGen's return on investment on its projects would rise from the current 4.0% to 5.3% (where we have assumed that KenGen will be able to build new capacity at Kshs105 or \$1.36 per MW). DCF model uses the following parameters: A WACC of 10.6%, terminal growth rate of 0% and net debt of Kshs22,095 m.

KenGen Valuations



Source: FIB Calculation

Exhibit 9: KenGen DCF Valuation, KShs mn

	2009E	2010E	2011E	2012E	2013E
EBIT	4,235	7,072	9,781	12,196	15,949
Less taxation	(1,059)	(1,768)	(2,445)	(3,049)	(3,987)
Tax adjusted EBIT	3,176	5,304	7,335	9,147	11,961
Depreciation	3,493	4,061	4,412	4,586	5,280
Less: capex	(6,246)	(17,754)	(18,347)	(23,629)	(19,166)
Change in working capital	798	(828)	(2,708)	(85)	(4,061)
Unleveraged free cash flow	1,221	(9,216)	(9,308)	(9,980)	(5,985)
Disc Unlevered CF @ 10.6%	1,191	(8,123)	(7,416)	(7,187)	(3,896)

Target Debt to Cap	20.0%
After-tax Cost of Debt	23.0%
Risk Free Rate	7.2%
Beta	1.00
P/E (Kenya Mkt)	13.30
Market Risk Premium	0.3%
Cost of Equity	7.5%
WACC	10.6%
Terminal Growth Rate	0.0%
Terminal Value	125,658
PV of Terminal Value	54,610
PV of Cash Flow Horizon	7,632
Enterprise Value	62,242
% of Terminal Value in EV	88%
Net Debt	22,095
Equity Value	40,147
Shares Outstanding	2,198
Ksh/Share	18.27/-

Risk Factors for Power Firms

- Liquidity & credit risk due to a high debt to equity ratio
- Environmental risk from damage or weather related generation
- Unreliable regulatory framework that cap returns
- Effect of increased competition on market share

The share price is trading below its 2006 IPO price (which was Kshs11.90) and we believe there is a substantial margin of safety on the current price

Target Price (12 month), Kshs	18.27/-				
Current share price	11.35/-				
Upside	61%				
Implied multiples (target price)	2009E	2010E	2011E	2012E	2013E
P/E	16.3x	15.0x	12.3x	10.3x	8.9x
EV/EBITDA	8.1x	5.6x	4.4x	3.7x	2.9x
EV/Sales	2.9x	2.8x	2.5x	2.3x	1.9x

Source: Company data, FIB Research estimates

Our recommendation

Investors should keep an eye on KenGen's ability to use its financial leverage to improve its bottom-line. Since the opening of the offer the share price has dipped 11% (possibly oversold considering the RSI) and thus a short term recovery may be in the offing particularly if our expected dividend yield of 10.4% (plus) materializes. Using our average valuation there appears to be a 25% plus margin of safety on the current price, but, long term investors should be careful not to invest in counters devoid of high dividend growth prospects. We believe that any further investment into the PIBO (through secondary market trading) makes sense given the positive response from investors to the coupon rate offered and the company's ability to generate cashflows to meet all debts. However, since the bond ranks poorly in the debt profile (not being backed fully by the government or a credit rating) we would advise looking for a premium (on yield) to mitigate market risks. Early media reports indicate that the subscription rate will be high (thus the greenshoe option exercised), so there maybe enough liquidity within the 20% retail pool to seek out a bargain.

At the start of the offer in early September 2009 the implied P/E on the 12.5% coupon bond was 8.0x (using 2008 earnings), so look for the yield to rise to the 15%-17% range to bring the P/E in line with the 12 month average of 6.5x

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General

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