TRANSCENTURY LIMITED (TCL) INITIATION OF COVERAGE

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September 2014

- We initiate coverage on Transcentury with a **BUY** recommendation based on a fair value of **KES 34.56**. On a relative basis, the stock is trading at par with the book value at KES 20.00 (book multiple of 1.0x), a discount to Centum's book multiple of 1.7x.

- Despite the political headwinds that have limited the degree of pick up in the engineering division, leveraging on the heightened regional infrastructure development and investments in energy will drive growth in the medium term. Effective business restructuring post RVR exit should support a turnaround in 2015. EPS is projected to decline to KES -2.27 in 2014 from KES 1.06 in 2013 but will accelerate to KES 1.11 and KES 1.44 in 2015 and 2016 respectively.

The Value Drivers

- *Power* – TCL sells electricity transmission, distribution and lighting cables through its subsidiary East African Cables. Tanelec Tanzania manufactures and distributes transformers within the region. TCL will double capacity in Cables to 650MT per month by 2015 from 320MT in 2014 and is considering moving to medium voltage cable production in 2016. The envisaged addition of 5000Mw of power to the national grid by 2016 provides an opportunity for joint ventures. KenGen has invited partnership in geothermal exploration. The legislation requiring 40% preferential for local manufactured goods in Kenya (Public Procurement and Disposal (Amendment) Regulation 2013) and a similar proposition in Tanzania should support the demand for TCL's products in the medium term. On average, power accounts for 60% of TCL's topline but TCL expects this to be diluted to about 50.0% once engineering and infrastructure picks up in 2016. In view of the move to new markets, we expect that power revenues will grow by a conservative 10% in the next three years. New markets include insulated cables and special cables used by other utilities companies, the Kigali Airport for example.

- *Engineering* – The anticipated 6% regional growth is predicated on increased investments in infrastructure particularly in the energy and transport sectors. TCL is keen on a niche in the underpenetrated privately funded projects including roads, up and downstream oil and gas storage facilities, industrial installation, bridges and other infrastructure around mineral exploration and exploitation zones. Africa is increasingly becoming the world's new resource frontier. Kenya, Uganda and Tanzania have confirmed presence of commercially viable deposits of oil and/or gas. DRC and Zambia are rich in minerals. TCL, through the 62% ownership in Civicon is strategically positioned to benefit from these opportunities and is already involved in projects with Tullow and Total Oil. TCL will sustain investments in engineering to maintain its leadership positions in targeted markets. On average, engineering contributes 40% of the group's earnings and is this is projected to increase to 50%.

Stock Data	
Price	20.00
Price Target	34.56
Date of Price	07.10.2014
Price Target Year End	2016
52-week Range (Kes)	20.00-37.75
Market Cap (Mn Kes)	5,606
Issued shares (Mn)	280.28

Source: CBA Capital

Source: NSE, CBA Capital

The market in our view has over discounted TCL shares and should be emerging from the headwinds in 2015. While we are not bullish on 2014 as a result of underperformance of the engineering division, the projects launched in 2014 should start contributing to the group's topline in 2015 supporting a recovery.

Key Valuation Metrics

Year	2013A	2014E	2015E	2016E
P/E	*18.87*	*-8.81*	*18.38*	*14.33*
P/BV	*1.05*	*1.00*	*0.90*	*0.80*
EV/EBITDA	*7.83*	*35.75*	*5.59*	*4.79*
Dividend yield	*2.0%*	*2.0%*	*2.0%*	*2.0%*
ROE	*12.1%*	*-20.5%*	*8.9%*	*10.1%*
ROA	*2.6%*	*-4.0%*	*1.8%*	*2.1%*

Source: CBA Research

- *Infrastructure projects*– These are projects in which TCL has an equity stake. TCL holds a 24.5% stake in Menengai 35Mw geothermal plant and will be looking to capitalise on the over 200 wells already dug by the Geothermal Development Company through Power Purchase Agreements(PPA). TCL will invest in and own infrastructure projects based on concessions and PPAs in power generation including coal, geothermal and LNG, road construction, rail transport development and bridges. The company may also raise funds and/or offer logistics for such projects.

- *Restructuring Post RVR- exit* **-** TCL exited the Kenya Uganda Railways Holding Company in March 2014 realizing the initial investment of USD 43.7mn from the sale of its 34% stake. As at the time of exit, TCL was carrying the investment at a fair value of USD 55.00mn resulting in a USD 11.3mn fair value loss. See Statistics below.

Redistribution of Proceeds from RVR Divestiture

Loan Reduction	USD 17.00 million
Power Capex	USD 11.00 million
Infrastructure Projects	USD 15.70 million (balance)
Total	USD 43.70 million
Fair Value of RVR investment	USD 55.00 million
Fair Value loss	USD 11.30 million

Source: TCL Management

- USD 17.0mn will be used to clean up the balance sheet through debt reduction.

Debt Structure	KES '000'
Long term borrowings	3,786,665
Short term borrowings	1,833,357

Source:TCL 2013 Annual Report

- USD11.0mn will be invested in the modernization and expansion of the power plants. The modernization of the Nairobi Cables plant is due for completion in November 2014. The expansion will also be done across plants in Tanzania, Zambia and South Africa.
- TCL has indicated that it has a strong pipeline of high return infrastructure projects in excess of USD 500mn in equity. This will in part be funded by USD 15.7mn balance from the RVR sale. The PPA for the 35Mw Menengai plant has already been initialed and construction will commence in 2014 for completion in 2015.

Downsides to our TP

- *Potential dilution from the bond conversion*

Year	Strike Price
2012	40.00
2012	42.40
2014	44.80
2015	47.20
2016	49.60

Source: TCL Management

TCL has reserved 150,929,616 ordinary shares for the conversion of USD 60.27 mn, 6.0% five year bond maturing in March 2016. In 2011, USD 3.435 mn of the outstanding bond value was converted to 6,912,194 ordinary shares. Although Management is confident that shareholders will convert the bond to equity, the current low share price and the unfavorable conversion rate (KES 80.49135 per USD) could be impeding. Holding all other factors constant, 100% conversation of the bond could result in a 34% dilution of our TP to KES 22.65. However, on a positive note, this could reduce the interest expense on the debt liability, easing pressure on the bottom-line.

- *Exposure to Foreign Exchange volatility* – The current shilling volatility could result in high interest expense, exerting more pressure on profit margins. The Bond will be redeemed in March 2016. TCL will pay an additional 6.0% interest in kind at maturity.

- *Expensing of the Accrued Interest* –We note that TCL has not been providing for the accrued interest on the convertible bond. The expensing of the interest may dilute earnings although with negligible impact on the DCF. Of concern also is the slow growth in cash flows. Failure to accumulate adequate cash in 2014/15 for the redemption of the convertible bond could increase borrowing sustaining the interest expense pressure on profit.

- *Delays in execution of key projects –* The engineering projects are sensitive to changes in the political landscape. A number of projects that were targeted for 2013 were rolled out in 2014, due to the electioneering period in 2013. However, these delays primarily affect the initial stages of projects.

Peer Analysis

Peer Analysis	Centum	TCL	Reliance Power	Ferrovial (SA)
P/E	13.00	19.34	19.10	30.18
P/BV	2.25	1.08	1.00	1.14
EBITDA Margin	83.8%	19.1%	37.04%	11.44%
EV/EBITDA	7.12	7.83	24.01	17.50
Div. Yield	0.00%	0.75%	0.00%	2.84%
ROE	18.0%	12.1%	5.40%	9.67%

Source: Bloomberg

On a book multiple, TCL compares favorably to its two peers, Centum of Kenya and Ferrovial of Spain. EV/EBITDA multiple is fairly higher than Centum given its higher levels of Debt and still compares unfavorably on a P/E basis to Centum. For all the four companies, dividend payout is low if not nil given their high investment appetite.
Note: The potential conversion of the bond will significantly dilute TCL's ROE, EPS in 2016.

The need for better infrastructure, integral in the production system, will further be driven by devolution in Kenya and the ongoing regional integration.

Reliance Power – Incorporated in India. Develops, constructs and operates power projects both domestically and internationally.
Ferrovial Power – Incorporated in Spain. An infrastructure operator and industrial company. It operates in various sectors including construction, airport, roads and municipal services. The service division provides facility management infrastructure maintenance and upkeep, energy and Waste management.

Other Power Projects in Kenya

Company	Project	Power Source	Target Year
KenGen	700 MW	Geothermal	2016
Centum	1000Mw Lamu Plant	Coal	To be Announced

Note: *Geothermal power is given preferential treatment in admission to the national* grid.

Top Shareholders in TransCentury Limited

Top 10 Holders of TCL	No. of Shares '000,	Shareholding
Anne Pearl Karimi Gachui	21,253	7.58%
Michael Gitau Waweru	21,216	7.57%
Peter Tiras Kanyago	15,680	5.59%
Standard Chartered Nominees A/C KE 15615	16,551	5.91%
Gitau Zephania Mbugua	13,279	4.74%
Ephraim Kariitthi Njogu	12,520	4.47%
Robin Munyau Kimotho	10,852	3.87%
Standard Chartered Nominees A/C KE 12424	10,438	3.72%
Stephene Njoroge Waruhiu	9,863	3.52%
Edward Njoroge	9,828	3.51%
Top 10shareholders	141,480	50.48%
Total Issued Shares	280,284	100.00%

Source: Nairobi Securities Exchange as at 31st August 2014

Transcentury Limited is largely owned by individual shareholders most of who were members of the initial investment club that evolved into TCL.

Summary of TCL's Respective Holdings in Subsidiaries

Company	Division	%Shareholding	Country of Incorporation
East African Cables	Power	68.37%	Kenya
Tanelec Limited	Power	70.00%	Tanzania
Tanelec Zambia	Power	70.00%	Zambia
KewBerg Cables	Power	100.00%	South Africa
Civicon	Engineering	62.00%	Kenya
Avery Africa	Engineering	94.41%	Kenya

Source: Transcentury Management

Power Division

Subsequent to the RVR exit, we anticipate a radical restructuring of TCL's business portfolio. Capacity building for the cable manufacturing plants across the region should enhance contribution to the topline.

Projected Installed Capacity	2014	2015	2016
Copper – MT/Month	320	650	650
Aluminium – MT/Month	750	750	750

Source: TCL

Power division currently constitutes 42.4% of the group's assets. TCL manufactures and distributes low voltage cables, transformers and switchgears. The firm also distributes generators, industrial products including bearings, weighting machines and, supplies distribution and transmission lines to substations.

Power Division 'Mn'	2010	2011	2012	2013
Revenue	5,505	7,730	6,742	6,709
EBIT	367	123	521	512
EBIT Margin	6.7%	1.6%	7.7%	7.6%
Capex	608	112	277	283
Assets	7,404	7,883	8,978	10,103

Source: Company filing, CBA capital

The division's revenues are projected to grow at a conservative rate of 10% annually in line with the anticipated growth in electricity demand. The Energy Ministry in Kenya expects that demand for electricity will in the medium term be driven by the standard gauge and light rail (1171Mw), Iron and Steel melting industry (2000Mw), the ICT sector (675Mw) and the Lapsset (350 Mw) project. Connection to electricity in Kenya remains below 25% and increased penetration should provide a ready market for both energy and power infrastructure.

Of concern however, are the challenges of cheaper copper and aluminum cables from China and the volatility of prices of the metals in the international markets. However, legislation towards a 40% preferential for locally manufactured goods in Kenya could help revamp sales. As Africa emerges as the next economic frontier, the need for local manufacturing, industrialization and urbanization will drive power demand in the medium to long term. The discovery of offshore gas in Tanzania, oil in Kenya and Uganda will significantly shape the regional energy space.

Power Subsidiaries

East African Cables (EAC)

EAC manufactures copper and aluminum cables for domestic and industrial distribution and transmission of electricity. The company has foot prints in East and Central Africa largely through a distribution network. The company also offers Data, Telecommunication and Fiber Optic solutions with requisite accessories. EAC has manufacturing facilities in Kenya, Tanzania and in Eastern DRC. Their presence in Uganda, Rwanda, Burundi, Southern Sudan and Ethiopia, is through a distribution network. TCL holds a controlling 100% stake in Cables Holding Kenya Limited which in turn owns 68.37% of East African Cables.

Top 10 East African Cables Shareholders	No. of Shares	Shareholding
Cable Holding (kenya) Ltd	121,596	43.4%
NIC Custodial Services	51,475	18.4%
ZED Holdings	4,239	1.5%
Genghis Nominee	2,921	1.0%
Abdulrehman Abdulkarim Juma	2,312	0.8%
The Jubilee Insurance Company of Kenya Ltd	2,277	0.8%
Patric Njogu Kariuki	2,124	0.8%
Ali Mohamed Adam	2,084	0.7%
Standard Chartered Kenya Nomineed LTD A/C KE20491	2,039	0.7%
Alimohammed Adam	1,762	0.6%
Jitendra CHandubhai Patel & Kirankurma Chandubhai Patel	1,419	0.5%
Mbogori Holdings Limited	1,000	0.4%
Top 10 Shareholders	**195,249**	**69.7%**
Total Shares	**280,284**	**100%**

Source: Nairobi Securities Exchange as at 31st August 2014

E.A Cables Earnings Summary

East Africa Cables 'KES' Year	2009	2010	2011	2012	2013
Sales (Kes bn)	2.81	3.6	4.97	4.3	4.5
Pbt (Kes Mn)	296	184	315	522	398
EPS	1.22	0.89	1.15	1.74	1.37
DPS	1.00	1.00	1.00	1.00	1.00
Total Assets (bn)				6.25	6.81

Tanelec Limited (Tanzania)

The company designs, manufactures and distributes transformers under the world's leading transformer manufacturer, ABB Group. TCL holds a 70% stake in Tanelec. The company has an engineering division and does repair and maintenance of power infrastructure.

Tanelec Zambia

Provides mining services in Zambia

KewBerg Cables South Africa

Manufactures instrumentation and control cables, mining and other specialized cables for power supply authorities, railway and transport organizations, municipalities, and companies in industries such as petrochemical, mining, wholesale, industrial, construction and domestic building.

Engineering Division

The relatively higher margins have informed the faster growth in assets in the engineering division. TCL holds a 62% stake in Civicon, a leading Mechanical and Civil Engineering Company in the region. Civicon offers logistic support and general infrastructure development. Key Projects include;

- Construction of roads, airstrips and other infrastructure around Tullow's 13 oil blocks in Kenya and Ethiopia.
- Constructing of Ormat 160Mw Geothermal Plant in Naivasha
- Construction and maintenance of 400km road in south Sudan
- Provision of mining services for a 5.6 million ounce mine in Congo
- Construction of a canning plant for GZ Industries (GZI)
- Cranage and erection of a 25Mw HFO plant in Kigali
- Transport of brewery vessels in Uganda

The company is banking on the growing infrastructure investment by the regional governments particularly in transport and energy power generation to propel its growth.

Engineering	2010	2011	2012	2013
Revenue	411	2,035	6,776	5,194
EBIT	65	655	771	694
EBIT Margin	15.8%	32.2%	11.4%	13.4%
Capex	14	27	1,186	350
Assets	252	4,774	5,934	6,146

Source: Company filings, CBA Capital

Kenya plans to increase power supply by over 5000Mw. This will require significant investment in infrastructure particularly in geothermal and thermal plants providing expansionary opportunities for TCL. Provision of weighing machinery could increase with the growth in industries in Kenya.

The insufficient indigenous engineering capacity in the region has contributed substantially to infrastructure lag in sub-Saharan Africa. The ability of TCL to tap into this space should drive medium to long term earnings from this division.

Engineering Subsidiaries

Civicon

Civicon is a leading regional mechanical engineering company. The company focuses mainly on the construction of fuel storage terminals, pipeline and piping for power generation, industrial plan construction and maintenance and customized steel fabrication works including specialized trailers, long distance fuel tanks, weighbridge platforms, bill board unipoles, spreader bars, oil and gas baskets.

Civicon has permanent fabrication workshops in Mombasa (Kenya) and Kampala (Uganda) and on specific projects builds temporary workshops on-site in order to facilitate the projects.
In civil works, Civicon handles bulk earthworks including construction of dams, roads and bridges, heavy concrete works, large paved areas, piled foundations, water and waste-water, civil and industrial buildings as well as supporting civil engineering enabling works for oil, gas and geothermal drilling.

Avery East Africa

Avery (East Africa) incorporated in Kenya, is the largest supplier of weighing equipment in Kenya. However over the years, the company has diversified its activities to include the supply, maintenance & repair of inkjet coding equipment. It recently ventured into the energy sector with the introduction of power systems (sales and service of generators) and power projects (construction of turnkey substation projects). TCL holds a 94.406% stake in Avery Kenya Limited.

Income Statement

Revenue	2010	2011	2012	2013	2014F	2015F	2016F
Power	5,504,917	7,730,211	6,742,011	6,709,299	7,380,229	8,856,275	9,741,902
Engineering	410,975	2,034,609	6,775,504	5,193,558	2,077,423	3,947,104	5,131,235
Transport	-	-	-	-	-	-	-
Consumer	914,617	982,641	-	-	-	-	-
Intra-group adjustments	(35,859)	(45,840)	(30,286)	(95,398)	(57,175)	(60,953)	(71,175)
Total Revenues	**6,794,650**	**10,701,621**	**13,487,229**	**11,807,459**	**9,400,477**	**12,742,426**	**14,801,962**
Cost of Sales	(4,718,393)	(7,676,422)	(9,814,036)	(8,248,302)	(6,580,334)	(8,919,698)	(10,361,374)
Gross Profit	2,076,257	3,025,199	3,673,193	3,559,157	2,820,143	3,822,728	4,440,589
Other Income	688,460	953,743	1,233,280	1,208,111	1,327,570	1,458,876	1,604,194
Operating Expenses	(1,348,889)	(2,036,391)	(2,293,137)	(2,509,021)	(2,585,131)	(3,185,606)	(3,700,491)
EBITDA	1,415,828	1,942,551	2,613,336	2,258,247	1,562,582	2,095,997	2,344,292
Depreciation & Amortization	235,479	336,478	643,904	723,315	794,994	854,222	938,619
EBIT	974,272	1,618,064	1,969,433	1,534,933	767,589	1,241,776	1,405,674
Net Interest Income	(343,686)	(748,798)	(742,959)	(676,459)	(1,699,623)	(520,193)	(508,193)
Pretax Profit	630,586	869,266	1,226,474	858,474	(932,035)	721,583	897,481
Net Profit	**468,263**	**616,101**	**740,648**	**626,316**	**(987,957)**	**505,108**	**628,237**
EPS	**1.29**	**1.32**	**1.66**	**1.06**	**-2.27**	**1.11**	**1.44**
DPS	**0.20**	**0.25**	**0.40**	**0.40**	**0.40**	**0.40**	**0.40**

Source: CBA Capital

Ratio Analysis

	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Returns							
Return on Common Equity	11.9%	13.9%	15.1%	12.1%	-18.3%	8.4%	9.4%
Return on Assets	4.2%	2.8%	3.4%	2.6%	-3.7%	1.7%	1.9%
Return on Capital	5.3%	3.9%	4.7%	3.6%	-5.6%	2.8%	4.8%
Margins							
Gross Margin	30.6%	28.3%	27.2%	30.1%	30.0%	30.0%	30.0%
EBITDA Margin	20.8%	18.2%	19.4%	19.1%	16.6%	16.4%	15.8%
Operating Margin	14.3%	15.1%	14.6%	13.0%	8.2%	9.7%	9.5%
Pretax Margin	9.3%	8.1%	9.1%	7.3%	-9.9%	5.7%	6.1%
Income before XO Margin	6.9%	5.8%	5.5%	5.3%	-10.5%	4.0%	4.2%
Net Income Margin	6.9%	5.8%	5.5%	5.3%	-10.5%	4.0%	4.2%
Leverage							
Debt/Equity	67.4%	76.3%	69.0%	71.8%	68.2%	61.6%	24.8%
Debt/Assets	31.8%	40.3%	40.4%	43.0%	40.3%	37.1%	13.2%

Source: CBA Capital

Valuation

Currency	2010 KES	2011 KES	2012 KES	2013 KES	2014F KES	2015F KES	2016F KES
EBIT(1-t)	974,272	1,618,064	1,969,433	1,534,933	767,589	1,241,776	1,405,674
(+)Depreciation and amortization	235,479	336,478	643,904	723,315	794,994	854,222	938,619
(-) Capital Expenditures	627,341	147,849	1,969,432	633,840	1,000,000	1,000,000	1,000,000
(-) Increase in Net working Cap					(167,145)	(497,718)	(559,641)
Other Non-cash Adjustments	251,071	101,991	217,221	425			
Cash flow to the firm	833,481	1,908,684	861,126	1,624,833	395,438	598,280	784,652
Discounted Cash Flows					343,630	451,784	514,892
Sum of Discounted CF							1,310,306
Terminal Value							8,157,271
Fair Value of the Firm							9,467,577
No of shares							273,950
Fair Value Per Shares							34.56
Current Price							20.5
Upside/(downside)							68.6%

Cost of Equity

Growth	5.0%
Cost of Debt	
5 Year T-bond	14.0%
Debt/(D+E)	45.6%
Equity	
Equity/(D+E)	54.4%
Cost of Equity, k	
Rf	11.0%
Rm	16.4%
beta	0.93
K	16.4%
Wacc	**15.1%**

Source: CBA Capital

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