



Member of Uganda Securities Exchange
Regulated by the Capital Markets Authority

KENYA AIRWAYS (KA) Research Note

No: 1.04

END YEAR FORECAST in KES

MARCH	2001	2002	2003	2004F
EPS	2.94	1.88	0.75	0.80
DPS	1.25	0.60	0.50	0.55
P/E	2.57	4.18	7.67	12.38
DY%	16.56	7.64	8.70	5.56
Share Price	7.55	7.85	5.75	9.90

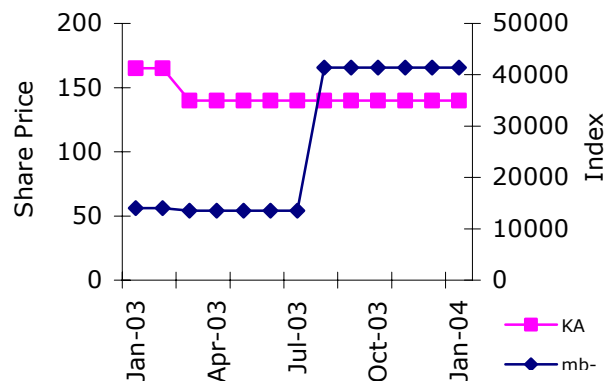
The Airline

- The group comprises Kenya Airways (KA)'s ground handling subsidiaries – African Cargo Handling (ACHL) and Kenya Airfreight Handling Limited (KAHL) as well as Kencargo Airlines International Limited (KAL) and Flamingo Airlines Limited. The Group also owns 49% of Precision Air of Tanzania.
- Kenya Airways was incorporated in Kenya by the Kenya Government in 1977 after the collapse of the East African Community.
- In early October 2003, acting on a hired consultant's recommendations, management initiated the absorption of Flamingo Airlines into KA. ACHL and KAL were to be combined into the 100% owned KAHL.
- The principal activities of the group are international, regional and domestic carriage of passengers and cargo by air, the provision of ground handling services to other airlines and the handling of import and export cargo.
- KA flies to 31 destinations in Africa, Middle East and Asia, Europe and Kenya.
- The group had a staff compliment of 3418 as at March 2003 compared with 3,427 the previous year.
- The strategic partnership with KLM, the Dutch carrier has enabled KA to enjoy international status as well as improve its own flight service levels to international standards.
- In the last 5 years, the company has embarked on an ambitious modern fleet expansion that has already boosted passenger load figures. In 1999, KA transported 1 million passengers for the first time in the history of the airline.
- In 2002, KA took delivery of 2 new narrow-body Boeing 737-700. This boosted capacity by 10%.
- The Airline has an enviable safety track record and with its worst disaster was being the plane crash off the coast of Cote d'Ivoire in January 2000. However this did not affect the bottomline performance that year as passengers continued to patronise the airline.
- In 2001, it launched an investor website www.kenya-airways.com

Listing

- In 1996, KA was listed on the Nairobi Stock Exchange (NSE). The share price has since declined by approx. 100% since the listing date to present mainly as a result of share oversupply in a depressed economy. The Dividend Yield has however remained one of the most attractive in the market.
- In late 2001, KA had even requested the Capital Markets Authority (CMA) Kenya for permission to buy back its own shares as a means of shoring up its value. However, Kenyan law does not permit re-purchases.
- In March 2002, KA became the second Kenyan company to be cross-listed on the Uganda Securities Exchange (USE).
- At the USE, the share price has since fallen from an initial listing price of US\$ 195.00 to US\$ 140.00 to date (a 39% decline) with minimal trading in the recent past months.
- As at 30th January 2004, the price was KShs 9.80 which is approximately US\$ 245.00. This would be the price at which a trade at the USE would take place. A KA transaction at the USE would reflect the equivalent exchange rate prevailing price in Nairobi.
- On the bourses, the share price out performed the mb-Index in Uganda until August 2003. At the NSE, the share price has rallied strongly against the NSE Index. KA is also expected to list on the Dar-es-Salaam Stock Exchange in a couple of months and this will make it the first and only company to be quoted on all the three East African Stock Exchanges.

KA Share Price vs mb-Index
Jan 03 - Jan 04

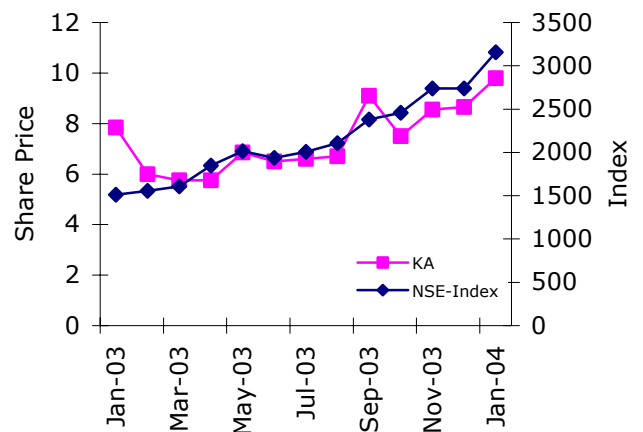


The Performance

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- Operating Profits declined 31% and although Profit after Tax declined by 60%, this was commendable in the face of the global melt down in the world airline industry (some airlines e.g. Swiss Air, Sabena and United Airlines swiftly filed for bankruptcy) a direct result of fewer passengers flying after the September 11,2001 terrorist attacks in the United States where commercial aircrafts were crashed into buildings and the ground in New York, Washington D.C. and Pennsylvania.
- KA also had to contend with a ban on its flights to Cameroon (now lifted), trouble with hard currency starved Zimbabwe and political instability in the major West African destination of Abidjan in Cote d'Ivoire.
- This increase in Total Revenue by 9%. came on account of improved passenger (international routes) and cargo activities.
- An increase of 11% in overall Costs offset the Revenue gains on account of increased fuel prices, diminished local/domestic performance abetted by the Mombasa terrorist attacks in November, negative travel advisories from the USA and the UK, unrest in West Africa and increased interest costs resulting from the new plane acquisitions.
- Passenger cabin factor was down from 69.5% to 68.0% owing to global excess capacity. Although not full taken up, the 10% increase in capacity arising from the new plane acquisitions had a positive bottom-line effect. KA expects this capacity to be fully taken up in the New Year.
- Worldwide airline industry losses were estimated to be in the region of USD 12 billion last year and a further USD 5 billion is projected for this year.
- However, KA is now feeling the pressure from the domestic/regional market where in the last one year increased competition by some new local players has resulted in price – cutting wars which have ironically also led to one of the start up Airlines closing shop during the year.
- East African Airlines remains the largest competitor on the lucrative Nairobi-Entebbe – Nairobi route. British Airways with Regional Air running its local route franchise has made in-roads into the other major earning route, which is Nairobi-Mombasa-Nairobi.
- However, KA, which must make adequate returns on its new plane acquisitions. is best equipped to weather any price war, being a network airline with over 1,495 city connections that enable close to seamless travel connections.
- KA has also been voted the 2nd most respected company in the East African region for 3 years running and has scooped many awards both locally and internationally which also testifies to its excellent management material.

**KA Share Price vs NSE-Index
Jan 2003 - Jan 2004**



The Fleet

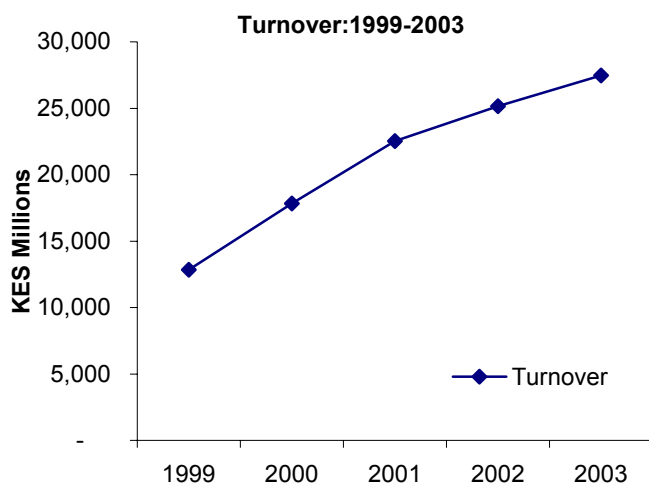
- KA has a long term development plan and according to the latest review, the airline projects to operate 10 narrow body aircraft from 2003 through 2005: and 6,7 and 8 wide body aircraft for 2003,2004,2005 respectively.
- The fleet projections are based on a forecast of air travel demand by route, taking into account past and recent trends and future expectations. It also takes into account new routes to be opened.
- Following the completion of the delivery of 3 new 767-300 wide body aircraft, and 5 narrow body (4 Boeing 737-700 and 1 Boeing 737-200QC, the next fleet of wide body aircraft-the Boeing 777-200ER (3 in all) will be delivered between May 2004 and June 2005.
- At year-end, the group had sixteen aircrafts in operation, either owned or on long term leases. These comprised 5 Boeing 767 wide Boeing 737 narrow body jets and two SAAB 340B turboprops.

Alliances and Partnership development

- As part of its strategy to develop its network and consolidate market position, KA has forged strategic and tactical alliances with key regional (Air Malawi, Air Senegal,) and international carriers (Cathay Pacific, Thai Airways, China Airlines, China Eastern Airlines, Japan Airlines and Dragon Air) in the areas of equity participation, joint venture, code sharing, joint pricing, joint marketing and sales, or special pro-rate arrangements, schedule synchronisation and through check-in arrangements.
- KA and KLM have also deepened their relationship with expanded code share destinations and better frequent flyer programme.

Product Development

- KA's front cabin was previously made of 2 elements – First Class in the intra-African routes and Business Class on inter-continental routes. In time it was realised for example, that the definition of First class was below that of global aviation standards. Corporate travel rules forbidding employees from flying First Class on duty travel also made for a product that was ultimately deemed unproductive to KA's aspirations.
- The whole front cabin was consequently converted into an enhanced business class product named "Premier world" and launched in late 2002.
- The main feature of "Premier World" is the "Flat bed" that comes with a larger pillow, blanket and headrest, all branded. The seat is fitted with laptop adapter facilities and in-flight entertainment service offering a large selection of programming in both audio and visual.



Air France-KLM Merger effect on KA

- The impact of the Air France-KLM proposed merger remains largely unclear as of date. Much will depend on the African strategy of the new Air France-KLM group particularly on both "profitable" and "loss making" subsidiaries.
- The uncertainty has already been discounted at the Nairobi Stock Exchange where the share price fell to US\$ 7.65 after jumping from US\$ 8.20 to US\$ 9.30 when news of the merger broke out on 30th September 2003.
- KLM has a 26% stake in K.A and a joint venture arrangement with the company dating back to November 1997. The agreement also allows the two airlines to cooperate in developing schedules and fares and to share generated revenue benefits and costs for the core routes between Nairobi and Amsterdam.
- Air France and KLM merger will lead to the creation of Europe's leading airline group

through a share exchange offer by Air France for KLM ordinary shares. The new group will be called Air France-KLM and will capitalise on two well-known brands, strong hubs and complimentary networks.

- The shareholding of the French government in Air France would be diluted to 54% from 44%. Other Air France shareholders would own 37% of the enlarged group. Notably, 51% of voting interest in KLM will be held by two Dutch Foundations and the Dutch government for a transition period of three years.
- The current option agreement with the Dutch government remains in place subject to certain amendments. It is in the details of the agreements that KA will find out where it stands. In most areas, the group says it will continue to benefit from ongoing cooperation with respective partners of both airlines.
- The merger needs to be approved by the respective shareholders and the European Union.
- The planned exchange offer to shareholders is planned for first half of 2004, ahead of Extraordinary General meetings of Air France and KLM later the same year. The proposed Air France-KLM transaction will strengthen the Sky team alliance, which will become the second largest alliance in the world. In the medium term, the combined group will be reinforced by the integration of Alitalia, the Italian airline.
- This means KLM and probably KA will have to ditch the Wings Alliance where they are currently members together with North West Airlines of USA.
- The Chairman and CEO of Air France, Mr. Jean-Cyril Spinetta, will be the Chairman and CEO of Air France-KLM. The CEO of KLM, Mr. Leo van Wijk will be the Vice Chairman of the Air-France-KLM Board.
- Given that Air France will obviously have a greater say in the long term, KLM's appointed directors on KA could be changed to reflect French interests.

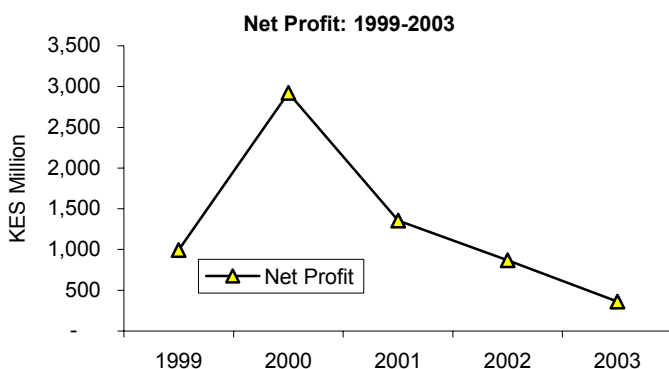
Hay Group/McKinsey Report & Restructuring

- Hay Group was founded in 1943 in Philadelphia and currently operates from 72 offices in 37 countries. It describes itself as a professional services firm that helps organizations worldwide get the most from their people by creating clarity, capability and commitment.
- McKinsey & Company founded by James O. McKinsey in 1926, is a global strategic management consulting firm, which advises the top management of leading companies and institutions on issues of strategy and organization.
- On the basis of their recommendations KA has begun a serious restructuring effort which will result in the loss of at least 400 jobs far less than 1050 which McKinsey has recommended, which is at least 30% of the 3500 strong labour force.

- The purge has begun with the dropping of 5 Directors whose former departments have been merged.
- Continued staff reduction can not be ruled out in the near future as KA needs to accommodate 80 well trained pilots over and above the present 170, to match its expansionist programme. Training a pilot costs approximately USD 45,000. KA argues that this is justified as it moves towards world-class status where a highly skilled workforce will be required.

LITIGATION

- Perhaps one of the dormant threats to the business are the various litigations and claims where the group appears as defendant or co-defendant
- Two of the more significant cases currently pending in court are the Tobias Ouma and others vs. Kenya Airways case where the High Court has ruled against KA. 960 former employees had lodged a reduced claim of KES 880 million from KES 2.6 billion for loss of service up to retirement. KA has appealed the ruling and is awaiting its determination. The group has not made any provisions believing on advise from its lawyers that there are good prospects of succeeding.
- 32 employees have also filed a dispute in the Industrial court for wrongful dismissal in connection with allegations of involvement in illicit trafficking in narcotics. They have also sued for defamation on the same matter. Both disputes are pending in both courts.
- We feel that a ruling by the Court of Appeal against KA could seriously undermine its operations and financial position.



OUTLOOK

- Returns on Investment continue to be attractive.
- We believe that any improved new financial end year results (31 March 2004) will be largely dependent and driven by not only external factors e.g. spread of SARS, and which are much beyond KA's control but on how the airline meets the challenges.
- The airline may also benefit marginally from the withdrawal by British Airways (BA) from flying into Kenya citing potential terrorist threats earlier this year. Seasoned BA

customers may therefore opt for KA as the best alternative. We are yet to determine what benefits may have accrued to KA as a result.

- To boost earnings and reclaim market share, the company will now focus on cost cutting as the key to maintaining future profitability, improved service delivery and product innovation (premier flat bed in business class - a first in Africa).
- Management has therefore embarked on a cost reduction and revenue enhancement programme by hiring a top management consultancy firm McKinsey and Company to advise on its implementation. The benefits of the exercise when put into practice are most likely to be evident within the next 12 to 18 months.
- At the end of the restructuring exercise, gleaned savings are expected to range from KES 1.6 billion to KES 2.4 billion reducing the cost to turnover factor significantly.
- Besides the conflicts in the Middle East, which was fast becoming a lucrative route for KA, the following may dampen any serious recovery efforts;
 - i. instability on its Western Africa routes,
 - ii. domestic pressure which is already forcing it to reduce fares,
 - iii. sluggish lower storage charges (a direct result of competition)
 - iv. threats/effects of global terrorism

may dampen any serious recovery efforts.

- KA, we feel, will most likely post better results in 2004F and reverse its past years' downward trend with gains garnered from cost cutting measures highlighted above and increased cabin capacity being taken up. These will be slightly offset by lower fares (owing to competition) and a weak dollar leading to greater foreign exchange losses in addition to the aforementioned threats. We also do not expect fuel prices to be an issue this year as the Middle East conflict situation normalises and Iraqi Oil comes into the international market.
- Under an excellent management team under a new Managing Director Titus Naikuni, who is a well respected figure in the region, Kenya Airways would for all intent and purposes be viewed as a stable and a good performer amidst adversity.
- However, external and uncontrollable circumstances would however dissuade us from recommending Kenya Airways as a Strong Buy

RECOMMENDATION: BUY

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KENYA AIRWAYS FINANCIAL HIGHLIGHTS

	Mar-03 KShs.Million	Mar-02 KShs.Million	%Change
ASSETS			
Fixed Assets			
Property and Equipment	13,785	11,262	22.40
Deposits for leases and acquisition of aircraft	3,585	2,185	64.07
Other	<u>503</u>	<u>358</u>	40.50
	<u>17,873</u>	<u>13,805</u>	29.47
Current Assets			
Inventories	909	924	-1.62
Tax recoverable	279	-	
Receivables and prepayments	2,896	3,893	-25.61
Cash and cash equivalents	<u>2,298</u>	<u>3,329</u>	-30.97
	<u>6,382</u>	<u>8,146</u>	-21.65
Total Assets	<u>24,255</u>	<u>21,951</u>	10.50
EQUITY AND LIABILITIES			
Shareholders' Funds			
Share Capital	2,308	2,308	
Reserves	4,799	4,859	-1.23
Proposed Dividend	<u>231</u>	<u>277</u>	-16.61
	<u>7,338</u>	<u>7,444</u>	-1.42
Non Current Liabilities			
Loans and borrowings (Eximbank and Barclays Bank PLC)	7,918	6,118	29.42
Deferred income taxes	1,603	1,530	4.77
Minority Interest	<u>30</u>	<u>11</u>	172.73
	<u>9,551</u>	<u>7,659</u>	24.70
Current Liabilities			
Sales in advance of carriage	1,914	1,044	83.33
Trade and other payables	3,776	3,932	-3.97
Tax payable	-	117	-100.00
Accruals for liabilities and charges	1,576	1,518	3.82
Bank Overdraft	<u>100</u>	<u>237</u>	-57.81
	<u>7,366</u>	<u>6,848</u>	7.56
Total Equity and Liabilities	<u>24,255</u>	<u>21,951</u>	10.50

Sources: KA 2003 Annual Report, Daily Nation 14th October 2003, and MBEA Research Department

"Remember Share Prices can go up or down"

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5