

Research Update: KTZ And KTT Outlooks Revised To Positive; 'BB+' Ratings Affirmed; KTZ SACP Revised To 'b+'

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Overview

- From May 2011, Kazakh-based rail group Kazakhstan Temir Zholy (KTZ) is likely to reduce its reliance on cash held in lower-rated banks.
- We are revising our outlook on both KTZ and 100%-owned rolling stock subsidiary JSC Kaztemirtrans (KTT) to positive from stable.
- We are affirming our 'BB+' long-term corporate credit and 'kzAA-' Kazakhstan national scale ratings on KTZ and KTT.
- The positive outlook reflects our view of the KTZ group's increased free cash flow generation and our assessment of a continuing "very high" likelihood of support for KTZ from the Republic of Kazakhstan.

Rating Action

On Sept. 24, 2010, Standard & Poor's Ratings Services revised its outlook to positive from stable on Kazakhstan Temir Zholy (KTZ), Kazakhstan's national railway group and rail network owner, and 100%-owned rolling stock subsidiary JSC Kaztemirtrans (KTT).

At the same time, we affirmed the 'BB+' long-term corporate credit and 'kzAA-' Kazakhstan national scale ratings on KTZ and KTT.

In addition, we revised the stand-alone credit profile (SACP) on KTZ, to 'b+' from 'bb'.

Rationale

The outlook revision reflects our view of the positive operational and financial evolution of the KTZ group, although the ratings remain constrained in the short term by the group's reliance on lower-rated banks holding most of its cash position.

The affirmation of the corporate credit ratings reflects our opinion that there continues to be a "very high" likelihood that the Republic of Kazakhstan (foreign currency rating BBB-/Stable/A-3) would provide timely and sufficient extraordinary financial support to KTZ in the event of financial distress. The ratings on KTT reflect the credit quality of KTZ because of the economic integration and interdependency between the two entities, and cross-default clauses and cross-guarantees linking the entities. As a consequence, we take a consolidated view of the KTZ group.

In accordance with our criteria for government-related entities, our view of a "very high" likelihood of extraordinary government support is based on our assessment of KTZ's:

- "Very important" role in Kazakhstan's economy as a national railroad company. KTZ plays a key role in Kazakhstan's national transport sector,
- for exports as well as transit; and
- "Very strong" link with the Kazakh government, illustrated by its 100% ownership, ongoing support, and monitoring, with no privatization risk in
- the short to medium term.

The revision of KTZ's stand-alone credit profile reflects our view that, although the group's business risk profile remains fair, we assess its financial risk profile as aggressive. In our view, KTZ's SACP is constrained by the group's exposure, for about two-thirds of its cash holdings, to two local banks that we rate in the 'B' category.

The fair business risk profile continues to reflect the KTZ group's vertically integrated business model, which combines monopoly rail infrastructure and profitable freight transport operations; a strong market and competitive position in the national transport sector; increasing profitability and cash flow from operations underpinned by higher tariffs; and strong ongoing government support. This ongoing government support is reflected, in our view, in the favorable, if nontransparent, regulatory regime; high and sustained tariff increases; and financial contributions as part of the implementation of the capex program. The business risk profile also reflects the group's currently degraded operating assets, although these assets will gradually benefit from ongoing investments. We also see a risk of commodity traffic volatility, and the potential, in the long term, of increased competition from alternative modes of transport, fostered by the higher tariffs.

We anticipate that, over the medium term, the KTZ group will retain significant headroom under its stated maximum 3.5x debt to EBITDA financial policy. This is because, in our opinion, the group's very ambitious capital expenditures (capex) program (about \$10 billion planned between 2010 and 2015) is flexible enough to be managed according to the group's cash flows and access to liquidity.

Liquidity

Excluding government support, we continue to consider the KTZ group's stand-alone liquidity as weak, because most of its cash reserves are concentrated in two domestic banks, whose liquidity and asset quality, in our opinion, remain under pressure. The group does not benefit from any significant undrawn liquidity line, and relies mostly on its cash deposits for day-to-day liquidity. However, our opinion of the group's overall liquidity benefits from our assessment of a "very high" likelihood of extraordinary government support, which mitigates the current contingent stand-alone risk.

We understand that the funds deposited in these two banks are to contribute, together with cash from operations, to the repayment of a \$450 million bond maturing in May 2011. Although the proposed \$700 million 10-year bond issuance will go some way toward meeting the group's requirements over the next 12 months, we understand that, by May 2011, KTZ will have spent most of the

proceeds of this proposed bond on new investments.

Depending upon the amount of capex that the group chooses to engage in over the next 12 months, its requirements should be broadly covered, as of end-June

2010, by:

- Its cash balances, if available;
- Cash flow from operations;
- A Kazakhstani tenge (KZT) 14 billion (\$95 million) equity injection to
- KTZ from its state-owned parent; and
- Up to KZT35 billion (\$237 million) in long-term (10-year) loans
- guaranteed by the state.

In our view, continuous implementation of the group's capex program at the pace it envisages will require regular access to either banks or debt markets until 2015.

Recovery analysis

The issue rating on the unsecured debt issues of KTZ group's finance subsidiary Kazakhstan Temir Zholy Finance B.V. is 'BB+', the same level as the corporate credit rating on KTZ and KTT. The recovery rating on the unsecured debt is '4', indicating our expectation of average (30%-50%) recovery in the event of a payment default.

We believe that in a default scenario, recovery prospects for the unsecured debt are likely to be heavily determined by the ability and willingness of the

Kazakhstan government to negotiate with bondholders. The recovery rating of '4' reflects this risk. It also reflects our expectation that bondholders would likely receive at least partial repayment in the event of default. Actual recoveries could be higher or lower than the indicated range.

KTZ is issuing new senior unsecured notes for up to \$700 million due 2020 through Kazakhstan Temir Zholy Finance B.V. The new notes, which rank pari passu with the previous notes, are guaranteed by KTZ and the group's two main subsidiaries, KTT and JSC Locomotive. The covenant package of the new notes includes a negative pledge clause, limitations on change of business and on the disposal of assets, and cross default provisions. The covenant package does not include financial covenants.

Outlook

The positive outlook reflects our view of increased free cash flow generation from operations at the group level; and the gradual implementation of the capex program, which we believe should allow the KTZ group, on a consolidated basis, to maintain a moderate financial profile throughout the investment phase. The outlook also reflects our assessment of a continued "very high" likelihood of support from the state.

The possibility of us raising the ratings depends on the pace and sustainability of the growth in cash flow generation, and on a reduction in the group's reliance on the cash reserves in lower-rated financial institutions.

However, indications of a drop in volumes due to the rapid rise in tariffs, a significantly more leveraged financial profile, or our assessment of a possible change in state support, could all have a negative bearing on our opinion of the group.

Related Criteria And Research

- Use Of CreditWatch And Outlooks, Sept. 14, 2009
-
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers'
- Speculative-Grade Debt, Aug. 10, 2009
-
- Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009
-
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
-
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
-
- Principles Of Corporate And Government Ratings, June 26, 2007
-
- Corporate Criteria--Parent/Subsidiary Links; General Principles; Subsidiaries/Joint Ventures/Nonrecourse Projects; Finance Subsidiaries;
- Rating Link To Parent, Oct. 28, 2004
-

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Kazakhstan Temir Zholy JSC Kaztemirtrans Corporate Credit Rating	BB+/Positive/--	BB+/Stable/--
Kazakh National Scale Rating	kzAA-/---/--	KzAA-/---/--

Ratings Affirmed

Kazakhstan Temir Zholy Finance B.V.
Senior Unsecured Debt BB+

Ratings Affirmed

Kazakhstan Temir Zholy Finance B.V.
Senior Unsecured
US\$350 mil 7.% bnds due 05/11/2016 BB+
Recovery Rating 4
US\$450 mil 6.5% bnds due 05/11/2011 BB+
Recovery Rating 4

New Rating

Kazakhstan Temir Zholy
Analytical Factors
Stand-Alone Credit Profile b+

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