

## Summary: Kazakhstan Temir Zholy

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### Rationale

The rating on Kazakh national railroad company Kazakhstan Temir Zholy (KTZ) reflects its high strategic importance to the state and ongoing financial support from the government. The rating on KTZ is based on a top-down approach, being two notches lower than the local currency rating on the Republic of Kazakhstan (foreign currency BBB-/Negative/A-3; local currency BBB-/Negative/A-3; Kazakhstan national scale rating 'kzAAA'). The company's stand-alone rating is 'BB+'.

The stand-alone rating on KTZ is constrained by Kazakhstan's opaque regulatory regime and the company's obsolete assets and aggressive investment program. The ongoing rail-sector restructuring, the risk of commodities traffic volatility, and competition from oil pipelines also constrain the rating.

These risks are mitigated by the company's high strategic importance to the state, strong government support, and its strong market and competitive position in the national transport sector. KTZ's vertically integrated business model, which combines monopoly rail infrastructure and profitable freight transport operations, and the company's intermediate financial profile and moderate financial policy also support the rating.

As the national rail company in Kazakhstan's vast, sparsely populated territory, KTZ is strategically important to the state. The company transports about 57% of national freight traffic and employs about 1.8% of the national labor force. This justifies government support to KTZ. Financial state support comes in the form of budget subsidies to the loss-making passenger segment and guarantees on some of KTZ's debt, although new borrowings are not guaranteed. The government also shares the burden of rail infrastructure development with KTZ and supports a benign low dividend policy.

KTZ holds a strong competitive position as a low cost commodities transporter, but at the same time is exposed to competition in oil transportation from pipelines and to volume risk in commodities exports, which are influenced by market prices.

KTZ operates under a cost-cover regulatory regime, which lacks transparency, is politicized, and does not ensure timely cost recovery. In January 2008, however, the government approved a new tariff policy for 2008-2012, which stipulates a substantial increase in KTZ tariffs and increases the visibility of the future tariff path.

The company faces significant operating risks due to its exposure to electricity and fuel prices and growing maintenance costs following divestment of its repair operations, as well as aged rail

infrastructure and rolling stock requiring significant investment.

The medium-term investment program for 2008-2012 approved by the government requires substantial investments of Kazakhstani tenge (KZT) 888 billion (\$7.4 billion).

KTZ currently has an adequate financial profile for the rating, with funds from operations to debt at 67% in 2007. Standard & Poor's Ratings Services expects KTZ's financial profile to weaken over 2008-2010, given its large investment program that partly relies on debt financing. There also might be a negative impact from a decrease in freight transportation volumes, but we understand that the company is increasing its efforts to reduce costs and optimize the freight transport structure. However, we expect KTZ to comply with its new financial policy targets, including debt to EBITDA of less than 2.9x and net debt to net capital of less than 40%.

#### Liquidity

KTZ has adequate liquidity. As of Sept. 30, 2008, according to the company, KTZ had KZT93.6 billion in cash and bank deposits, which covered its current portion of long-term debt of KZT3.4 billion. The 2009 investment program will require external financing. However, the company has indicated that it has flexibility in implementing capital expenditures. KTZ has no financial covenants on its outstanding financial obligations.

#### Outlook

The stable outlook reflects our expectation that KTZ will continue to benefit from solid state financial support, such as higher operating subsidies to the passenger segment and financial support for investments in railroad infrastructure. We also expect that KTZ will retain an adequate financial profile within approved financial policy targets that will underpin KTZ's stand-alone credit quality, and balance the growing macroeconomic risks in Kazakhstan and balance to some extent the growing macroeconomic risks in Kazakhstan and weakening sovereign creditworthiness.

Consistent implementation of the government's tariff policy for KTZ and the sector restructuring plan, including ownership unbundling of the passenger segment from KTZ and higher subsidies, could create upside potential in the absence of negative macroeconomic implications.

Because KTZ's stand-alone credit quality is 'BB+', a negative change in the sovereign rating might not result in a similar action on the company, unless the trigger for the sovereign rating change also materially impairs KTZ's stand-alone credit quality.