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Research Update:

DRAFT: Railway Operator Kazakhstan Temir Zholy And Subsidary Kaztemirtrans Downgraded To 'BB+' On Higher Leverage; Outlook Neg

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S&P Lowers Kazakhstan Temir Zholy To 'BB+'; Outlook Negative

Overview

- We expect that the devaluation of the Kazakhstani tenge and lower freight volumes will meaningfully increase the debt leverage of Kazakhstan's national rail operator, Kazakhstan Temir Zholy (KTZ).
- We are lowering our global corporate credit ratings on KTZ and its core subsidiary, JSC Kaztemirtrans, to 'BB+' from 'BBB-' and our national scale ratings to 'kzAA-' from 'kzAA'.
- The negative outlook mirrors that on the sovereign and reflects our view that we would most likely downgrade KTZ if we lower our ratings on Kazakhstan.

Rating Action

On Sept. 21, 2015, Standard & Poor's Ratings Services lowered its long-term corporate ratings on Kazakhstan's national railroad company, Kazakhstan Temir Zholy (KTZ), and its core subsidiary, freight-wagon owner JSC Kaztemirtrans (KTT), to 'BB+' from 'BBB-'. The outlook is negative.

We also lowered our Kazakhstan national scale ratings on these entities to 'kzAA-' from 'kzAA'.

At the same time, we lowered our rating on KTZ's senior unsecured bonds, including those issued by its financing subsidiary, Kazakhstan Temir Zholy Finance B.V., to 'BB+' from 'BBB-'.

Rationale

The downgrade primarily reflects our expectation that KTZ's adjusted debt to EBITDA will increase to more than 5x by year-end 2015 and will not improve to a level we consider commensurate with a higher rating in 2016.

The increase in leverage is largely due to the devaluation of the Kazakhstani tenge since mid-August 2015 by more than 30%, which resulted in an increase in KTZ's debt, of which more than one-half is foreign-currency nominated. Additionally, KTZ's railway transportation volumes have been declining throughout 2015 at about 15% on an annual basis, reflecting a drop in commodity exports, primarily to China and Russia. Flat tariffs and low cost flexibility have further translated into a decline in KTZ's EBITDA margin, by about 10% in the first half of 2015. As a result, we expect that Standard & Poor's-adjusted debt to EBITDA will increase to more than 5.0x and that funds from operations (FFO) to debt will fall to less than 12% by year-end 2015. This has led us to revise our assessment of KTZ's financial risk profile to "highly leveraged" from "significant."

We also revised our assessment of KTZ's liquidity to "less than adequate" from "adequate." With less cash available due to lower profitability and higher interest payments, KTZ will need to find additional funding sources for its considerable investment program, which cannot be easily postponed. We understand that higher leverage has led KTZ to breach financial covenants under some of its loans, which were set at debt to EBITDA of 4.5x. We understand that the company has obtained a waiver for the first half of 2015, but will have to agree on resetting the covenant level, which further weighs on our liquidity assessment.

KTZ is a 100% indirectly government-owned, national railroad owner and operator. The rating on KTZ reflects our view of the company's stand-alone credit profile (SACP) at 'b' and the "very high" likelihood that its owner, the government of Kazakhstan, would provide extraordinary support to the company.

Historically, KTZ has benefitted from the state's tangible financial aid, subsidies, and equity injections, and we expect that will continue, although some projects may be delayed. We also note that the country lacks access to the sea or navigable rivers, making railroads vital for national transportation. KTZ, as the national railroad company responsible for about one-half of all freight traffic in Kazakhstan, plays a key role in Kazakhstan.

We equalize our ratings on KTZ's subsidiary KTT with those on KTZ, reflecting the overall creditworthiness of the group. This is because we assess KTT as "core" to KTZ, given the company's close operational integration in the group; KTZ's 100% ownership of KTT; the financial guarantees on a major part of the debt issued by KTT and KTZ; and large intragroup cash flows. Furthermore, we believe that as one of the main subsidiaries of KTZ, KTT is closely associated with KTZ, and we think that its default could impair KTZ's access to capital markets.

In our base case, we assume:

- KTZ's freight volumes will decline by about 15% in 2015 and remain stable in 2016.
- Tariffs will remain flat in 2015 with an inflation-linked increase in 2016.
- The company's EBITDA margin will decline to less than 25% in 2015, with moderate recovery beginning in 2016.
- Ongoing government support in various forms, including subsidies.
- A moderate decline in capital spending.

Based on these assumptions, we arrive at the following credit measures:

- Standard & Poor's-adjusted debt to EBITDA of 5x-7x in 2015-2016.
- FFO to debt of 8%-12% over the same period.

Liquidity

We assess KTZ's liquidity as "less than adequate" under our criteria, reflecting its breach of leverage covenants and lack of sufficient committed resources to fund investment projects, which cannot be postponed. Nevertheless, we expect that the company will be able to reset the covenants in the coming months and will eventually secure financing of its projects that cannot be cancelled, either on its own or with some kind of government participation.

As of June 30, 2015, we assess that principal liquidity sources include:

- Balance-sheet cash and short-term bank deposits of about Kazakhstani tenge (KZT) 80 billion (about $430 million);
- FFO of about KZT135 billion for the 12 months beginning July 2015; and
- State subsidies and proceeds from asset sales of about KZT75 billion.

As of the same date, we assume principal liquidity uses include:

- Contractual debt maturities of about KZT33 billion for the 12 months beginning July 2015;
- About KZT250 million of nondiscretionary capital expenditures; and
- Dividends in line with the group's dividend policy.

Outlook

Standard & Poor's negative outlook on KTZ and KTT mirrors the outlook on Kazakhstan.

Downside scenario

We could lower the ratings on KTZ if we downgrade the sovereign. We could also downgrade KTZ if our assessment of extraordinary government support weakens, because of the state's reduced willingness or ability to provide tangible financial aid, subsidies, and equity injections. Lessened government support could also result from KTZ's partial privatization. We could also lower our ratings if we saw a significant deterioration of liquidity, such as the inability to secure funding for capital investment or the inability to reset the covenants to comfortable levels.

Upside scenario

We would likely revise our outlook on KTZ to stable if we revise our outlook on the sovereign to stable.

Ratings Score Snapshot

Corporate Credit Rating: BB+/Negative/--

Business risk: Fair
- Country risk: High
- Industry risk: Low
- Competitive position: Fair

Financial risk: Highly leveraged
- Cash flow/Leverage: Highly leveraged

Anchor: b

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: b
- Related government rating: BBB
- Likelihood of government support: Very high (+4 notches from SACP)

Related Criteria And Research

Related Criteria

Related Research

Ratings List

Additional Contact:
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