Summary: Kazakhstan Temir Zholy

Publication date: 16-Jul-2009

Primary Credit Analyst: Sergei Gorin, Moscow 7 495 783 4132; sergei_gorin@standardandpoors.com

Secondary Credit Analyst: Boris Kopeykin, Moscow (7) 495-783-4062; boris_kopeykin@standardandpoors.com

Rationale

The ratings on Kazakh national railroad company Kazakhstan Temir Zholy (KTZ) were placed on CreditWatch with negative implications on June 16, 2009 to reflect our concerns about the high concentration of the company's large cash reserves in several domestic banks.

The ratings on KTZ reflect its very strong link to the government and very important role in the economy and transport sector of Kazakhstan, due to the country's vast territory. We assess the company's stand-alone creditworthinesss at the 'BB' level.

KTZ's stand-alone credit profile reflects the company's fair business risk profile and significant financial risk profile. It is constrained by the company's obsolete assets and aggressive investment program and Kazakhstan's opaque regulatory regime. Ongoing rail-sector restructuring, the risk of commodity traffic volatility, and competition from oil pipelines further constrain the company's stand-alone credit profile.

These risks are mitigated by the company's high strategic importance to the state, strong ongoing government financial support, and the company's 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 support the rating.

Key business and profitability developments

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

We expect the remainder of 2009 and 2010 to prove challenging for KTZ due to a fall in overall freight volumes, resulting in weaker operational results. According to management, freight traffic in the first quarter of 2009 decreased by 16% year on year, while revenues increased by a marginal 0.4%. This fact is mainly explained by a positive tariff adjustment in April 2008, though we understand that company has been taking steps to optimize its freight structure to increase the proportion of profitable cargoes.

In January 2008, the government approved an investment program and tariff policy for KTZ, and its subsidiaries JSC Kaztemirtrans (BB+/Watch Neg/--; kzAA-) and JSC Locomotiv (not rated) for 2008-2012. The tariff policy sets out increases designed to partly finance the ambitious investment program, however, the annual adjustments stipulated have to be approved by the regulator each year. In the current economic environment, we do not expect any tariff increases in 2009. The capital spending program envisaged for KTZ is heavily dependent on future tariff increases. In 2008, KTZ reported a fall in profitability; the company's EBITDA margin decreased to 21.4% from 23.3% in 2007. This was mainly a result of operating cost growth per conventional ton-kilometer. If lower freight volumes transported are accompanied by a lack of tariff increases, we expect margins to continue declining in 2009.

Key cash flow and capital-structure developments

KTZ's cash flow generation improved in 2008 on the back of tariff increases in April 2008. In 2008, the company reported funds from operations of KZT104 billion, up 7% year on year.

The company's cash flow protection ratios were solid in 2008, with funds from operations to debt at 73%. We expect KTZ's financial profile to weaken over the 2009-2011 period, given the company's large investment program that, even though reduced, partly relies on debt financing. In addition, a more aggressive financial policy on top of declining revenues and growing operating costs would lead to weaker cash flows. In our opinion, KTZ's ratio of funds from operations to debt could fall to as low as 30% over the next two years, depending on the company's success in its cost reduction initiatives. However, we expect KTZ to comply with its set financial policy targets, including debt to EBITDA of less than 2.9x and net debt to net capital of less than 40%.

We expect KTZ's financial performance in 2009 to be negatively impacted by the depreciation of the national currency, though U.S. dollar-denominated cash and deposits together with transit tariffs which are denominated in Swiss francs soften this impact to some extent. KTZ has high exposure to foreign currency risk, as practically all its debt is denominated in foreign currencies, mainly U.S. dollars. The company has no financial hedges in place, other than the natural hedges mentioned above.

KTZ has a favorable debt structure and adequate average term to maturity duration exceeding five years, although its maturity profile is concentrated in two outstanding Eurobond tranches of $450 million and $350 million due in 2011 and 2016, respectively.

Liquidity

We view KTZ's liquidity as still adequate. As of March 31, 2009, according to the company, KTZ had KZT61.7 billion ($411 million) in cash and bank deposits, which amply covered its current long-term debt of KZT4.3 billion. At the same time, KTZ's cash and deposits are mainly held in Halyk Savings Bank of Kazakhstan (B+/Negative/B), Kazkommertsbank (JSC) (B/Negative/C), BTA Bank J.S.C. (D/--/D) (exposure is US$27 million), and Sberbank (not rated). We believe, however, that such concentration might result in restricted flexibility for KTZ and JSC Kaztermirtrans in managing their cash assets. Currently the ratings incorporate the expectation that the KTZ group will accumulate and have proper access to the cash that it will need to redeem the $450 million bond maturing in 2011.

Credit Watch

We plan to review the CreditWatch placement when we have a greater understanding of the level of financial support the government will provide to KTZ and the company's flexibility in managing its liquidity.

If we believe KTZ's liquidity position has deteriorated or if there are indications of lower state support than we previously expected, we could lower our estimation of KTZ's stand-alone credit profile and/or lower the corporate credit ratings on the company.

Additional Contacts:	Lidia Polakovic, London (44) 20-7176-3985; lidia_polakovic@standardandpoors.com
	Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com