Recovery Report: Kazakhstan Temir Zholy Finance B.V.'s Recovery Rating Profile

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Table 1 | Download Table

Kazakhstan Temir Zholy--Credit Profile

Corporate credit rating	BB+/Stable/--				
Estimated enterprise value at default	N/A				
Estimated year of default	2011				
Facility/Issue	**Outstanding at default**	**Issue rating**	**Recovery rating**	**Expected recovery**	**Maturity**
Unsecured debt					
$450 mil. 6.5% bond*	$450 mil.	BB+	4	30%-50%	2011
$350 mil. 7.0% bond*	$350 mil.	BB+	4	30%-50%	2016

*Issuer: Kazakhstan Temir Zholy Finance B.V.; Guarantors: Kazakhstan Temir Zholy and JSC Kaztemir Trans.

Recovery Rationale

The issue rating on the unsecured debt issues of Kazakhstan Temir Zholy Finance B.V. is 'BB+', the same level as the corporate credit rating on its parent, Kazakhstan Temir Zholy (KTZ; BB+/Stable/--), the Kazakh national railroad company. The recovery rating on the unsecured debt is '4', indicating our expectation of average (30%-50%) recovery in the event of a payment default.

Standard & Poor's Ratings Services believes that in a default scenario, recovery prospects for the notes 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 range indicated.

Business Description

KTZ is Kazakhstan's national railroad company. It owns and operates the national railroad infrastructure and provides transportation services to clients. KTZ is also a holding company for the KTZ group, including several subsidiary companies that were legally unbundled from KTZ and operate its locomotives (JSC Locomotiv) and rolling stock (JSC Kaztemirtrans), and provide repair and auxiliary services.

Freight transport is the key group segment in terms of revenue and cash flow generation. Other activities, including the sale of inventories and electricity, the repair of wagons, and other auxiliary services generate less than 4% of total revenues.

KTZ is strategically important to Kazakhstan as a national rail company, transporting 58% of national freight and employing 1.7% of the national labor force. This justifies government support to KTZ, and KTZ benefits from state support through budget subsidies to the passenger segment and guarantees on some 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.

Corporate Credit Rating Rationale

Corporate credit rating: BB+/Stable/--

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. At the same time, there is a degree of uncertainty regarding exactly how the mechanisms of government support would operate in Kazakhstan's economic environment. This uncertainty is reflected in our one-notch deviation from our standard correlation for entities with a "very high" likelihood of extraordinary support (see table 4 in the report "Enhanced Methodology And Assumptions For Rating Government-Related Entities," published June 29, 2009).

We apply a top-down approach to the company's long-term rating, which is two notches lower than the local currency long-term rating on the sovereign. We believe that privatization risk is low, due to KTZ's strategic importance as the country's major transport vehicle and transport policy instrument. The national law "On Railroad Transportation" does not allow for privatization of railroad infrastructure and requires 100% state ownership of the national railroad company's operating rail infrastructure.

KTZ's stand-alone credit profile reflects our view of the company's "fair" business risk profile and "significant" financial risk profile. In our view, the stand-alone credit profile 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 vertically integrated business model, which combines monopoly rail infrastructure and profitable freight transport operations. Furthermore, KTZ benefits from a strong market and competitive position in the national transport sector and strong ongoing government financial support.

Recovery Analysis

Table 2 | Download Table

Kazakhstan Temir Zholy--Recovery Summary

Security	Both notes are unsecured and benefit from guarantees provided by KTZ and its main operating subsidiaries.
Insolvency regime	We consider the Kazakhstan insolvency regime unfavorable for creditors.
Valuation method	Going concern. However, we believe that recoveries will be linked to the ability and willingness of the government to reach a negotiated settlement.

Security package

Both bonds are issued by Kazakhstan Temir Zholy Finance B.V. They are unsecured but benefit from a guarantee from JSC KTZ, JSC Lokomotiv, JSC Kaztemirtrans which allows an indirect claim on the group's other assets. Some of the group's other debt facilities also benefit from a guarantee from JSC Lokomotiv and KTZ.

Insolvency regime
Kazakhstan is categorized as a Group C country for the purposes of assigning recovery ratings. We consider Group C countries to be the least creditor-friendly jurisdictions and to offer only limited formal protection to creditors. Recoveries could be affected by significant and unexpected priority claims, extensive delays during insolvency proceedings, and unpredictable outcomes because of potential external influences that would be detrimental to creditors.

For more information on the way we classify the world's legal jurisdictions with regard to creditor friendliness and, in particular, on our view of Kazakhstan's insolvency procedures please see "Debt Recovery for Creditors and the Law of Insolvency in Kazakhstan," published Feb. 19, 2008, and "Jurisdiction-Specific Adjustments to Recovery and Issue Ratings," published June 20, 2008, on RatingsDirect.

Documentation
The bonds are unsecured obligations of the issuer. The documentation limits the ability of the issuer, the guarantors, and their material subsidiaries to create liens or enter into other lines of businesses, and also prevents the material subsidiaries from creating pledges and mortgages or asset disposals. Further, the bond documentation has cross guarantees from other parts of the business and cross default provision on most group debt and debt exceeding $25 million. The bonds have neither maintenance nor incurrence covenants.

Simulated default scenario
Standard & Poor's simulated default scenario contemplates a combination of the following factors:

- Cost growth coupled with inflation and currency devaluation;
- Adverse tariff regulation;
- Increased competition from oil pipelines;
- High capital expenditure requirement for obsolete assets, aged rail infrastructure, and rolling stock; and
- Rising interest costs on variable rate debt.

Under this scenario, a payment default is most likely by 2011, caused by difficulties refinancing the bond due in that year.

Valuation
Given the implied sovereign support and strategic nature of the group's assets, we consider it unlikely that the strategic rail infrastructure would be sold to repay bondholders. The key issue is governmental support and its willingness to repay the bondholders. We believe that more liquid assets within the group, such as part of rolling stock fleet, could be used to repay the bondholders.

Results
The recovery rating of '4' indicates our expectation of 30%-50% recovery in the event of default. However, recovery could be either higher or lower depending on the outcome of negotiations post-default. We estimate that, for a minimum of 30% recovery on the rated debt instruments, the business would need to be valued above $415 million to allow for enforcement costs and pre-petition interest. In addition, the future investment program, as previously announced by the government, could have a material impact on the recovery rating because the capital structure would need to change materially to facilitate the program.

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