

RatingsDirect®

Research Update:

Railway Operator Kazakhstan Temir Zholy Downgraded To 'BB-' On Weaker Assessment Of Government Support; Outlook Negative

Primary Credit Analyst:

Mikhail Davydov, Moscow (7) 495 662 3492; mikhail.davydov@spglobal.com

Secondary Contact:

Alexander Griaznov, Moscow (7) 495-783-4109; alexander.griaznov@spglobal.com

Table Of Contents

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria And Research

Ratings List

Research Update:

Railway Operator Kazakhstan Temir Zholy Downgraded To 'BB-' On Weaker Assessment Of Government Support; Outlook Negative

Overview

- We believe the likelihood that the government of Kazakhstan will provide timely and extraordinary support to Kazakhstan Temir Zholy (KTZ) in a stress scenario is now lower.
- Following KTZ' delayed payments on debt at a subsidiary, we also believe some of the company's internal controls may not be working efficiently.
- We are therefore lowering our global corporate credit ratings on KTZ and its core subsidiary, JSC Kaztemirtrans, to 'BB-' from 'BB' and our national scale ratings to 'kzBBB+' from 'kzA'.
- 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 Oct. 19, 2016, S&P Global Ratings 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 'BB'. The outlook is negative.

We also lowered our Kazakhstan national scale ratings on these entities to 'kzBBB+' from 'kzA'.

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

Rationale

The rating action primarily reflects our view that the likelihood that the Kazakhstan government would provide timely and sufficient extraordinary support to KTZ in a potential stress scenario has weakened to high from very high previously. This is based on the following considerations:

- The government has tolerated a sharp deterioration of KTZ' stand-alone credit quality since the beginning of 2015 and did not provide the funds to reduce its leverage. KTZ' adjusted debt-to-EBITDA ratio increased to about 8.6x at end-2015 from about 3.4x at end-2014, and its funds from operations (FFO)-to-debt ratio dropped to about 7.5% in 2015 from 24.7%

in 2014. We have thus lowered the group's stand-alone credit profile (SACP) by three notches to 'b-' from 'bb-' since the beginning of 2015. In our view, the continued deterioration in the company's stand-alone creditworthiness may signal that the government's readiness to support the institution is diminishing.

- In addition, we believe that government oversight may not be sufficient to monitor debt repayments at all levels of the group, notably within the smaller subsidiaries, which may have material amounts of debt service. We note that the government did not intervene in a timely manner to prevent late payment by Vostokmashzavod (VMZ), a relatively small subsidiary of KTZ, by more than five business days on its payments to Halyk Bank on its loan of \$31.9 million partially guaranteed by the parent company. Although we do not see the situation as a selective default, we believe that were such a case to occur again and on a marginally bigger scale, it could have negative implications for the ratings. This could happen, for example, if the subsidiary's late payment triggers the cross-default clauses on the bonds of the main parent company KTZ.
- We have observed that in the case of KTZ, the administrative procedures for receiving extraordinary support have been complex and time consuming. We now see lower visibility on government support and heightened risk of support being delayed should it be needed again in cases of financial stress.

That said, we assess the likelihood of extraordinary government support as high based on our assessment of KTZ':

- Very important role in Kazakhstan's economy as the national railroad company responsible for about one-half of all freight traffic in Kazakhstan. KTZ plays a key role in land-locked Kazakhstan's national transport sector, which lacks access to the sea or navigable rivers; and
- Strong link with the Kazakh government, which wholly owns KTZ indirectly via the sovereign wealth fund Samruk-Kazyna, and provides stable ongoing support. We note that the government ultimately provided \$150 million in extraordinary support to KTZ in relation to the refinancing of a \$350 million Eurobond in May 2016.

We have lowered our assessment of KTZ' SACP to 'b-' from 'b' as part of our review, reflecting the company's handling of the late payments at VMZ. VMZ' lateness on payments to Halyk Bank by significantly more than five business days could technically make its outstanding debt of Kazakhstani tenge (KZT) 10.6 billion (\$31.9 million) due. We do not consider this situation a selective default on the group's financial obligations because KTZ' guarantee of part of this debt (about KZT5.9 billion or \$17.2 million) does not meet our criteria for guarantees. Additionally, this did not trigger a cross-default with KTZ' bonds since the amount of debt outstanding is below the \$35 million threshold set out by the bond documentation. The situation was resolved on July 31, 2016, with a new amortization schedule providing a grace period until January 2018 for VMZ. We see the situation as providing evidence that certain internal controls in the group may not be working efficiently and have therefore we lowered our assessment of KTZ' management and governance to weak from fair.

Our view of KTZ' SACP at 'b-' also reflects the company's strong market position in Kazakhstan and its exposure to commodity traffic volatility. The company's SACP also reflects its high leverage, stemming from inflation of its foreign currency debt and lower EBITDA generation, reflecting the fall in cargo transportation volumes. The group's adjusted debt-to-EBITDA ratio increased to about 8.6x at end-2015 from about 3.4x at end-2014 and its FFO-to-debt ratio dropped to about 7.5% in 2015 from 24.7% in 2014. KTZ' operating performance has improved moderately so far in 2016, on the back of recovering freight volumes and revenues from transit operations. We currently expect that KTZ' adjusted debt to EBITDA will improve to 6.5x-8.0x and FFO to debt to 7.5%-9.0% this year.

In our base case, we assume:

- Revenue growth of about 7%-13% in 2016, primarily driven by foreign-currency nominated transit revenues, and 2%-7% in 2017, supported by recovering freight volumes and domestic tariff growth.
- EBITDA margin in the range of 21%-26% in 2016-2018.
- Capital expenditures (capex) of KZT200 billion-KZT220 billion per year in 2016-2017.
- Ongoing government support in various forms, including subsidies and direct cash injections.

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

- Debt to EBITDA of 6.5x-8.0x in 2016 and 6.0x-7.5x in 2017-2018.
- FFO to debt of 7.5%-9.0% in 2016 and 7.0%-10.0% in 2017-2018.

Liquidity

We assess KTZ' liquidity as less than adequate, primarily reflecting the ratio of sources to uses for the 12 months beginning June 30, 2016, of below 1.2x. Additionally, we expect that the company will be in breach of its financial covenants for 2016 and that it will be able to reset them or receive a waiver, as has happened in the past.

Principal Liquidity Sources:

- Balance-sheet cash and short-term bank deposits of about KZT97 billion (about \$289 million) as of June 30, 2016;
- FFO of about KZT109 billion; and
- State support to finance capital investments of about KZT82 billion (this includes support only for the second half of 2016, since 2017 numbers have not yet been confirmed).

Principal Liquidity Uses:

- Contractual debt maturities of about KZT87 billion;
- Working capital outflows of up to KZT16.8 billion;
- About KZT150 billion of capex (the amount includes only maintenance capex for 2017, since the actual amount of capex depends on the amount of subsidies for 2017 yet to be confirmed); and
- Dividends in line with the group's dividend policy.

Outlook

The 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 we believe the likelihood of extraordinary government support has weakened further, 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' partial privatization.

Upside scenario

We would likely revise our outlook on KTZ to stable if we revised 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: Weak (-1 notch)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: b-

- Related government rating: BBB-
- Likelihood of government support: High (+3 notches from SACP)

Related Criteria And Research

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008

Ratings List

Downgraded

	To	From
Kazakhstan Temir Zholy JSC Kaztemirtrans Corporate Credit Rating Kazakhstan National Scale	BB-/Negative/-- kzBBB+/--/--	BB/Negative/-- kzA/--/--
Kazakhstan Temir Zholy Senior Unsecured[1]	BB-	BB
Kazakhstan Temir Zholy Finance B.V. Senior Unsecured[2]	BB-	BB

[1]Guaranteed by JSC Kaztemirtrans.

[2]Guaranteed by Kazakhstan Temir Zholy and JSC Kaztemirtrans.

Additional Contact:

Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed

to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

Copyright © 2016 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.