FITCH REVISES KAZAKHSTAN TEMIR ZHOLY'S OUTLOOK TO NEGATIVE

Fitch Ratings-London-22 October 2015: Fitch Ratings has revised JSC National Company Kazakhstan Temir Zholy's (KTZ) Outlook to Negative from Stable. In addition, Fitch has affirmed KTZ's Long-term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB'. Kazakhstan Temir Zholy Finance B.V.'s senior unsecured rating is also affirmed at 'BBB'.

The change in the Outlook reflects our view that state support is weakening during the rapid deterioration of KTZ's standalone creditworthiness. This is evidenced by a lack of tariff increases and continued payment of cash and in-kind dividends by KTZ to its sovereign parent. Insufficient tariff increases or other support beyond 2015 would lead to a downgrade.

Currently the company is rated one notch lower than the sovereign, based on our view of still strong links with the government and expectation that the state will provide sufficient and timely tangible support to the group when needed. KTZ's standalone profile has now weakened to a level commensurate with 'BB-' rather than 'BB+'.

KEY RATING DRIVERS

Weakening State Support

We apply a one-notch differential between the rating of KTZ and the government, reflecting strong strategic and operational ties with the state but also the absence of significant explicit guarantees or cross-default provisions. The one-notch differential is based on our expectation that the government would provide sufficient tangible support for KTZ to service its liabilities.

However, during 2015 KTZ's financial metrics have deteriorated beyond our expectations, with insufficient tangible financial support provided to the company so far. Moreover, KTZ is burdened with cash dividends and the construction of various buildings, requested by the state in 2012-2014, which the company funds from its own balance sheet and recognises as 'in kind' distributions (e.g. multi-functional ice palace). Should the state allow KTZ's weak financial metrics to persist in the foreseeable future, we would reconsider the level of support incorporated in the rating.

KTZ is fully state-owned (indirectly through the JSC National Welfare Fund Samruk-Kazyna (S-K), BBB+/Stable/F2). The company is strategically important to Kazakhstan (BBB+/Stable/F2) as the monopoly owner/operator of the Kazakhstan rail infrastructure and provider of around half of freight and passenger transportation in the country. KTZ's tariffs are regulated and its investment plans approved and partially funded by the state, through equity injections and loans. The government also provides direct subsidies to the loss-making passenger business.

Multi-notch Weakening in Standalone Profile

A number of adverse developments in 2015 have eroded KTZ's financial ratios. These include a freight tariff freeze, a drop in freight turnover and a near 50% devaluation of the tenge against USD since August this year. As a result we expect KTZ's funds from operations (FFO) adjusted gross leverage to increase to 5.4x in 2015 from 3.3x in 2014 and FFO interest coverage to fall to 3.1x from 6.2x. Given a challenging economic outlook in Kazakhstan and its neighbouring Russia and weaker growth prospects in China, we do not expect the company's leverage to recover to below 5.0x over the medium term, unless it receives tangible government support or cuts company-funded capex more than we already expect.

The business profile continues to benefiting from the company's monopolistic position, a fairly diversified product and customer mix and balanced exposure to the domestic, transit and export markets. However, the weakening in credit metrics, particularly increased leverage, places considerable pressure on the company's underlying credit quality, which Fitch is reassessing to 'BB-' from 'BB+'.

Freight Turnover Dips

KTZ's freight turnover (tonne kilometres) declined 6% in 2014 and is estimated by the company to fall a further 11% in 2015. This is mainly due to reduced exports and slower transit cargo flows. Russia and China are Kazakhstan's major trade partners, contributing 19% and 14% respectively to the total country's trade flow (8M15). A drop in Kazakhstan's exports to those countries has directly impacted KTZ's export cargo turnover. Sharp rouble devaluation in 2014 has caused many Kazakh commodities and industrial products to lose their price competitiveness versus those produced in Russia.

The reduction in turnover is affecting KTZ through lower revenue and profitability due to an inflexible, predominantly fixed-cost base. The tenge devaluation may improve Kazakhstan's competitive position and trade flows, although Fitch expects a further moderate fall in freight turnover in 2016.

Uncertainty after Tariff Freeze

Freight and passenger tariffs received no increase in 2015 due to the government's concern over its adverse impact on the weakened national economy. This has hurt KTZ's cash flow generation and financial profile.

The company is expecting tariff increases close to inflation over the next five years. In our view tariff uncertainty is high, driven by the uncertain impact of tenge devaluation on the national economy. To sustain its financial profile KTZ may need to substantially reduce its investments if tariffs are increased at the inflation rate only.

The introduction of new asset-based tariff regulation has been postponed due to affordability concerns.

Capex and Cost Optimisation

KTZ is applying a number of cost-cutting initiatives to partially mitigate the negative impact of the tariff freeze and slower turnover. Such initiatives led to a 16.6% reduction in operating costs in 1H15. The company has also reduced its capex plan by 23% for 2015-2018, and has the flexibility to cut it further if required (potentially by further 24%). Although these measures are credit-positive, the benefits are limited by the company's inflexible cost base and pressure to invest heavily, in line with Kazakhstan's plans to maximise the country's transit potential.

KTZ undertakes additional infrastructure projects in connection with the country's 'Nurly Zol' economic policy. Fitch expects that these projects will receive state funding since assets under construction and modernisation are not legally owned by the company. So far KTZ has received KZT44bn of the total KZT83bn approved state funding for these investment projects.

Negative Impact of Tenge Devaluation

The tenge has lost around 50% of its value versus USD since the government moved to a floating exchange rate in August 2015. KTZ is vulnerable to currency exchange rate swings due to the currency mismatch between its earnings and debt. At end-September 2015, 59% of its gross debt was denominated in foreign currency (mainly USD) versus only 20% of revenue (mainly transit, CHF-denominated). Most of the costs and capex are tenge-denominated. Fitch estimates that 2015 tenge devaluation added 0.6x to the KTZ's FFO-adjusted gross leverage.

The company plans to reduce the proportion of foreign-currency denominated debt by issuing tenge-denominated bonds. We have yet to see whether sufficient tenge liquidity will be made available by the authorities. Financial hedging of KZT/USD risk has historically been limited to monitoring exchange rates and maintaining a portion of cash in USD.

KEY ASSUMPTIONS
Fitch's key assumptions within the rating case for KTZ include:
-Average freight tariff increase of 6.5% in 2016-2018 versus inflation rate of 7%
-A continuing 6% decline in freight turnover in 2016, before reversing to 1.5% and 2.5% growth in 2017 and 2018, respectively
-KZT16.6bn average annual proceeds from privatisation of minority stakes in non-core subsidiaries in 2015-2018
-Continued loss compensation in the passenger division via state subsidies
-Total capex of KZT860bn in 2015-2018
-15% cash dividend pay-out ratio
-State equity injections for selected investment projects of KZT68.5bn in 2015 and KZT36.4bn in 2016
-Average interest rate for new borrowings of 9%
-Continued tenge depreciation to 365 KZT/USD by end-2018

RATING SENSITIVITIES
Positive: The Outlook is Negative and we currently do not anticipate an upgrade. However, future developments that could nonetheless lead to positive rating actions include:

--A positive change in Kazakhstan's rating may be replicated for KTZ, unless its links with the state weaken.

A revision of the Outlook to Stable would be contingent on evidence of tangible state support in the near term, including but not limited to tariff growth sufficient to cover inflationary cost increases, equity injections alleviating balance sheet pressure, and assistance in re-negotiating the covenant package with creditors.

Negative: Future developments that could lead to negative rating action include:

--A negative change in Kazakhstan's rating would be replicated for KTZ;
--Continued weakening of tangible support provided to KTZ, for example lack of tariff increases or continued in-kind and cash dividends that adds to negative free cash flow, lack of state support in covenant renegotiation and weak credit metrics such as failure to reduce FFO adjusted gross leverage towards 5.0x, which would prompt Fitch to reconsider KTZ's links with the Kazakhstan government.

For the sovereign rating of the Kazakhstan, KTZ's ultimate parent, the following sensitivities were outlined by Fitch in its rating action commentary of 01 May 2015:

The Outlook is Stable, meaning that the downside and upside risks are evenly balanced. However, the following risk factors individually, or collectively, could trigger negative rating action:
- Policy mismanagement and/or a prolonged fall in oil prices leading to a decline in SNFA allied to reduced economic and financial stability
- Renewed weakness in the banking sector, which leads to contingent liabilities for the sovereign
- A political risk event

Conversely, the following factors, individually or collectively, could result in positive rating action:
- Moves to strengthen monetary and exchange rate policy

- An effective restructuring of banks' balance sheets
- Steps to reduce the vulnerability of the public finances to future oil price shocks, for example, by reducing the non-oil deficit, currently estimated at more than 9% of GDP
- Substantial improvements in governance and institutional strength

LIQUIDITY
KTZ's liquidity adequacy is contingent on covenant renegotiation and waivers. At end-1H15 the company had KZT58.2bn of cash and equivalents and KZT80bn of available credit facilities versus short-term debt repayments of KZT124.6bn. Additionally, negative free cash flow is expected to add to funding requirements around KZT110bn.

Its KZT80bn of available credit facilities at end-1H15 included a USD300m syndicated loan from EBRD and a number of banks, committed specifically for the refinancing of USD350m eurobond falling due in April 2016. Due to the tenge devaluation, the company no longer expects to meet the financial covenants set in this facility and is renegotiating the financing package. Additionally, the company is renegotiating the covenants on some of its existing debt (the overall exposure close to KZT150bn). Should the company not be successful in its covenant re-negotiation, Fitch expects the state to step in with timely financial support.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362