FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Transnet SOC Ltd's IDR to 'BB-'; Outlook Negative

Fri 26 Feb, 2021 - 11:13 AM ET

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Fitch Ratings - London - 26 Feb 2021: Fitch Ratings has downgraded South Africa-based Transnet SOC Ltd's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) to 'BB-' from 'BB' following the downgrade of the South African sovereign (see "Fitch Downgrades South Africa's IDR to 'BB'; Outlook Negative"; dated 20 November 2020 at www.fitchratings.com). The Outlook is Negative.

Transnet's senior unsecured rating has also been downgraded to 'BB-' from 'BB'. A full list of rating actions is below.

KEY RATING DRIVERS

Downgrade Reflects GRE Links: Transnet's rating is constrained by the sovereign's rating through our assessment of the strength of the links with the sovereign under our Government-Related Entities (GRE) Rating Criteria and Parent and Subsidiary Rating Linkage Criteria (PSL). We have also revised Transnet's Standalone Credit Profile (SCP) to 'bb' from 'bbb-', mainly due to our expectation of pandemic-driven weakening of its financial profile and ongoing irregular expenditure issues, but it remains higher than the South African sovereign rating.

Adverse Impact of COVID-19: The pandemic-driven national lockdown in 1Q21 (April to June 2020) had a sizeable impact on Transnet, despite it continuing operations as it was classified as an essential service by the South African government. The 17% decline in revenues in 1H21 was due to the decline in shipment volumes of coal, iron ore, manganese and other general freight commodities resulting from the sharp decline in economic activity in the country.

Transnet's high fixed cost base resulted in the EBITDA margin declining about 15% to 31%. However, economic activity recovered quickly in 3Q21 and Fitch expects Transnet's FY21 (ending March 2021) revenue to decline by about 12% from FY20 and EBITDA margin to be about 7% lower.

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Capex Flexibility Mitigates Impact: The impact of the pandemic on Transnet's cash flows is largely mitigated by delayed execution of Transnet's capital projects due to stoppage of activity during the hard lockdown and restrictions period, which has moderated capex by close to 30%. Management also plans to limit capex to 80% of cash generated from operations over the medium term from FY22. However, we expect free cash flow (FCF) in FY21 of about negative ZAR6 billion due to lower EBITDA, higher cash interest and higher working capital outflow, partially offset by lower capex.

Transnet also plans to reinstate dividends, albeit at moderate levels of about ZAR300 million per year, which could be delayed due to the pandemic. The company has continued to access capital markets including bonds, loans and commercial paper to refinance debt maturities and maintain its liquidity position.

Covenant Compliance Uncertain: The expected decline in EBITDA in FY21 will likely lead to Transnet's cash interest cover covenant under its bilateral and syndicated loans falling short of the minimum 2.5x requirement at end-March 2021. If this happens, we expect Transnet to arrange a waiver for this test period. The inability to do so, resulting in any acceleration of debt or pressure on liquidity would have an adverse impact on the ratings.

Qualified Audit Opinion: As Transnet has been working on instituting sustainable systems to ensure the completeness of reporting on irregular expenditure from prior years' non-compliant procurement contracts, it received a qualified audit opinion in FY20, which through covenants affected bilateral and syndicated loans. All affected lenders have now granted waivers to early repayments. The qualified opinion relates to the completeness of reported irregular expenditure. Transnet has improved

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compliance and the reporting of irregular expenditure and the number of new contracts that are irregular has been declining gradually.

SCP Revised to 'bb': We forecast Transnet's financial profile to weaken in the near term, with FFO net leverage forecast to increase to 5.4x at FY21 from 3.7x at FY20. We expect FFO interest cover to weaken to 1.9x at FY21 from 3.0x at FY20 before both metrics recover to pre-pandemic levels in the medium term. In addition, Transnet's ongoing irregular expenditure reporting issues, including the qualified audit opinion, have led us to revise Transnet's SCP to 'bb' from 'bbb-'.

Supportive Business Profile: The ratings reflect Transnet's strong business profile characterised by its near monopolistic market position in freight rail, services to eight commercial sea ports and multi-product pipeline for hydrocarbon products. Fitch views demand volatility in line with economic cycles in the port and pipelines segment, but the freight rail segment (about 55% of EBITDA for FY20) is sustained by long-term take-or-pay contracts with diversified counterparties, including miners, industrial companies and general freight trade.

The national lockdown implemented during 1Q20 resulted in a significant decline in freight rail volumes, which have since recovered. Fitch forecasts South African GDP to grow 3.6% in 2021 after a decline of 8.1% in 2020.

DERIVATION SUMMARY

Fitch assesses Transnet's SCP at 'bb', benefiting from its strong business profile with high levels of vertical integration across key markets, monopolistic position in rail, port and pipeline services, with a long-term contract base and business diversification underpinning operating cash flows. Structural weaknesses in the operating environment, funding needs due to capex, and legacy irregular expenditure issues constrain the SCP.

The SCP is lower than JSC Russian Railways (bbb+), which has higher geographical diversity and a more conservative financial profile.

Transnet's national scale rating of 'AA(zaf)'/Stable is lower than Namibian Port Authority (NamPorts, AAA (zaf)/Negative) primarily due to the latter's high level of debt guaranteed by the Namibian government.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Moderate revenue decline in 2H20 resulting in FY21 revenue 12% lower than FY20;

- FY22 revenue to recover back to its pre-pandemic growth trajectory of around mid-single digit growth compared to FY20;

- EBITDA margin to decline to about 38% in FY21 and then recover to pre-pandemic levels in FY22;

- No cash tax payments in the near term;

- Reduction in up to 30% of planned capex in FY21

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

A revision of the sovereign Outlook to Stable while links between Transnet and the sovereign remain unchanged under the GRE criteria could lead to a revision of Transnet's Outlook to Stable.

Upgrade - we do not anticipate an upgrade, as reflected in the Negative Outlook.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A downgrade of South Africa's sovereign rating.

Structurally weaker world commodity markets leading to a fall in South African exports, a weak domestic economy and concurrent breach of the cash interest coverage covenant without mitigating actions would be negative for the SCP.

South African sovereign sensitivities as per the rating action commentary ("Fitch Downgrades South Africa to 'BB-'; Outlook Negative") published on 20 November 2020

Factors that could, individually or collectively, lead to positive rating action/downgrade:

Public Finances: A clear and credible path towards stabilising the government debt/GDP ratio over the medium term.

Macroeconomic Performance, Policies and Prospects: Greater confidence in stronger growth prospects, sufficient to support fiscal consolidation and address challenges from high inequality and unemployment.

The main factors that could, individually or collectively, lead to negative rating action/downgrade:

Public Finances: A continued rise in government debt/GDP and failure to formulate a clear and credible path towards stabilising the government debt/GDP ratio.

External Finances: Rising risk of a de-stabilising large net capital outflow that triggers sharp exchange rate depreciation, higher inflation and interest rates.

Macroeconomic Performance, Policies and Prospects: Persistent weak trend GDP growth rate that further undermines fiscal consolidation efforts and raises socioeconomic pressures in the face of exceptional inequality.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Tight Liquidity: Transnet had about ZAR4.9 billion of cash at the end of September 2020. It also had about ZAR12.3 billion undrawn and available under ZAR13.3 billion short-term call facilities. This compares with short-term debt of about ZAR14.3 billion and Fitch's expectation of about negative ZAR6 billion FCF for FY21. We expect Transnet to continue accessing the capital market to fund its financing requirements in line with its five-year plan of raising over ZAR80 billion to 2024. During 1H21, Transnet raised about ZAR16.3 billion in borrowings from loans, bonds and commercial paper issuance and repaid borrowings of ZAR17.7 billion.

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REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Transnet's ratings are linked with the South African sovereign rating.

ESG CONSIDERATIONS

Transnet SOC Ltd.: Financial Transparency: '4'

Financial Transparency score of '4' reflects insufficient reporting systems to identify all irregular expenses as a result of non-compliant procurement under prior years' contract.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR

ENTITY/DEBT	RATING			PRIOR
Transnet SOC Ltd.	LT IDR	BB- Rating Outlook Negative	Downgrade	BB Rating Outlook Negative
	ST IDR	B	Affirmed	B
	LC LT IDR	BB- Rating Outlook Negative	Downgrade	BB Rating Outlook Negative
	LC	B	Affirmed	B

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Parent and Subsidiary Linkage Rating Criteria (pub. 26 Aug 2020)

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Sector Navigators - Addendum to the Corporate Rating Criteria (pub. 21 Dec 2020)

Corporate Rating Criteria (pub. 21 Dec 2020) (including rating assumption sensitivity)

National Scale Rating Criteria (pub. 22 Dec 2020)

Country-Specific Treatment of Recovery Ratings Criteria (pub. 05 Jan 2021)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Transnet SOC Ltd.	UK Issued, EU Endorsed

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ADDITIONAL DISCLOSURES FOR UNSOLICITED CREDIT RATINGS

Transnet SOC Ltd. (Unsolicited)

With Rated Entity or Related Third Party Participation	Yes
With Access to Internal Documents	Yes
With Access to Management	No

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UNSOLICITED ISSUERS

ENTITY/SECURITY	ISIN/CUSIP/COUPON RATE	RATING TYPE	SOLICITATION STATUS
Transnet SOC Ltd. ZAR 1.5 bln 10% Gtd Bonds 30 Mar 2029	XS0095884424	National Long Term Rating	Unsolicited
Transnet SOC Ltd.	-	Stand-Alone Credit Profile	Unsolicited
Transnet SOC Ltd. ZAR 2 bln 13.5% Gtd Bonds 18 Apr 2028	XS0085235090	National Long Term Rating	Unsolicited
Transnet SOC Ltd.	-	Local Currency Short Term Issuer Default Rating	Unsolicited
Transnet SOC Ltd. ZAR bond/note	-	National Long Term Rating	Unsolicited

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Corporate Finance: Middle Markets Corporate Finance Industrials and Transportation

Corporate Finance: Leveraged Finance Africa South Africa

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