Research Update:

Transnet SOC Ltd. 'BB-' Ratings Affirmed; Outlook Stable

November 25, 2020

Overview

- As a result of the COVID-19 pandemic's negative impact on Transnet SOC Ltd.'s (Transnet) cash flow generation, we expect the company's revenues and EBITDA will decline by 10% and 27% respectively in fiscal 2021 (ending March 31, 2021), followed by a modest recovery from fiscal 2022.
- Transnet's liquidity remains less than adequate, in our view, and we believe there is a possibility it will breach financial and/or ratings-related covenants in the next six months.
- We are affirming our 'BB-' long-term foreign and local currency issuer credit ratings on Transnet, our 'BB-' foreign and local currency issue ratings on its senior unsecured debt, and our 'BB' local currency issue rating on Transnet's South African rand (ZAR) 3.5 billion government-guaranteed debt. At the same time, we are affirming our 'zaAA' long-term and 'zaA-1+' short-term South Africa national scale ratings on Transnet.
- The stable outlook reflects the outlook on South Africa, and our belief that Transnet will continue to benefit from a very high level of government support, although we view the need for direct extraordinary support as fairly limited at this time.

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Rating Action

We expect South Africa's COVID-19 related lockdown, introduced at the end of March 2020, will have a significant negative impact on on Transnet's revenue and EBITDA in fiscals 2021 and 2022. However, we note that the lockdown did not have a significant impact on the group's operations in fiscal 2020. As an essential service provider, Transnet continued to operate during the most intense period of South Africa's lockdown in April and May this year, enabling the company to meet demand from companies allowed to operate during the initial lockdown phase. However, we believe that Transnet's revenue reduced significantly (relative to its pre-COVID-19 budget) in April and May as a result of severely constrained demand for port, pipeline, and rail freight services during that period, as well as restrictions on the movement of nonessential goods. Correspondingly, we forecast a significant decline in EBITDA as a result of our expectation of lower revenue and a high proportion of fixed costs in the cost structure.

However, we have already observed some recovery in freight volumes, and modest improvement in economic activity should drive recovery in fiscals 2022 and 2023. Following the easing of lockdown restrictions in June, some of Transnet's operations have started to slowly rebound. While operating levels have also started to improve, we expect that lost earnings will not be recouped given infrastructure capacity limits. We expect revenue will decline by about 10% in fiscal 2021 compared with fiscal 2020, reflecting the impact of the pandemic. This includes or expectation of constrained economic, import, and export growth trajectories and prospects for Transnet's customers, resulting in sharp declines in freight, port and pipeline volumes. In line with our expectation of an economic rebound in South Africa, we anticipate Transnet's revenue will recover only modestly in fiscals 2022 and 2023, likely resulting in persistently higher financial risk and weaker credit metrics. We foreast S&P Global Ratings EBITDA will decline by 27% to South African rand (ZAR) 24 billion-ZAR25 billion in fiscal 2021 versus fiscal 2020, before rebounding to ZAR32 billion-ZAR34 billion in fiscal 2022. Although we believe that volumes, particularly in the mining sector, have recovered quite quickly given miners' imperative to export products given the supportive commodity price environment, system inefficiencies and below-capacity pipeline and containerized freight usage might continue to constrain EBITDA.

Transnet's liquidity remains less than adequate, in our opinion, although the company has made significant progress toward funding maturities due in calendar year 2021. In our assessment of Transnet's standalone credit profile (SACP) as 'bb-', we consider Transnet's less-than-adequate liquidity, our view of the high amount of debt subject to varied and complex covenants, which is uncommon for similarly rated peers, as well as the covenants' potential to further affect Transnet's liquidity. We continue to see risk to Transnet's SACP stemming from further liquidity stress, including the impact of potential un-remediated breaches of financial and rating-related covenants (covenants with a minimum rating requirement). For example, if a financial covenant breach seems likely at end-fiscal 2021, and management does not have a remediation plan in place prior to the testing period, we might reassess the company's liquidity as weak, which could result in a multi-notch downward revision of the company's SACP. We understand that certain loan agreements, totaling about ZAR41 billion, or approximately 31% of Transnet's total debt, contain rating-related covenants. Breaches of these covenants could result in higher interest cost, requirements for third-party guarantees, or, in a limited number of cases, loan acceleration.

We view Transnet's executive appointments in the last 12 months as a positive step toward resolving the company's management and governance deficiencies. Nevertheless, we asses Transnet's management and governance only as fair given past deficiencies in the risk control framework and failed oversight of the Board, which led to insufficient control over procurement and contract management. However, we note that, in pursuit of transparency, accountability, and sound financial management, Transnet is overhauling its procurement and finance functions, is establishing a loss control function, and members of the senior leadership team and the Board are now subject to lifestyle audits. Overall, we believe Transnet is laying a solid foundation that will help bring back a culture of integrity and heightened control, preventing and mitigating corruption and irregularities related to the Public Finance Management Act (PFMA) and other legislative instruments, which have plagued Transnet in the recent past. We will continue to monitor how management and the Board succeed with the new framework and governance mechanisms.

Environmental and social considerations are broadly in line with industry peers. Transnet displays acceptable service delivery and regulatory risk and public opinion management, supported by its monopoly position in several markets. We believe transportation infrastructure providers have moderate environmental exposure, reflecting their indirect exposure to emissions and pollution via the transportation industry. From a social perspective, the impact on local communities in relation to lifestyle, congestion, noise, and air quality is becoming more prominent, but we view these risks as limited given the critical nature of existing road, airport, and port operations.

We expect Transnet's capital expenditure (capex) will continue to ramp up through fiscal 2023, in line with the company's objective to increase port and rail infrastructure capacity to support economic development in South Africa. Transnet's capex in fiscal 2020 of ZAR18.6 billion comprised ZAR3.5 billion invested in expansion of infrastructure and equipment, and ZAR15.1 billion invested to maintain capacity in the rail, pipelines, and ports divisions. We expect slightly lower capex of about ZAR16.6 billion in fiscal 2021 due to the negative impact of COVID-19 restrictions on project execution. In fiscals 2022 and 2023, we expect capex of ZAR17 billion-ZAR20 billion, representing a capex intensity of 20%-25%. We forecast Transnet's S&P Global Ratings adjusted operating cash flow for fiscal 2021 at about ZAR12 billion, improving to ZAR21 billion-ZAR24 billion over fiscals 2022-2023.

Outlook

The stable outlook reflects our view that Transnet's creditworthiness is underpinned by the very high likelihood of extraordinary government support. This would be the case even if the company's SACP were to deteriorate by up to two notches due to, for example, liquidity stress over the next 12 months, or further cash flow constraints due to persisting COVID-19-related effects on freight, port, and pipeline volumes.

A lower interest rate environment in South Africa has somewhat moderated the risk of higher interest costs on future debt refinancing, and, furthermore, foreign currency debt is fully hedged. We therefore expect the company will achieve S&P Global Ratings-adjusted funds from operations (FFO) to debt of 13%-23% and FFO interest coverage ratio of 2.0x-3.0x over the next two-to-three years, with fiscal 2021 (estimated 2.3x-2.4x) representing a particularly weak year due to the impact of the COVID-19 pandemic on the local economy and GDP growth. The company's solid competitive position in key freight and port operations supports our view of the company's business and financial risk.

Downside scenario

If we downgraded South Africa further, we would take a similar action on Transnet. We could also downgrade Transnet if its SACP, which we currently assess at 'bb-', were to weaken by more than two notches. This could stem from:

- Liquidity stress linked to the triggering of financial or nonfinancial covenants (including ratings-related covenants), to the extent that these covenants cannot be waived or renegotiated;
- Materially weaker cash flow than forecast, given the interruption of volume recovery, which might be linked to a second wave of the pandemic; or
- Increased cash flow volatility or a reassessment of country risk, leading us to apply higher financial thresholds at the same rating level.

We could revise our SACP assessment downward if Transnet's FFO to debt declined and stayed below 13%, if FFO interest coverage fell to below 2.0x over a prolonged period, or if liquidity deteriorated markedly. The latter could happen if there was a pronounced shortfall in available liquidity, or if a financial covenant breach occurred by the next testing date (March 31, 2021), without a covenant lift or waiver being in place.

Upside scenario

We could revise the outlook to positive if we revised the outlook on South Africa to positive, alongside an improvement in Transnet's cash flow or liquidity. This could happen if the company recovered more strongly than expected from the effects of the COVID-19 pandemic, refinanced its upcoming debt maturities with long-term funding, and received waivers with respect to any covenant breaches.

Company Description

Transnet, which is wholly state owned via the Department for Public Enterprise (DPE), owns and operates integrated rail freight, port, and pipeline infrastructure in South Africa. The company's main objectives include constructing an efficient rail freight corridor to reduce reliance on road transport, and operating the ports efficiently to reduce ocean freight costs. These objectives reflect the government's strategic initiative to improve the efficiency and competitiveness of the South African economy for the bulk and manufacturing sectors.

Freight Rail is the largest of Transnet's five core operating divisions, contributing 59% of fiscal 2020 revenue and 55% of EBITDA. Regulated activities, which are subject to the National Energy Regulator (NERSA) for pipelines or the Port Authority Regulator for the port business, account for 24% of Transnet's revenue and 34% of EBITDA. Because about 65% of Transnet's rail freight volumes are from take-or-pay contracts, about 60% of its revenue is either regulated or based on predictable volumes and prices over the medium term. The remainder of the Freight Rail unit's business is exposed to competition, but has been gaining market share in recent years (through 'rail over road' initiatives).

Transnet also provides cargo-handling services and container activities in ports, which accounted for about 14% of its EBITDA in fiscal 2020.

Our Base-Case Scenario

Assumptions

- Real GDP for South Africa contracting by 7.3% in calendar year 2020, recovering to 3.6% in 2021, and 2.5% in 2022.
- Revenue decline of 9%-10% in fiscal 2021 mainly due to the impact of the pandemic, recovering to 9%-10% growth in fiscal 2022 and 6% in 2023 as GDP growth recovers.
- S&P Global Ratings-adjusted EBITDA margin of 35%-37% in fiscal 2021, mainly due to lower freight volumes and high fixed costs, recovering to 44% in fiscal 2022 due to a combination of cost containment initiatives and improved operational outcomes.
- Capex representing 20%-25% of revenue in fiscals 2021 and 2022.
- No dividends distribution for fiscal 2021, however, we forecast a modest dividend payment of

ZAR200 million from fiscal 2022, in line with government statements that indicate profitable state-owned companies should start paying dividends.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures for Transnet in fiscals 2021 and 2022:

- Annual FFO to debt of 10%-12% in fiscal 2021 and 15%-18% in fiscal 2022.
- Debt to EBITDA of 4.5x-5.5x in fiscal 2021 improving to 3.5x-4.0x in fiscal 2022.
- Annual FFO interest coverage of 2.0x-2.5x in fiscal 2021, improving to 3.0x-3.5x in fiscal 2022.

Liquidity

We consider the group's liquidity as less than adequate, based on our estimate that the ratio of liquidity sources to uses will be below 1.2x for the 12 months started Oct. 1, 2020. The uses of liquidity exclude any potential consequences of the triggering of financial or rating-related covenants, which we qualitatively reflect in our liquidity assessment and our comparative ratings analysis.

We estimate that principal liquidity sources over the 12 months from Oct. 1, 2020, will include:

- Cash and liquid investments of about ZAR4.9 billion;
- Committed undrawn bank lines maturing beyond 12 months of ZAR4.1 billion; and
- Expected average annual cash FFO of about ZAR20 billion.

For the same period, we estimate principal liquidity uses will include:

- Short-term debt maturities of ZAR14.1 billion;
- Working capital outflow of ZAR2 billion;
- Annual maintenance capex of ZAR15 billion;
- Dividend payments of about ZAR200 million; and
- No acquisitions or mergers in the short term.

Covenants

We understand that certain loan agreements, totaling about ZAR41 billion, or approximately 31% of Transnet's total debt, contain rating-related covenants. Since 2017, the ratings on South Africa have been on a downward trajectory, and, during this period, Transnet has successfully negotiated with its lenders regarding covenant triggers for facilities. This has led to interest rate increases, posting of additional guarantees, and, in limited cases, debt acceleration. Should there be further negative sovereign rating actions, we expect the company will be able to negotiate with banks, given its track record of supportive relationships in the credit markets. That said, we would also evaluate the potential impact of further negative rating actions on Transnet's liquidity position.

In addition, some loans (constituting about 27% of Transnet's outstanding debt) contain a leverage covenant stipulating debt to debt plus equity of 60% and FFO cash interest coverage of 2.5x. Transnet has so far met these covenants with satisfactory headroom (both covenants had at least 16% headroom at the end of fiscal 2020). However, if stress conditions, such as slower-than-expected operating performance recovery or higher debt-funded capex materialize, we believe headroom will diminish further, leading to a potential breach of the FFO cash interest coverage covenant at March 31, 2020. If we expect coverage tests will be breached and there is no credible plan to mitigate this, such as obtaining covenant lifts or a waivers, we might reassess the company's liquidity as weak, which could result in a multi-notch downward revision in our SACP assessment.

Issue Ratings--Subordination Risk Analysis

Capital structure

We align our issue ratings on Transnet's debt with the respective issuer credit ratings due to the low amount of secured and priority debt issued by the operating entities.

Analytical conclusions

Accordingly, our ratings on the senior unsecured debt are at the same level as the respective long-term issuer credit ratings.

We equalize our ratings on two debt instruments (maturing in 2028 and 2029) guaranteed by South Africa with the respective long-term sovereign ratings.

Ratings Score Snapshot

Issuer Credit Rating:

- Foreign currency BB-/Stable/--
- Local currency BB-/Stable/--

Business risk: Satisfactory

- Country risk: Moderately high
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than adequate (-1 notch)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)

- Comparable ratings analysis: Negative (-1 notch)

Stand-alone credit profile: bb-

- Group credit profile: bb-
- Entity status within group: Not applicable
- Sovereign rating: foreign currency 'BB-'; local currency 'BB'
- Likelihood of government support: Very high

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- South Africa Long-Term Foreign And Local Currency Ratings Affirmed; Outlook Stable, 20 Nov 2020
- Rating Actions Taken On Various Corporate And Infrastructure Issuers Following Downgrade Of South Africa, May 12, 2020

Ratings List

Ratings Affirmed	
Transnet SOC Ltd.	
Issuer Credit Rating	BB-/Stable/--
South Africa National Scale	zaAA/--/zaA-1+
Senior Unsecured*	BB
Senior Unsecured	BB-

*Guaranteed by the Republic of South Africa.

Regulatory Disclosures

Transnet SOC Ltd.

•Primary Credit Analyst: Omega Collocott, Director

•Rating Committee Chairperson: G. Andrew Stillman

•Date initial rating assigned: Sept. 4, 1997

•Date of previous review: May 12, 2020

Disclaimers

This rating has been determined by a rating committee based solely on the committee's independent evaluation of the credit risks and merits of the issuer or issue being rated in accordance with S&P Global Ratings published criteria and no part of this rating was influenced by any other business activities of S&P Global Ratings.

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Materials Used In The Credit Rating Process: Sufficient information in general consists of both (i) financial statements that describe the Issuer's financial condition, results of operations and cash-flows, and (ii) a description of the activities and obligations of the entity including of its governance and legal structure.

This credit rating was disclosed to the rated entity or related third party before being issued.

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Glossary

Anchor: The starting point for assigning an issuer a long-term rating, based on its business risk profile assessment and its financial risk profile assessment.

Business risk profile: This measure comprises the risk and return potential for a company in the market in which it participates (its industry risk), the country risks within those markets, the competitive climate, the company's competitive advantages and disadvantages (its competitive position).

Comparable rating analysis: This involves taking a holistic review of a company's stand-alone credit risk profile (SACP), because each of the subfactors that ultimately generate the SACP can be at the upper or lower end, or at the midpoint, of such a range. It may also touch upon the overall comparative assessment of an issuer in relation to its peers across industry and jurisdiction and may capture some factors not (fully) covered, such as a short operating track record, entities in transition, unusual structures, or contingent risk exposures.

Competitive advantage: The strategic positioning and attractiveness to customers of the company's products or services, and the fragility or sustainability of its business model.

Competitive position: Our assessment of a company's: competitive advantage; operating efficiency; scale, scope, and diversity; and profitability.

Corporate Industry and Country Risk Assessment (CICRA): Derived by combining an issuer's country risk assessment and industry risk assessment.

Country risk: This measures a country's influence on the overall credit risks for a rated company with regards to a country's economic, institutional and governance effectiveness, financial system, and payment culture/rule of law risks.

CreditWatch: This highlights the potential direction of a short- or long-term rating over the short term, typically less than three months. Ratings may be placed on CreditWatch where, in our view, an event or a deviation from an expected trend has occurred or is expected and additional information is necessary to determine the rating impact.

Creditworthiness: Ability and willingness of a company to meet its debt and debtlike obligations; measured by assessing the level current and future resources relative to the size and timing of its commitments.

Diversification/portfolio effect: Applicable to conglomerates. An assessment of the extent to which an entity's multiple core business lines are correlated and whether each contributes a material source of earnings and cash flow.

Earnings: Proxy for profit or surplus yielded by an entity after production and overhead costs have been accounted for in a given period.

EBITDA margin: This is EBITDA as a fraction of revenues.

EBITDA: This is earnings before interest, tax, depreciation, and amortization.

Economies of scale: This is the cost advantage that arises with increased size or output of a product.

Efficiency gains: Cost improvements.

Financial headroom: Measure of deviation tolerated in financial metrics without moving outside or above a predesignated band or limit typically found in loan covenants (as in a debt-to-EBITDA multiple that places a constraint on leverage) or set for the respective rating level. Significant headroom would allow for larger deviations.

Financial risk profile: This measure comprises our assessment of a company's cash flow/leverage analysis. It also takes into account the relationship of the cash flows the organization can achieve given its business risk profile. The measure is before assessing other financial drivers such as capital structure, financial policy, or liquidity.

Free operating cash flow: Cash flow from operations minus capital expenditure.

Funds from operations: EBITDA minus interest expense minus current tax.

Government-related entity: An entity that could, under stress, benefit from extraordinary government support in order to meet its financial obligations; or conversely an entity controlled by a government that could be subject to negative extraordinary government intervention if the government is under stress.

Group rating methodology: The assessment of the likelihood of extraordinary group support (or conversely, negative group intervention) that is factored into the rating on an entity that is a member of a group.

Industry risk: This addresses the major factors that affect the risks that companies face in their respective industries.

Issue credit rating: This is a forward-looking opinion about the creditworthiness of an obligor with respect to a specific class of financial obligations or a specific financial program.

Issuer credit rating: This is a forward-looking opinion of an obligor's overall creditworthiness.

Leverage: The level of a company's debt in relation to its earnings before interest, tax, depreciation, and amortization.

Liquidity: This is the assessment of a company's monetary flows, assessed over a 12 to 24 month period. It also assesses the risk and potential consequences of a company's breach of covenant test, typically tied to declines in EBITDA.

Management and governance: This addresses how management's strategic competence, organizational effectiveness, risk management, and governance practices shape the issuer's competitiveness in the marketplace, the strength of its financial risk management, and the robustness of its governance.

Operating efficiency: The quality and flexibility of the company's asset base and its cost management and structure.

Outlook: This is the assessment of the potential direction of a long-term issuer rating over the short to intermediate term (typically six months to two years).

Stand-alone credit profile (SACP): S&P Global Ratings' opinion of an issue's or issuer's creditworthiness, in the absence of extraordinary intervention or support from its parent, affiliate, or related government or from a third-party entity such as an insurer.

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