MOODY'S
INVESTORS SERVICE

# Credit Opinion: South African National Roads Ag. Ltd (The)

Global Credit Research - 04 May 2012

*Pretoria, South Africa*

## Ratings

| Category | Moody's Rating |
|---|---|
| Outlook | Negative |
| Issuer Rating | Baa2 |
| NSR Issuer Rating -Dom Curr | A2.za |
| ST Issuer Rating | P-3 |
| NSR ST Issuer Rating -Dom Curr | P-2.za |

## Contacts


| Analyst | Phone |
|---|---|
| Kenneth Morare/Johannesburg | 27.11.217.5470 |
| Francesco Soldi/Milan | 39.02.9148.1100 |
| David Rubinoff/London | 44.20.7772.5454 |


## Key Indicators

**South African National Roads Ag. Ltd (The)**

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 (E) |
|---|---|---|---|---|---|---|
| Total Assets (ZAR million) | 9 826.3 | 16 690.0 | 30 603.7 | 187 084.0 | 220 490.7 | 226 569.6 |
| Operating margin (%) | 14.1 | 18.3 | 41.0 | 24.1 | 9.0 | 18.3 |
| Surplus (Deficit) for the Year / Total income (%) | 29.2 | 10.1 | 21.5 | -9.6 | -29.0 | -24.1 |
| Total Debt / Total Assets (%) | 63.1 | 66.2 | 67.1 | 12.8 | 14.4 | 16.2 |
| Debt / Cash flow from operations (x) | 17.5 | 8.2 | 21.3 | 27.1 | 18.4 | 13.1 |
| Cash interest cover ratio (x) | 1.0 | 2.1 | 1.7 | 0.6 | 0.8 | 0.9 |
| Current Assets / Current Liabilities (x) | 1.2 | 1.3 | 2.3 | 1.5 | 1.2 | 1.1 |

E - 2012 Figures are estimates.

## Opinion

### SUMMARY RATING RATIONALE

The Baa2/P-3 (Global scale, local and foreign currency) and A2.za/P-2.za (South African national scale) issuer ratings of the South African National Roads Agency Ltd (SANRAL) are underpinned by the company's public legal status - which is regulated by the Public Finance Management Act (PFMA) -, its close financial and operational linkages with the South African government, and SANRAL's good historical financial management. The ratings also consider the heightened uncertainties over the e-tolling operations on the company's largest road, the Gauteng Freeway Improvement Project (GFIP).

On 4 May 2012, Moody's downgraded SANRAL's long- and short-term issuer ratings to Baa2/P-3 and to A2.za/P-2.za, from Baa1/P-2 and Aa3.za/P-1.za, respectively. The ratings outlook has remained negative.

### Credit Strengths

The credit strengths for SANRAL include:

- State-ownership and public-policy mandate

- Close integration with the central government

- Traditionally adequate management of operational risks and low risks from existing off-balance sheet public-private partnership (PPP) projects

### Credit Challenges

The credit weaknesses for SANRAL include:

- Very high debt levels

- Uncertainties over Gauteng e-tolling operations

- Large debt exposure, partially guaranteed by the national government

- Expenditure pressure from maintenance of existing infrastructure

### Rating Outlook

The negative outlook reflects (i) SANRAL's weakening financial situation over the medium term and the inherent operational risks associated with the e-tolling system; and (ii) concerns over South Africa's deteriorating operating environment, as reflected by the negative outlook on South Africa's A3 government bond ratings.

### What Could Change the Rating - Up

Stabilization of SANRAL's ratings will require stabilisation of South Africa's government bond ratings, as well as a positive resolution of the GFIP issue leading to a stabilisation of SANRAL's financial position and prospects.

### What Could Change the Rating - Down

SANRAL's ratings could come under pressure in the event of (i) an unfavorable resolution of the GFIP toll issue, resulting in a further material deterioration of the company's financial metrics and cash flows, and/or a downgrade of South Africa's government bond rating.

### Recent Developments

On 28 April 2012, the North Gauteng high court ordered to halt e-tolling operations on SANRAL's largest toll road, the Gauteng Freeway Improvement Scheme (GFIP). The court ruling follows public protests that since mid-2011 led the national government to postpone the implementation of e-toll collections to 30 April 2012 from June 2011. More recently, and the government agreed on a significant reduction in e-toll rates, in return for which the authorities extended a ZAR5.75 billion budget allocation. The postponement of e-toll collections is credit negative for SANRAL, which relies on e-toll revenue to service its ZAR20 billion debt, which it incurred to finance GFIP's construction and absorb concomitant operating costs.

### Issuer Profile

SANRAL is a public company, wholly owned by the Republic of South Africa, with the Ministry of Transport representing the government as the sole shareholder. The company is ultimately accountable to the central government, which established SANRAL's mandate to develop, finance and manage the national road infrastructure in South Africa.

## DETAILED RATING CONSIDERATIONS

The rating assigned to SANRAL reflects the application of Moody's Joint Default Analysis (JDA) rating methodology for government related issuers (GRIs). In accordance with this methodology, Moody's first establishes the baseline credit assessment (BCA) for the entity and then considers the likelihood of support coming from the South African national government to avoid an imminent default by SANRAL, should this extreme event ever occur.

### Baseline Credit Assessment

SANRAL's BCA of 11 (equivalent to Ba1) on a scale of 1-21, where 1 represents the lowest credit risk, reflects the following factors:

Institutional Framework

SANRAL was established in 1998 by an Act of Parliament as an independent statutory company operating along commercial lines and at arm's length from the central government. As a national public entity under the PFMA, it is not subject to privatisation and bankruptcy; it does not pursue profit as a business objective; and it is tax exempt. SANRAL's legal status is also regulated by the South African National Roads Agency Limited and National Roads Act, No 7 of 1998.

The company operates under a mandate from the central government and operates under well-defined treasury-related corporate governance rules. The government is responsible for overall policy, and it approves new projects, annual transfers for non-toll road operations, toll charges, PPP initiatives, new debt and guarantees for new debt. Transport has traditionally played a central role in the creation of jobs and promoting economic transformation, sustainable growth and resource development. The government mandated SANRAL to consolidate and expand the national roads network, with a focus on maintaining the network in good order and resourcing finance from alternative sources to that of tax-based revenues. According to official sources, the national roads network is an integral part of the state infrastructure and there is no political will to privatise nor would it be practical to do so.

Financial Performance

SANRAL's budget has expanded considerably over the past five years, primarily supported by rising fiscal transfers from the national government and some growth in toll revenues. The current revenue composition (approximately 70:30 non-toll to toll revenues) illustrates a high degree of dependence on allocations from the national government for non-toll roads. In FY2011, government grants amounted to ZAR3.4billion, or 56% of SANRAL's revenue. Estimates for FY2012 indicate an 18% increase in revenue, supported by continued growth in fiscal transfers and some (approximately 3%) organic growth in existing toll operations. This provides comfort that existing tolls are operating well and were not affected by recent social opposition to GFIP e-tolls.

Within the remainder of the three-year period covered by the Medium-Term Expenditure Framework (MTEF, 2012-2014), we expect SANRAL's budget to reflect consistent fiscal transfers for non-toll roads as well as growing revenue from existing toll roads (excluding GFIP). FY2012 estimates show strong resilience despite the delay in e-tolls for the longer part of the financial year. Growing cash flow from operations partially offset the high finance costs of ZAR3.2 billion for the year. Despite generally positive results recorded in FY2012, going forward we expect significant financial pressure due to the continuing revenue loss as a result of the court proceedings.

Thus far, the delayed implementation of e-tolls has resulted in revenue losses of approximately ZAR2.7 billion for SANRAL, which is a sizable 40% of its estimated 2012 annual budget. These losses will grow by an estimated ZAR100 million each month that the delay continues and will gradually erode the company's cash buffer. We further believe that operational risks associated with GFIP e-toll project have substantially increased, following intense public opposition and unfavorable court resolutions. Also, the new legislation aimed at empowering SANRAL to enforce compliance is yet to be tested.

Besides the contentious GFIP Projects - SANRAL is also involved in PPP projects, under which toll road concessions are offered to private companies under build-operate-transfer (BOT) contracts. Of the total current toll road network of 3,120 km, about 60% is managed by SANRAL directly, whilst the balance relates to concessions. Moody's views off-balance sheet PPP projects as low risk, as BOT contracts basically transfer operational risks, including construction and funding, to third parties.

Debt and Liquidity

SANRAL's debt stock was expected to rise to ZAR39.7 billion for FYE2012, up from ZAR32.6 billion in FY2011. 57% of interest-bearing liabilities are bonds guaranteed by the South African government, with the balance (43%) made up of senior unsecured debt. Excluding total cash and cash equivalents and long-term investments as at 31 March 2012, SANRAL's total financial exposure falls to ZAR34.4 billion. The majority of this debt is fixed rate and rand-denominated. Maturities for SANRAL's debt are long dated, with 33% maturing between five and 10 years and 67% after ten years.

SANRAL relied extensively on borrowed funds to finance its operations and capex, benefiting from the implicit guarantee of the government of South Africa. In the past five years, the agency raised over ZAR33.5 billion funds from local investors and is currently one of the largest borrowers in the country. Going forward, we expect that the e-toll dispute will significantly impact SANRAL's business plan and borrowing strategy, at least in the short to medium term. We believe that SANRAL's high gearing and uncertainties over e-tolling issues could make it difficult for the company to debt-finance the operating deficits resulting from its loss of e-toll revenue.

SANRAL has historically reflected sufficient liquidity, underpinned by robust cash generated from operations and has recently been able to record positive cash flows despite previous e-toll delays. If not compensated by additional transfers or alternative source of funding, continued e-toll revenue shortfall will harm SANRAL's cash flows and liquidity position, with negative repercussions on its credit profile.

Governance and Management

The management structure and governance clearly point to a high degree of control and operational integration with the government. SANRAL's management practices are oriented towards improving operational efficiency, albeit within limits inherent in its public policy mandate. SANRAL consistently provides highly informative and comprehensive financial statements which usually do not include qualifications by the Auditor General.

Albeit relatively sophisticated and effective in managing enterprise-wide risks, the recent challenges associated with GFIP proved to be outside of the control of SANRAL's management and highlight the operational limits embedded in its arm's length nature. The GFIP toll issue also casts doubt on the government's transport policy strategy and the impact of the government's decisions on SANRAL's operations and financial sustainability. Prudent financial management, coupled with a clear policy strategy and financial commitment from the government is crucial for SANRAL to financially sustain itself.

**Extraordinary Support Considerations**

Moody's assigns a high likelihood of extraordinary support from the South African government, reflecting primarily SANRAL's status, which implicitly guarantees ultimate support of the central government. SANRAL performs its role - a critical component of the government's social and economic policy - on behalf of the central government. In contrast to other state-owned South African companies, there is no risk of migration towards a corporate structure.

Moody's also assigns a very high level of default dependence between SANRAL and the South African government, as SANRAL is subject to the same political and economic risks that can impact the country.

**ABOUT MOODY'S SUB-SOVEREIGN RATINGS**

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Methodology published in March 2011 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings."

Country Ceilings for Foreign Currency Obligations

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, in cases where foreign-currency denominated securities benefiting from special characteristics are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

Baseline Credit Assessment

Moody's baseline credit assessment incorporates the Government Related Issuer's (GRI) intrinsic credit strength and accounts for all aspects of the entity's existing (or anticipated) activities, including benefits (such as regular subsidies or credit extension) and/or detriments associated with the government relationship. In effect, the baseline credit assessment reflects the likelihood that a GRI would require extraordinary support.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a Government Related Issuer (GRI) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0 - 30%), moderate (31 - 50%), strong (51 -70%), high (71 - 90%) and very high (91 - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to GRIs, default dependence reflects the tendency of the GRI and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the government to provide extraordinary support and prevent a default by a GRI is conditional on the solvency of both entities, the more highly dependent - or correlated - the two obligors' credit profiles, the lower the benefits achieved from joint support. In most cases GRIs demonstrate moderate to very high degrees of default dependence with their supporting governments, which reflects the existence of institutional linkages and shared exposure to economic conditions that draw credit profiles together.

Default dependence is described as either low (30%), moderate (50%), high (70%) and very high (90%).

Moody's
INVESTORS SERVICE