Moody's Investors Service

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

Global Credit Research - 28 Aug 2009

Pretoria, South Africa

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	A3
NSR Issuer Rating -Dom Curr	Aa2.za
ST Issuer Rating	P-2
NSR ST Issuer Rating -Dom Curr	P-1.za

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Key Indicators

South African National Roads Ag. Ltd (The)

	2005	2006	2007	2008	[1]2009F
Total Assets (ZAR million)	9,076.1	9,270.2	9,826.3	16,690.0	30,603.7
Operating margin (%)	45.3	15.5	14.1	18.3	41.0
Surplus (Deficit) for the Year / Total income (%)	18.4	-9.4	-1.1	10.1	21.5
Total Debt / Total Assets (%)	71.5	71.7	63.1	66.2	67.1
Debt / Cash flow from operations (x)	7.3	8.7	17.5	8.2	21.3
Cash interest cover ratio (x) [2]	1.8	1.6	1.0	2.1	1.7
Current Assets / Current Liabilities (x)	1.0	0.8	1.2	1.3	2.3

[1] 2009 figures and ratios are inflated by a ZAR1 billion one-off revaluation of investment properties, which translates into an equivalent increase in non-cash income; [2] Cash flow from operations / Net finance expenditure.

Opinion

SUMMARY RATING RATIONALE

The A3/P-2 (Global scale, local and foreign currency) and Aa2.za/P-1.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, its key role for and close financial links with the central government. The ratings also take into account the potential increase in business risk arising from SANRAL's expansion strategy in the toll roads sector, with the accompanying substantial increase in leverage.

As a reflection of the application of Moody's Joint Default Analysis methodology for Government-Related Issuers, SANRAL's rating is composed of two principal inputs: a baseline credit assessment (BCA) of 8 (on a scale of 1 to 21, where 1 represents the lowest credit risk); and a high likelihood of support from the South African government (A3 stable outlook) to prevent a default in case of need.

In August 2009, we lowered SANRAL's BCA to 8, reflecting the recent downgrade of South Africa's local currency bond rating and the SANRAL's growing exposure to toll business risk and financial leverage. However, SANRAL's ratings are not affected by the change in the BCA, as they reflect a high likelihood of support from the South African government. The high likelihood of support primarily reflects SANRAL's status, which implicitly guarantees the ultimate support of the central government. SANRAL performs its mission - 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 type of structure.

Credit Strengths

The credit strengths for SANRAL include:

- Public entity 100% owned by the Republic of South Africa within a supportive legal framework

- Strategic importance for and oversight by the central government

- High degree of operational and financial integration with the government

- Adequate management of operational risks

- Low risk from existing off-balance sheet PPP projects

Credit Challenges

The credit weaknesses for SANRAL include:

- Expansion strategy involving new toll road projects increases business risk

- Rapidly growing debt burden, including non-guaranteed debt

- Expenditure pressure from maintenance of ageing infrastructure

Rating Outlook

The rating outlook is stable.

What Could Change the Rating - Up

The rating is sensitive to changes in country credit risk.

What Could Change the Rating - Down

The rating is sensitive to changes in country credit risk. Although unlikely, structural changes in the company's legal framework, its role in and its financial links with the state may also alter SANRAL's credit quality.

Issuer Profile

SANRAL is a public company, wholly owned by the Republic of South Africa, with the Minister of Transport representing the government as the sole shareholder. The company is accountable to the central government, which has determined its mandate to develop and maintain the national road infrastructure in South Africa. This currently comprises about 16,200 kilometres of roads, of which 81% are non-toll roads.

DETAILED RATING CONSIDERATIONS

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 Public Finance Management Act (PFMA), it is not subject to privatisation and bankruptcy, it does not pursue profit as a business objective and it is tax exempt. 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 approves new projects, annual transfers for non-toll road operations, toll charges, public-private partnership (PPP) initiatives, new debt and guarantees for new debt. The government recognises that transport plays a central role in the creation of jobs and promoting economic transformation, sustainable growth and resource development. The strategy is to consolidate and expand the national roads network, with a focus on toll roads, particularly in view of South Africa's hosting of the Football World Cup in 2010. 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 Position and Performance

SANRAL's budget has doubled in the past five years, with high and increased allocations from the central government to finance the ongoing expansion of operations and capital projects for non-toll roads - 64% of the company's revenue in 2009 (adjusted to ZAR1 billion non-cash income). Going forward, Moody's expects budget allocations from the central government to increase substantially due to the maintenance costs for the ageing infrastructure. High and increasing maintenance costs are expected to foster an increase in the operating expenditure to capital expenditure ratio to 30-70% from the current 20-80% by 2012.

Toll roads - 36% of SANRAL's adjusted income - are mostly financed by toll levies and debt issued by SANRAL with and without the explicit guarantee of the Republic of South Africa. Going forward, the company projects a regular increase in revenues from existing toll roads, while new toll roads are expected to contribute a minor proportion of the company's budget from 2011.

SANRAL's strategy is geared towards expanding the management of the South Africa's national roads network to around 20,000 km by 2010. Toll roads will play a pivotal role in SANRAL's expansion strategy, with a consequent increase in the company's exposure to toll business risk and financial leverage. In the coming years, we expect a deterioration of credit protection measures due to the start-up of the investment projects; however, SANRAL's good track record in past projects, established traffic patterns and the ultimate backing of the central government provide comfort with regard to the sustainability of these projects in the long term and the company's ability to meet its obligations.

Debt and Liquidity

Long-term borrowings at July 2009 were ZAR16.5 billion, including domestic bonds with (ZAR5.5 million) and without (ZAR9.9 billion) the government's guarantee, and a ZAR1 billion CPI-linked loan due 2018 and secured by a government guarantee. In addition to long-term borrowings, in 2009, SANRAL resorted to short-term debt of ZAR230 million. Discounting liquid assets, the total financial exposure reduces to ZAR12.8 billion. The majority of the borrowings (78%) are at a fixed rate, thus reducing its exposure to the volatile interest rate environment in South Africa, with no exposure to foreign currency risk. Excluding the CPI-linked loan, all debt is amortising and maturities are relatively long, with 32% maturing between five and ten years and 54% after ten years.

The long-term borrowing requirements of SANRAL are very ambitious given its corporate structure and budget volumes, and the company's debt exposure is expected to increase substantially in the coming years. In recent months, SANRAL obtained authorisation from the central government to issue guaranteed debt of up to ZAR31.9 billion through 2012.

SANRAL is also involved in PPP projects, under which toll road concessions are offered to private companies under BOT (build-operate-transfer) contracts. Currently, around 11% of the SANRAL's road network is managed by the company itself and 8% is allocated to concessionaires. 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.

Governance and Management Factors

The management structure and governance clearly point to a high degree of operational integration with the government. SANRAL's management practices are oriented towards improving operational efficiency, albeit within limits and principles embedded in its social mission and its instrumental role. SANRAL consistently provides highly informative and comprehensive financial documents, which do not include qualifications by the Auditor General. SANRAL has so far adequately managed operational risks associated with its business. Going forward, prudent financial management, combined with continued strategic and financial commitment from the government, will be core to supporting SANRAL's ability to sustain its expansion strategy without impairing its finances.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's assigns national scale ratings in certain local capital markets in which investors have found the global rating scale provides inadequate differentiation among credits or is inconsistent with a rating scale already in common use in the country. Moody's National Scale Ratings are opinions of the relative creditworthiness of issuers and issues within a particular country. While loss expectation will be an important differentiating factor in the ultimate rating assignment, it should be noted that loss expectation associated with National Scale Ratings can be expected to be significantly higher than apparently similar rating levels on Moody's global scale. Moody's National Scale Ratings rank issuers and issues in order of relative creditworthiness: higher ratings are associated with lower expected credit loss.

National Scale Ratings can be understood as a relative ranking of creditworthiness (including relevant external support) within a particular country. National Scale Ratings are not designed to be compared among countries; rather, they address relative credit risk within a given country. Use of National Scale Ratings by investors is only appropriate within that portion of a portfolio that is exposed to a given country's local market, taking into consideration the various risks implied by that country's foreign and local currency ratings.

The Moody's Global Scale rating for issuers and issues in local currency allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

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, for foreign-currency denominated securities benefiting from special characteristics that 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%), medium (31% - 70%) or high (71% - 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, the close economic links and/or close intergovernmental fiscal arrangements between a GRI and its associated government result in a medium to high degree of default dependence.

Default dependence is described as either low (0% - 30%), medium (31% - 70%) or high (71% - 100%).