Moody's
INVESTORS SERVICE

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

Global Credit Research - 17 Jun 2011

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)

	2006	2007	2008	2009	[1]2010
Total Assets (ZAR million)	9 270.2	9 826.3	16 690.0	30 603.7	187 084.0
Operating margin (%)	15.5	14.1	18.3	41.0	24.1
Surplus (Deficit) for the Year / Total income (%)	-9.4	-1.1	10.1	21.5	-9.6
Total Debt / Total Assets (%)	71.7	63.1	66.2	67.1	12.8
Debt / Cash flow from operations (x)	8.7	17.5	8.2	21.3	27.1
Cash interest cover ratio (x) [2]	1.6	1.0	2.1	1.7	0.6
Current Assets / Current Liabilities (x)	0.8	1.2	1.3	2.3	1.5

[1] Balance sheet ratios are inflated by ZAR145 billion revaluation of properties, plant and equipments. Income statement and cash flow ratios are net off this extraordinary non cash item. [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 - which is regulated by the Public Finance Management Act (PFMA) -, its key role for and close financial links with the South African 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. These downside risks are mitigated by SANRAL's good financial management and planning ability, and by the government's sponsorship.

Credit Strengths

The credit strengths for SANRAL include:

- Public legal status within a supportive legal framework

- Strategic importance for and close integration with the central government

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

Credit Challenges

The credit weaknesses for SANRAL include:

- Expansion strategy involving new toll road projects increases business risk

- Rapidly growing debt levels, albeit sponsored by the national government

- 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, any 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 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 8 (equivalent to Baa1) 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.

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. 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. 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 in the past five years, primarily supported by growing fiscal transfers from the national government, and growing toll revenue inflows, albeit to a lesser extent. The current revenue composition - of 68:32 non-toll to toll revenues - illustrates a high degree of SANRAL's dependence on allocations from the national government to discharge its mandate of providing and maintaining the national road infrastructure network. Government grants are set to further increase in FY2011, with a total of ZAR2.3 billion already recorded in semi-annual reports as at 30 September 2011 - same level as full FY2010. Notwithstanding the sustained revenue growth over the previous years, SANRAL faces lingering expenditure pressure for the maintenance of the existing road network and the start-up of new capital projects. When revenues are adjusted to ZAR144.8 billion (USD21 billion) revaluation of property, plant and equipment, SANRAL reported a loss of ZAR427 million in FY2010, or 9.7% of its annual revenue.

In the three-year period covered by the Medium-Term Expenditure Framework (MTEF, 2011-2013), we expect SANRAL's projects to show continued revenue increase, driven by growing traffic volumes on toll roads and consistent fiscal transfers for non-toll roads. Operational spending activities in the MTEF's non-toll network comprises 33% of the total non-toll revenues, leaving the balance of 67% available for utilisation in new capital projects. During the MTEF period, SANRAL expects to spend ZAR12.9 billion on capex which includes improvements to the existing road network as well spending on new facilities; the implementation of new projects will require significant new borrowings, with consequent increase in debt service requirements. Half-year finance costs constituted a high 45% of corresponding semi-annual total revenues of ZAR3.1 billion as at 30 September 2010.

SANRAL's strategy is focused on expanding the management of South Africa's national roads network to around 20,000 km from the current 16,200 kilometres (of which 81% are non-tolled roads). Toll roads - mostly financed by toll levies and debt issued by SANRAL - 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. Long-term forecasts for toll road projects indicate the debt burden climbing rapidly during the construction phase of the toll roads and net operating cash flows being adversely affected by the rising interest costs. Whilst the implementation of its investment projects will result in a deterioration of credit protection measures, SANRAL's good track record in past projects, established traffic patterns as well as 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 financial obligations.

Debt and Liquidity

Unaudited figures reflect SANRAL's debt stock accelerating to ZAR30.2 billion by 30 June 2011, from ZAR26.9 billion in FY2010. The interest-bearing liabilities largely comprise bonds guaranteed by the South African government (58%), non-guaranteed bonds 39%, and CPI-linked loan due in 2018 and secured by government guarantee (3%). Net off total cash and cash investments (as at 31 March 2011), SANRAL's total financial exposure reduces to ZAR25.6 billion. The majority of the borrowings (82%) are at a fixed rate and all borrowings are in domestic currency. Maturities for SANRAL's debt are long dated, with 33% maturing between five and ten years and 67% after ten years.

SANRAL's long-term borrowing requirements are substantial and the significant upward trend in debt levels will continue in the three-year period (2012-2014) to fund the entity's aggressive strategy of expanding and improving the national toll road network. In fact, a total of ZAR6.2 billion worth of debt was issued for FY2011, with a total of ZAR6.7 billion earmarked for issuance in the next three years ending 31 March 2014 out of the total pool of ZAR31.9 billion government guarantee authorised in 2009. This could propel SANRAL's gross indebtedness to ZAR37 billion by 2014. Notwithstanding the inherent business risk, revenues to be generated from the forthcoming tolling sources, especially the Gauteng Freeway Improvement Project (GFIP) will substantially bolster SANRAL's tolling base and should enable the entity to scale down on the aggressive debt issuance as funds generated from operations will contribute significantly towards funding the continuous capex in the near-term.

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.

Liquidity continues a moderate growth, underpinned by robust cash and cash equivalents which increased to ZAR2.9 billion at mid-year 30 September 2010 - from ZAR1.6 billion for the full FY2010. In addition, SANRAL also has long-term investments of ZAR1.3 billion. Available cash holdings are sufficient to absorb ZAR1.2 billion of debt repayments in FY2011.

Governance and Management

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 inherent in the Regulatory Framework which provides for, amongst others, the entity's national social responsibility and the key instrumental role it plays for the government. SANRAL consistently provides highly informative and comprehensive financial statements which usually do not include qualifications by the Auditor General. SANRAL has so far adequately managed its enterprise-wide risks, including those associated with business strategy and operations. Prudent financial management, coupled with continued strategic and financial commitment from the government is crucial for SANRAL to financially sustain its expansion strategy.

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 Implementation Guidance published in August 2010 entitled "Mapping Moody's National Scale Ratings to Global Scale 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, 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%).

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