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Research Update:

Transnet SOC Ltd. Ratings, Including 'BB-' Issuer Credit Rating, Placed On CreditWatch Negative On Elevated Leverage

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Rating Action Overview

- We expect Transnet's operational performance will gradually improve, but anticipate that the company's cash flow will not rise sufficiently or quickly enough to maintain its existing liquidity, leverage, and capital structure.
- At the same time, the company's capital expenditure (capex) requirements and debt servicing costs are elevated, in our view, leaving limited room foroperational underperformance.
- We believe the company will likely require incremental government support to transform its capital structure, fund capex and meet upcoming debt maturities.
- Therefore, we placed the ratings on Transnet, including the 'BB-' issuer credit rating, national scale ratings, and our rating on its senior unsecured debt, on CreditWatch with negative implications. We affirmed our 'BB' issue rating on its South Africa rand (ZAR) 3.5 billion government-guaranteed debt.
- The CreditWatch placement reflects the increased likelihood of a downgrade if the anticipated turnaround in Transnet's business performance and cash flow generation does not materialize soon enough to control the current leverage levels and capital structure.

Rating Action Rationale

The CreditWatch placement reflects our view that Transnet's cash flow will not improve sufficiently or quickly enough to maintain its existing leverage, and capital structure. That is because we see Transnet's leverage remaining elevated (without government support), which will result in the company generating persistent negative FOCF. While we expect Transnet's performance will gradually improve as its turnaround initiatives and government-instituted freight logistics sector reforms slowly take effect, leverage and debt service costs remain very high. We estimate Transnet's gross debt could increase to about ZAR151 billion by the end of fiscal 2025 from ZAR134.7 billion at the end of fiscal 2024. Consequently, we estimate the company's annual

interest expense will remain high at ZAR15 billion-ZAR17 billion. At the same time, high annual capex (ZAR26.5 billion in fiscal 2025 and ZAR30.5 billion in fiscal 2026) will result in the company generating negative annual S&P Global Ratings-adjusted FOCF of ZAR15 billion-ZAR16 billion. Therefore, we expect Transnet's cash flow will not improve sufficiently or quickly enough to retain a long-term capital structure commensurate with our 'BB-' issuer credit rating. We also think that our forecast level of cash generation leaves management with limited room for operational underperformance.

We continue to see a very high likelihood of Transnet receiving extraordinary support from the government. The South African government has instituted measures to help Transnet, including advancing ZAR5.8 billion for capex and flood damage-related repairs in fiscal 2023 (ended March 31, 2023) and a ZAR47 billion guarantee facility (provided in fiscal 2024). We also understand that as part of Transnet's funding plan for the period up to the end of fiscal 2026, the company will receive, in addition to the ZAR47 billion guarantee framework, further guarantees. Two recently concluded facilities totaling about ZAR19.6 billion are expected to receive these additional guarantees. Furthermore, we understand that the National Treasury is exploring numerous infrastructure project funding mechanisms to assist Transnet with reducing the capex burden on its generated cash flows. The recently delivered Medium Term Budget Policy Statement disclosed the Cape Town Container Terminal Expansion Phase 2B and Ukuvuselela Gauteng-Eastern Cape High-Capacity Rail Corridor as part of the contemplated project funding.

That said, we note that Transnet' persisting liquidity and capital structure challenges imply a requirement for significant additional government support. Our assessment of the likelihood of extraordinary government support results in an uplift of the SACP and our issuer credit rating to 'BB-'. Should we view the certainty on the quantum, form, and timing of further government support as reduced, we could revise our assessment of very high government support downward. We will particularly focus on the timely or sustainable manner of government support as we see this as required to effect Transnet's capital structure and operational transformations. This is because Transnet's operating model, long-term prospects and the company's role and reach will likely evolve given the anticipated cumulative effects of sector-wide reforms.

Notwithstanding the challenges facing Transnet, we think the company continues to play an instrumental role in South Africa's transport industry and by extension its economic growth, due to its control of all major logistics infrastructure. Transnet has a dominant position in rail freight and monopoly positions in regulated port and pipeline activities. Consequently, it enjoys good diversity and some revenue visibility due to TFR's take-or-pay contracts and pipelines and national ports regulated tariff linked revenue.

We expect Transnet's financial performance and credit metrics to sequentially improve in fiscal years 2025 and 2026, but remain weak due to a high fixed-cost base and elevated balance sheet debt. Transnet put in place a recovery plan in October 2023 and has been focusing on improving its operations on the back of an expected recovery in rail and port volumes performance over an 18-month period ending March 2025. While the company continues to make progress in optimizing the use of existing infrastructure and improving its operational efficiency, significant capex is required for the company to realize expected turnaround plan volumes. Moreover, operational challenges--including vandalism on the rail lines--persist. Notably, in fiscal 2024, Transnet's freight volumes grew to 151.7 million metric tons (mt) from 149.5 million mt, halting a five-year-long decline in freight rail volumes. For fiscal 2025, Transnet is targeting to handle about 170 million mt and expects improving availability of locomotives to aid further recovery in rail volumes. Under our base case, we expect the improvement in rail volumes and efforts to improve

availability of ports equipment will lead to revenue improving to about ZAR82 billion–ZAR88 billion versus our previous expectation of ZAR72 billion–ZAR74 billion. However, given Transnet's high fixed-cost base, we expect Transnet to generate S&P Global Ratings-adjusted EBITDA margins of 36%-38% over fiscal years 2025 and 2026 (translating into EBITDA of ZAR26 billion-ZAR32 billion), still below historical margins of 45% when Transnet Freight Rail was delivering volumes around 183 million mt. With structurally high cash uses due to high levels of debt, we forecast the company will generate adjusted annual funds from operations (FFO) of ZAR11 billion-ZAR16 billion over fiscal years 2024 and 2025. Our financial risk assessment therefore incorporates our expectation that Transnet's credit metrics will remain within the indicative ratio ranges for a highly leveraged financial risk profile, including S&P Global Ratings-adjusted debt to EBITDA above 5x and FFO to debt below 12%.

CreditWatch

The CreditWatch with negative implications reflects our view that Transnet's cash flow will not improve sufficiently or quickly enough to maintain its existing leverage levels, and capital structure.

We could take a negative rating action over the coming months if Transnet does not have a firm and viable plan to reduce leverage, and negative FOCF worsens because of slower-than-expected improvement in operating cash flow.

We could resolve the CreditWatch placement if the company addresses operational challenges faster than expected, leading to enhanced cash flows. In resolving the CreditWatch, we will also determine if Transnet's balance sheet optimization plan and/or additional government support are in our view credible and sufficient to achieve a long-term capital structure commensurate with our 'BB-' issuer credit rating.

Company Description

Transnet, which is wholly state owned, owns and operates integrated rail freight, port, and pipeline infrastructure in South Africa. The company's main objectives include constructing an efficient rail freight system to reduce reliance on road transport, and operating 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 six core operating divisions, contributing about 51% of fiscal 2024 revenue and 36% of EBITDA. Regulated activities, which are subject to the National Energy Regulator for pipelines or the Port Authority Regulator for the National Ports Authority business, account for 42% of the company's revenue and 64% of EBITDA. Since 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. The remainder of the freight rail unit's business is exposed to competition.

Transnet also provides cargo-handling services and container activities in ports.

Our Base-Case Scenario

Assumptions

- South African real GDP growth of 1% in 2024, 1.6% in 2025, and 1.4% and 2026.
- Annual revenue growth of 5%-8%, versus our previous expectation of 2%-4% in fiscals 2025 and 2027.
- S&P Global Ratings-adjusted EBITDA margin of 31%-36% over the coming two years compared with our previous expectation of 35%-38%. Our lower EBITDA expectations are underpinned by Transnet's high fixed-cost base and the strain on costs from operational issues.
- Annual capex of ZAR26.5 billion in fiscal 2025, increasing to ZAR30 billion-ZAR31 billion in fiscal years 2026 and 2027.
- No dividend distributions in the forecast period.

Key metrics

Transnet SOC Ltd.--Forecast summary

	--Fiscal year ended March 31--				
(Mil. ZAR)	**2023a**	**2024a**	**2025e**	**2026f**	**2027f**
Revenue	68,715	76,699	81,578	87,888	92,812
EBITDA	24,122	21,003	25,896	31,839	35,296
Funds from operations (FFO)	10,483	4,005	10,536	15,968	18,160
Cash flow from operations (OCF)	19,020	11,528	10,693	15,509	15,904
Capex	11,892	14,151	26,477	30,524	30,609
Free operating cash flow (FOCF)	7,128	(2,623)	(15,784)	(15,015)	(14,705)
Debt	129,235	142,941	158,725	174,427	189,778
Cash interest expense	13,639.0	17,000	15,360	15,871	17,137
Adjusted ratios					
EBITDA margin (%)	35.1	27.4	31.7	36.2	38.0
Debt/EBITDA (x)	5.4	6.8	6.1	5.5	5.4
FFO/debt (%)	8.1	2.8	6.6	9.2	9.6
FFO cash interest coverage (x)	1.8	1.2	1.7	2.0	2.1
EBITDA interest coverage (x)	1.8	1.3	1.7	2.0	2.0
OCF/debt (%)	14.7	8.1	6.7	8.9	8.4
FOCF/debt (%)	5.5	(1.8)	(9.9)	(8.6)	(7.7)

All figures are adjusted by S&P Global Ratings, unless stated as reported. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess the Transnet's liquidity as less than adequate, based on our estimate that the ratio of liquidity sources to uses will be less than 1.2x in the 12 months started Oct. 1, 2024. We also expect financial headroom to be tight and put pressure on cash FFO generation considered in our liquidity assessment. Transnet's liquidity has, however, improved since our previous review in November 2023. This is mainly due to the recently completed funding initiatives of ZAR32 billion supported by capacity under the ZAR47 billion government guarantee and about ZAR19.6 billion concluded on the back of additional government guarantees.

While we expect operational cash flows will improve over the next 12 months in line with an improvement in port and rail volumes, we consider that prospects for an improvement in the cash interest covenant headroom remain limited due to high net finance costs. We note, however, that the supportive nature of Transnet's banking relationships, as seen in lenders granting waivers for financial and nonfinancial covenant breaches several times over the past few years.

We estimate that principal liquidity sources over the 12 months started Oct. 1, 2024, will include:

- Cash and liquid investments of about ZAR10.9 billion;
- Committed undrawn bank lines maturing beyond 12 months of about ZAR4.1 billion;
- Expected average annual cash FFO of about ZAR13.5 billion; and
- ZAR45.6 billion facilities raised, supported by government guarantees.

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

- Short-term debt maturities of ZAR33.9 billion;
- Negative working capital of about ZAR690 million;
- Annual maintenance capex of about ZAR30 billion; and
- No dividends, acquisitions, or mergers.

Covenants

On March 31, 2024, approximately 39% of Transnet's total debt contained rating-related covenants. In addition, some loans contain a leverage covenant stipulating debt to debt plus equity of 60% and cash interest coverage (CIC) of 2.0x-2.5x.

Transnet's leverage covenant was within the debt covenant requirement on the same date, at 46.2%, and the CIC was 1.9x, in breach of covenants on 11 loans, with a total capital balance of ZAR45.4 billion. After fiscal year-end 2024, Transnet secured waivers from all lenders affected by the breach.

Based on our current forecasts, we expect a breach on the CIC covenant through fiscal 2025, due to constrained cash flow and high net finance costs.

Environmental, Social, And Governance

Social and governance factors are negative considerations in our credit rating analysis of Transnet.

Social risks are more prevalent in emerging economies such as South Africa. Underlying social tensions and inequalities, which in 2021 manifested as severe social unrest that interrupted national supply chains, translate into weaker business and investment conditions, affecting operating efficiency. Infrastructure damage from human encroachment and criminality elevates safety risk and undermines Transnet's ability to operate at planned capacity. For example, in 2021, train derailments affected the company's dedicated coal line, and a cyberattack complicated port and railway operations. Floods in parts of South Africa in 2022 also damaged infrastructure, hitting operating efficiency in rail, port, and pipeline operations.

Transnet also has a weaker governance structure and risk management framework relative to peers'. Governance failures and irregularities, allegedly involving the company's former board and executive team, enabled operational mismanagement and misconduct related to procurement processes before 2019. Although there has been progress in the past several years, governance challenges will take time to remediate, and recent executive management churn will place focus on how the entity's governance structure and risk management framework is further strengthened.

Issue Ratings--Subordination Risk Analysis

Capital structure

We align our issue ratings on Transnet's debt with the respective global scale and national scale issuer credit rating due to the low amount of secured and priority debt issued by the operating entities. We estimate senior secured debt of about 20%, which is below our 50% threshold for lowering issue ratings.

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	BB-/Watch Neg/--
Business risk:	Fair
Country risk	Moderately high
Industry risk	Low
Competitive position	Fair
Financial risk:	Highly leveraged
Cash flow/leverage	Highly leveraged
Anchor	b
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)

Issuer Credit Rating	BB-/Watch Neg/--
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Less than adequate (no impact)
Management and governance	Moderately negative (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	b
Group credit profile	b
Related government rating	Foreign currency 'BB-'; Local currency 'BB'
Likelihood of government support	Very high (+2 notches)

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- General Criteria: National And Regional Scale Credit Ratings Methodology, June 8, 2023
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013

Related Research

- Tear Sheet: Transnet SOC Ltd., April 19, 2024.
- Transnet SOC Ltd. 'BB-' Ratings Affirmed; Outlook Negative; SACP Revised To 'b' On Reassessed Competitive Position, Nov. 13, 2023.

Ratings List

CreditWatch Action; Ratings Affirmed;

	To	From
Transnet SOC Ltd.		
Issuer Credit Rating	BB-/Watch Neg/--	BB-/Negative/--
South Africa National Scale	zaAA-/Watch Neg/zaA-1+	zaAA-/--/zaA-1+
Senior Unsecured	BB-/Watch Neg	BB-
Ratings Affirmed		
Transnet SOC Ltd.		
Senior Unsecured*	BB	
*Guaranteed by Republic of South Africa		

Regulatory Disclosures

- Primary Credit Analyst: Munya Chawana, Associate
- Rating Committee Chairperson: Omega Collocott
- Date initial rating assigned: Sept. 4, 1997
- Date of previous review: Nov. 13, 2023

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This credit rating is solicited. The rated entity did participate in the credit rating process. S&P Global Ratings did have access to the accounts, financial records and other relevant internal, non-public documents of the rated entity or a related third party. S&P Global Ratings has used information from sources believed to be reliable but does not guarantee the accuracy, adequacy, or completeness of any information used.

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.
- ESG credit factors: Those environmental, social, and governance (ESG) factors that can materially influence the creditworthiness of a rated entity or issue and for which we have sufficient visibility and certainty to include in our credit rating analysis. These credit factors can have a negative or positive impact on creditworthiness, depending on whether they represent a risk or an opportunity.
- 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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