Transnet SOC Ltd. 'BB-' Ratings Affirmed; Outlook Remains Negative

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S&PGR Affirms Transnet SOC Ltd. At 'BB-'; Outlook Negative

Overview

- Transnet SOC Ltd. (Transnet)'s post-pandemic earnings recovery has been slower than we anticipated given persistent operational challenges, particularly in rail, and the effects of floods, strikes, and criminality on infrastructure stability and service delivery.
- We revised down Transnet's financial risk profile to aggressive from significant given our expectation of slow revenue growth and lower margins in the fiscal years ending March 31, 2023-2024; forecast free operating cash flow (FOCF) is negligible at a time when the company has limited liquidity buffers, elevated maintenance capital expenditure (capex) needs, and high upcoming debt repayments.
- Higher financial risk combined with our view that liquidity is less than adequate, and that the risk of covenant breaches remain elevated, has also led us to revise down Transnet's stand-alone credit profile (SACP) to 'b+' from 'bb-'—.
- We view Transnet as benefitting from a very high likelihood of support (LOS) from its owner, the government of **South Africa** (foreign currency rating BB-/Positive), and note that a South African rand (ZAR) 5.8 billion cash transfer has been earmarked for the company in the next four months.
- We therefore affirmed our 'BB-' issuer credit ratings on Transnet, 'BB-' issue rating on its senior unsecured debt, 'BB' issue rating on its ZAR 3.5 billion government-guaranteed debt, and the 'zaAA/zaA-1+' South Africa national scale ratings.
- The negative outlook reflects our view that current operational challenges, as well as ongoing liquidity and refinancing risks, remain significant.

Rating Action Rationale

We revised our assessment of Transnet's financial risk profile downward to aggressive from significant given persisting operational challenges and insufficient investment hampering robust cash flow recovery.

Transnet's operational challenges remain largely unresolved leading to weaker operational performance than we previously anticipated. These challenges include having a less-than-optimal number of locomotives in operation for its main revenue and EBITDA generating division, Transnet Freight Rail (TFR), as well as cable theft, infrastructure vandalism, and flooding earlier in 2022. Operational challenges compounded by the recent two-week staff strike, and the effects of rising inflation on operational costs, lead us to believe Transnet will continue to face significant headwinds to its recovery, pressuring profitability and FOCF. Therefore, we revised down our base-case projections, leading to weaker forecast operating metrics. We now expect the company to post S&P Global Ratings-adjusted EBITDA margins of about 36%-38% over the next two years relative to our previous expectation of 38%-40%. Our lower EBITDA expectations are underpinned by Transnet's high fixed-cost base and the strain on costs from operational issues. We now forecast annual funds from operations (FFO) of ZAR15 billion-ZAR16.0 billion for fiscals 2023-2024, versus our previous expectation of ZAR18 billion–ZAR20 billion. At the same time, we expect capex requirements will remain significant (about ZAR15 billion-ZAR16 billion) given sub-optimal investment in prior years. Based on our view of Transnet's weaker financial risk profile, our SACP assessment for the company is now 'b+' compared with 'bb-' previously. Transnet has multiple strategic initiatives that it expects to benefit its core operations. In our view, the resolution of locomotive availability as well as the containment of security incidents, which have disrupted TFR operations significantly in the past few years, are more likely to be credit positive.

We now see the very high likelihood of Transnet receiving extraordinary support from the government as more prominent for our rating, providing one notch of uplift above the 'b+' SACP.

Our LOS assessment is based on the company's very important role for South Africa, owing to its position as the monopoly provider of port and pipeline infrastructure, dominant position in port operations and freight rail, and very strong link with the state. The government fully owns Transnet and oversees its strategy, funding plans, and regulation. We previously noted that we could revise our LOS assessment downward if Transnet's liquidity continued to deteriorate without an adequate response from the government. Notably, as Transnet's cash flows and liquidity have deteriorated in fiscal 2023, partly due to

unforeseen events such as flooding, in October 2022 the government allocated ZAR5.8 billion in funding to the company, with disbursement expected in the coming months. In our view, our current LOS is underscored by this extraordinary financial support, together with nonfinancial support including Transnet's exemption from specified provisions of South Africa's Public Finance Management Act (PFMA) and National Treasury Instruction Note No. 2 of 2019/2020, which serve to reduce Transnet's risk of events of default arising from audit qualifications for the next two fiscal years.

Our business risk assessment continues to balance Transnet's instrumental role in South Africa as a major transportation company against our view of weaker and more volatile operating and service delivery outcomes.

Transnet plays an instrumental role in South Africa's transport industry and by extension its economic growth, due to its control of all major logistics infrastructure assets. The company has a dominant position in rail freight and monopoly positions in regulated port and pipeline activities. Consequently, it enjoys good diversity and high barriers to entry in its business segments. Although the company is exposed to the volatile commodities industry, revenue declines are somewhat mitigated by 65% of TFR's volumes being under take-or-pay contracts, which guarantee fixed revenue (provided that Transnet has the capacity to deliver on contracted volumes). We also understand that at least 30% of Transnet's earnings (from pipelines and national ports) are derived from regulated tariff determinations. Despite strong revenue underpinning its operations, Transnet's weakening operating efficiency and elevated profit volatility, due to escalating cable theft, vandalism, infrastructure sabotage, as well as infrastructure underinvestment and rehabilitation, represent downside risk to our business risk assessment. Transnet's current inability to provide the rail volumes required by its customers, particularly in the bulk commodities space, raises the risk of customers turning to alternative transportation channels and port providers to maintain their export volumes. Notably, we expect gross revenue from TFR to be about 12% lower in fiscal 2023 than fiscal 2019 and its 58% contribution to revenue/EBITDA to fall to 55% for revenue and 50% for EBITDA over the same period. We have seen increased use of road freight and non-Transnet-controlled ports in neighboring countries by bulk commodity exporters, as companies wish to capitalize on supportive commodity prices and prioritize service reliability over price.

We believe further funding success and improved cash flow are required before healthy liquidity levels are achieved and covenant headroom risk is reduced.

As noted in our recent article (see "
DisplayText cannot span more than one line!," published July 25, 2022, on RatingsDirect), recent fundraising efforts prompted us to see the refinancing risk in fiscal 2023 (ending March 31, 2023) as largely, but not completely resolved. However, given that long-term funding is yet to be secured ahead of Transnet's next significant debt maturity in February 2023, we estimate the liquidity buffer to be well below 20% and still see tight headroom under Transnet's cash interest coverage covenant, underpinning our assessment of the group's liquidity as less than adequate. We note that material operational underperformance and inability to refinance short-term facilities with longer-term debt heighten liquidity pressure over the next few months. Our assessment of liquidity as less than adequate (as opposed to weak) considers the supportive nature of Transnet's banking relationships and that Transnet is well advanced with several funding initiatives. Therefore, we do not consider the improvement in Transnet's liquidity as solely dependent onlow probability, unforeseen events; an important consideration under our criteria for assessing weak liquidity.

Outlook

The negative outlook reflects our view that the current operational challenges and environment, as well as ongoing liquidity and refinancing risks, remain significant.

Downside scenario

We could downgrade Transnet if its SACP weakens to 'b-' from 'b+' due to:

- A deterioration of liquidity, to our weak category from less than adequate;
- Materially weaker cash flows and financial metrics than we forecast because of an interruption of volume recovery or worsening capacity constraints; or
- Heightened cash flow volatility, leading us to apply higher financial thresholds at the same rating level.

We could also lower our rating if we view the LOS to have weakened. This could result if we view the government's response to further negative operating or liquidity developments at Transnet as neither timely nor sufficient.

Upside scenario

We may raise the rating if we see improvement in Transnet's cash flow or liquidity. This could happen if the company addresses operational challenges faster than expected, leading to enhanced cash flow, and it secures additional long-term funding while maintaining manageable leverage. We may also raise the rating if we take a similar action on South Africa.

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 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 51% of fiscal 2022 revenue and 68% 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 23% of Transnet's revenue and 48% of EBITDA. As 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.

Transnet also provides cargo-handling services and container activities in ports, which accounted for about 17% of its EBITDA in fiscal 2022.

Our Base-Case Scenario

Assumptions

- South African real GDP growth of 1.9% in 2022, 1.5% in 2023, and 1.7% in 2024.
- Revenue is expected to increase modestly by 3.8% in fiscal 2023 relative to our previous expectation of about 10%, then rise 6%-8% in fiscal 2024 and 4%-6% in fiscal 2025.
- S&P Global Ratings-adjusted EBITDA margin of 36%-38% over the coming two years relative to our previous expectation of 38%-40%. Our lower EBITDA expectations are underpinned

by Transnet’s high fixed-cost base and the strain on costs from operational issues.
- Annual capex of ZAR15 billion-ZAR16 billion in fiscals 2023-2024.
- No dividend distributions in the forecast period.

Key metrics

Transnet SOC Ltd.*--Key Metrics -

Liquidity

We consider the group's liquidity less than adequate, based on our estimate that the ratio of liquidity sources to uses will be less than 1.2x in the next 12 months, and that financial headroom is tight. Our assessment of liquidity as less than adequate (as opposed to weak) considers the supportive nature of Transnet’s banking relationships, evidenced by lenders granting waivers for financial and nonfinancial covenant breaches several times over the past few years. It also takes into consideration that Transnet is well advanced with several funding initiatives, and therefore, we do not consider the improvement in Transnet’s liquidity as solely dependent on low probability, unforeseen events..

We estimate that principal liquidity sources over the 12 months started Oct. 1, 2022, will include:

- Cash and liquid investments and committed undrawn bank lines maturing beyond 12 months of about ZAR9.5 billion;
- Expected average annual cash FFO of about ZAR15.6 billion.
- Government support of ZAR5.8 billion.

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

- Short-term debt maturities of ZAR23 billion;
- Negative working capital of about ZAR500 million;
- Annual capex of ZAR15.4 billion; and
- No dividends, acquisitions, or mergers in the short term.

Covenants

We understand that certain loan agreements (approximately 39% of Transnet's total debt at March 31, 2022), contain rating-related

covenants. Between 2017 and 2021, the ratings on South Africa were on a downward trajectory, and, during this period, Transnet successfully negotiated with its lenders regarding covenant triggers for facilities. Should there be any negative rating actions on Transnet, 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 fundraising capability and liquidity position.

In addition, some loans (about 38% of Transnet's outstanding debt at March 31, 2022) contain leverage and cash interest coverage covenants. At March 31, 2022, Transnet met these covenants with ratios of 45.5% and 2.6x respectively. Based on our current forecasts, we expect Transnet’s ability to meet the cash interest coverage, at the end of fiscal 2023, to be dependent on management’s working capital management initiatives. If we expect the coverage covenants will be breached and there is no credible plan to mitigate the breach, such as obtaining covenant lifts or waivers, we might reassess the company's liquidity as weak, which could result in our SACP assessment being capped at 'b-'.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-4, G-4

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 Transnet’s dedicated coal line, and a cyberattack complicated port and railway operations. Recent floods in parts of South Africa in 2022 have 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 Transnet's former board and executive team, enabled operational mismanagement and misconduct in relation to procurement processes prior to 2019. Although we see positive progress under

the new leadership, governance challenges will take time to remediate.

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

RSSTbl	**Table RSS**
Issuer Credit Rating	BB-/Negative/--
Business risk:	Satisfactory
Country risk	Moderately high
Industry risk	Low
Competitive position	Satisfactory
Financial risk:	Aggressive
Cash flow/leverage	Aggressive
Anchor	bb
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Less than adequate (-1 notch)
Management and governance	Fair (no impact)
Comparable rating analysis	Negative (-1 notch)

Stand-alone credit profile:	b+
Group credit profile	b+
Entity status within group	N/A
Related government rating	foreign currency 'BB-'; local currency 'BB'
Likelihood of government support	Very high
Rating above the sovereign	N/A

Related Criteria

- **DisplayText cannot span more than one line!**, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- **DisplayText cannot span more than one line!**, April 1, 2019
- **DisplayText cannot span more than one line!**, June 25, 2018
- **DisplayText cannot span more than one line!**, March 28, 2018
- **DisplayText cannot span more than one line!**, March 25, 2015
- **DisplayText cannot span more than one line!**, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- **DisplayText cannot span more than one line!**, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- **DisplayText cannot span more than one line!**, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- South Africa 'BB-/B' Foreign Currency Ratings Affirmed; Outlook Remains Positive, Nov. 18, 2022.

Ratings List

Regulatory Disclosures

- Primary Credit Analyst: Munya Chawana, Associate
- Rating Committee Chairperson: G. Andrew Stillman
- Date initial rating assigned: Sept. 4, 1997
- Date of previous review: July 25, 2022

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.

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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where necessitated by the updated Ratings Model.

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.
- ESG credit indicator: An ESG credit indicator is an alphanumeric representation of the qualitive assessment of ESG factors' impact on creditworthiness produced as part of the ratings process. Our ESG credit indicators provide additional disclosure by reflecting our opinion of how material the influence of ESG factors is on the various analytical components in our rating analysis through an alphanumerical 1-5 scale. ESG credit indicators are applied after the ratings have been determined.
- 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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