BANK OF GEORGIA RESEARCH

Georgian Railway

Keep the wheels rolling

Georgia | Transportation
Georgian Railway
September 10, 2012

Fully state-owned Georgian Railway (GR) recently placed US$ 500mn in Eurobonds, the country's first EMBI-eligible benchmark corporate bond, which helped broaden GR's investor base and increase liquidity. The nature of GR's operations is dictated – mostly to the company's benefit – by Georgia's geographical position as a key transit corridor linking oil- and commodity-rich Central Asia to the powerful European market. Operationally, the company is marked by impressive profitability thanks to stable revenue streams and subdued cost growth, while its debt servicing ability is solid. Georgian debt issuers are also benefiting from active investor interest due to the country's prospects for continued economic growth and its low debt profile.

Superior profitability versus peers

With an impressive 54% EBITDA margin in 2011, Georgian Railway stands well above regional rail peers (Russian Railways: 21%, Deutsche Bahn 9%), and boasts a solid net margin of 37%. Operating profit margins are well-placed to improve further as operating costs are largely fixed and lag revenue growth. We see GR's EBITDA margin widening to 60% as of 2017. Moreover, ongoing investments into infrastructure and the rolling stock fleet will help subdue the operating cost base.

Safe on debt covenants

We see GR's end-2012 net debt-to-adjusted EBITDA at 2.5x, safely below the new Eurobond's 3.5x covenant. We also expect the ratio to decline gradually to 1.5x as of 2017. GR's leverage is below that of Deutsche Bahn and Hungarian Railways and in-line with Kazakh and Russian peers. In 2012, we expect net debt-to-equity of 0.4x. We also believe the company has a strong capacity for servicing debt, with adjusted interest coverage ratio of 3.6x in 2012E, set to increase further to 4.5x by 2017F.

On-track growth

Dry cargo, in our view, will be the key driver of mid-term revenue growth. In 1H 2012, dry cargo volumes increased 20% y/y to 5.2mn tonnes, while liquid cargo volumes fell 14% y/y to 4.6mn tonnes. Management attributed the decrease to a shortage of tank cars. In order to eliminate the bottleneck GR has signed a 1,000 tank car lease agreement with AS Spacecom. We expect total freight transportation to grow at 7% of CAGR reaching 30.6mn tonnes in 2017.

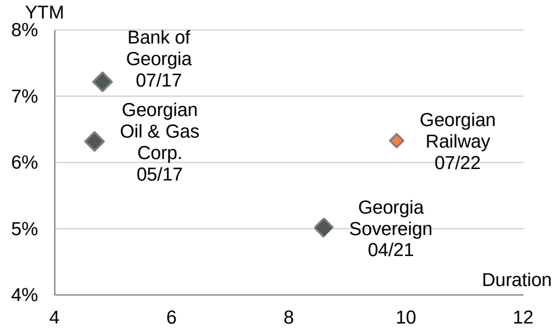
Georgia's first EMBI-eligible corporate bond

In early July GR sold US$ 500mn in Eurobonds with a 7.750% coupon due 2022. This was Georgia's first EMBI-eligible benchmark corporate bond, which helped broaden the company's investor base – the issue was 4x oversubscribed. A portion of the proceeds were used to refinance GR's US$ 250mn Eurobonds due 2015, while the balance will be used to finance large-scale capex programs and to pay dividends in respect of cumulative profits.

George Shengelia
Associate Director | gshengelia@bog.ge | +995 322 444 444 ext.3751

Giorgi Iremashvili
Associate | giremashvili@bog.ge | +995 322 444 444 ext.4691

Georgian Eurobond universe



Source: Bloomberg

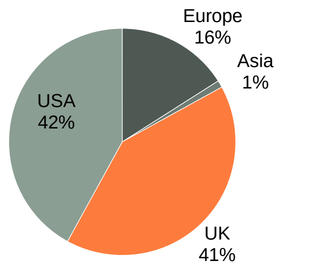
Georgian Eurobond parameters

	GOGC 05/17	Georgia 04/21	GR 07/22	BoG 07/17
Amount, US$ mn	250	500	500	250
Issue date	05/12	04/11	07/12	07/12
Maturity date	05/17	04/21	07/22	07/17
Coupon	6.875%	6.875%	7.750%	7.750%
Fitch/S&P/ Moody's	BB-/B/-	BB-/BB-/Ba3	BB-/BB-/-	BB-/BB-/Ba3
YTM(1)	6.3%	5.0%	6.3%	7.2%

(1) *YTM as of 7th September, 2012*

Source: Bloomberg

GRAIL investors at placement by region



Source: Company data

Key financials (US$ mn) and ratios

	FY10	FY11	FY12E
EBITDA	109.3	154.2	163.0
EBIT	53.9	99.5	94.3
Net income	57.0	103.4	79.8
Assets	1,316.2	1,446.7	1,763.7
Equity	921.2	1,078.9	1,148.6
Debt	274.6	266.9	500.0
EBITDA margin	48.1%	54.4%	50.0%
EBIT margin	23.7%	35.1%	28.9%
Net debt/EBITDA[1]	0.8 x	1.5 x	2.5 x
Adj. Interest coverage[12]	2.9 x	4.0 x	3.6 x

1 Excluding disposal of Batumi tower in 2012
2 Including previously capitalized Eurobond interest expense
Source: Company data, Bank of Georgia Research

Company Overview

Fully state-owned rail monopoly in Georgia. Georgian Railway (GR) owns and operates a 1,326 km freight and passenger railway network, 114 stations, and a sizeable rolling stock fleet (139 locomotives, 8,122 freight cars, 98 passenger railcars, and more). It is Georgia's single largest employer with over 13,000 workers as of end-2011.

The nature of GR's business is largely dictated by Georgia's position as the shortest transportation route from the Caspian Sea to the Black Sea. GR and Azerbaijan Railway make up the key section of the Transportation Corridor Europe Caucasus Asia (TRACECA), which connects oil-rich Central Asia with Europe, making GR mainly a transit railway (transit accounts for 63% of all freight transported in 2011).

Map 1: Caucasus Railway Corridor

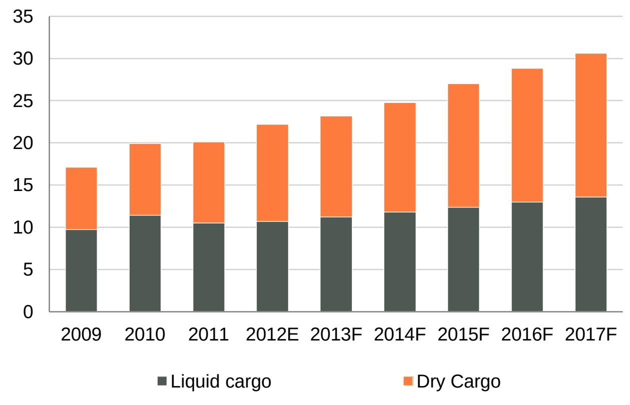
Source: Company data, Bank of Georgia Research

Freight transportation is the key revenue source, accounting for 95% of total revenues, with only 3% generated by passenger transport in 2011. The freight segment includes liquid and dry cargo and revenues from freight car rentals. The remaining 2% of revenues come from the sale of scrap. In 2011, liquid cargo (crude oil and oil products) accounted for 52% of total freight transportation, while dry cargo (ores, construction materials, grain, ferrous metals, scrap, etc.) took the remaining 48%.

Freight transportation

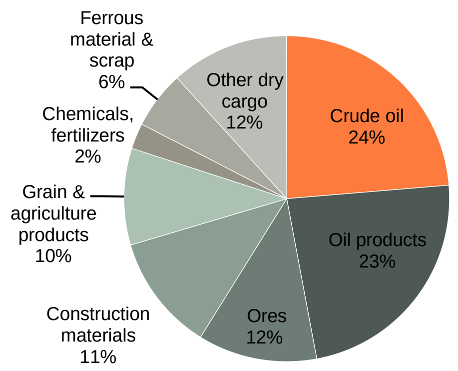
We see dry cargo as the key mid-term driver of revenue growth. In 1H 2012, dry cargo transportation volumes increased 20% y/y to 5.2 mn tonnes, while liquid cargo decreased 14% y/y to 4.8mn tonnes. Management attributed the shift to a shortage of oil tank cars. To address the bottleneck, GR has signed a tank car lease agreement with AS Spacecom. Under the contract, GR can lease up to 1,000 tank cars. Total cargo transportation remained nearly unchanged at 9.8mn tones.

Figure 1: Freight transportation volumes, mn tonnes



Source: Company data, Bank of Georgia Research

Figure 2: Freight segment breakdown, 1H 2012

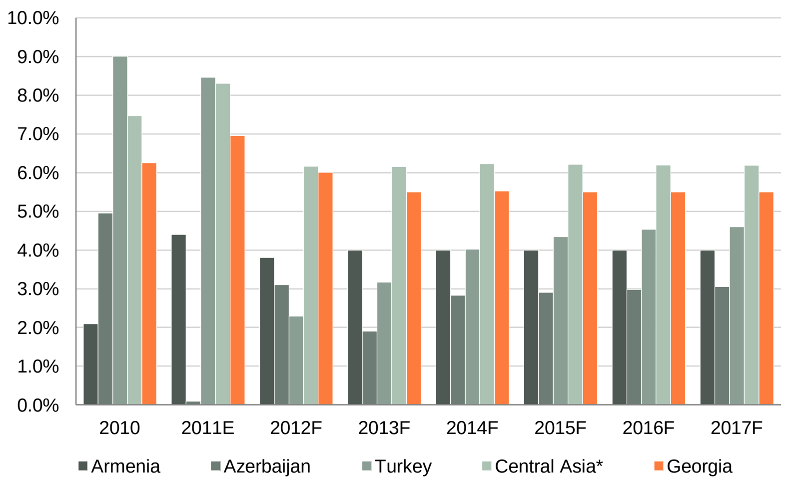


Source: Company data

Dry cargo

Correlated with regional GDP growth, we forecast dry cargo volumes to grow at a 10% CAGR by 2017 to 17.0mn tonnes. Demand for dry cargo transported by GR is largely linked to the region's economic activity, which is forecasted by IMF to remain solid.

Figure 3: GDP growth rate



**Central Asia weighted average GDP growth rate includes: Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan.*
Source: IMF forecasts

We believe increased demand for the following products will be the major source of dry cargo transportation volumes:

Construction materials –1H 2012 construction material transportation volumes grew 38% y/y to 1.1mn tonnes. We believe the impressive growth rate will not slow in the coming years and we see the total reaching the pre-crisis level of 3.1mn tonnes in 2013. Growth will be supported by ongoing large-scale infrastructure projects initiated by the government of Georgia, the total cost of which is around US$ 0.8bn. There are also up to 25 hydro power plants under construction in Georgia at a total estimated cost of US$ 4bn.

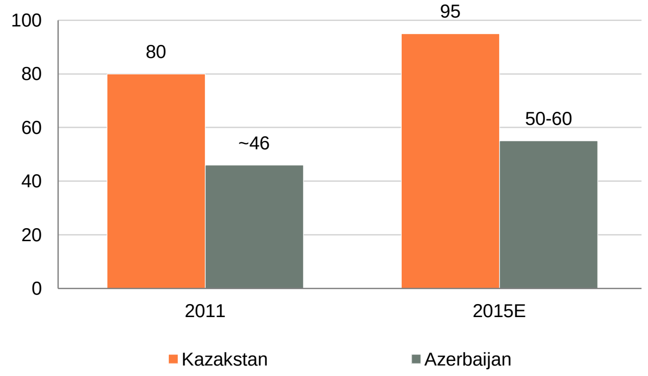
Ore products – 1H 2012 ore product transport volumes rose 29% y/y to 1.2mn tonnes. Continued growth in the segment will, in our view, be driven by increased regional production of aluminum, which will translate into a higher demand for bauxite. The reopened Ganja aluminum plant, which consumes 80k tonnes of bauxite annually, and a new integrated aluminum plant (with 100k annual production capacity) in Azerbaijan will be the main drivers of growth. Georgian Manganese, one of the largest industrial companies in the country, also plans to increase output around 5% annually until 2015.

Agricultural products – Georgia's improved warehousing infrastructure, led by the modernization of the grain terminal in Poti by Bunge, leads us to expect an increase in agro product transportation. A new 1mn tonne storage capacity warehouse terminal was also constructed in Vale. Externally, Kazakhstan plans to transport up to 0.5mn tonnes of grain per year through Georgia to Europe, which would equal 42% y/y growth in 2012. Georgia's Agriculture Ministry is also aiming to boost agricultural exports to Europe through the Black Sea.

Liquid cargo

Growth in the liquid cargo segment should be slower (4% projected CAGR) than in the dry segment, reaching 13.6mn tonnes in 2017. We believe growth will be supported by increased volumes of crude oil sourced from Kazakhstan and Azerbaijan. Both countries are expected to boost production in the near- to mid-term. The production of related oil goods from refineries in Turkmenistan and Azerbaijan are expected to move largely in-line with regional GDP growth.

Figure 4: Crude oil production forecasts, mn tonnes



Source: Oil and Gas Ministry of the Republic of Kazakhstan, KazMunayGas, SOCAR

GR's major competitors in transporting crude oil are pipelines, including Baku Novorossiysk, Baku Supsa, Caspian Pipeline Consortium (CPC) and Baku-Tbilisi-Ceyhan (BTC). In 2011, pipelines accounted for 89% of total west-bound oil transportation. Georgian Railway transported the remaining 11%. The CPC pipeline is slated to double annual capacity to 67mn tonnes to meet increasing production in

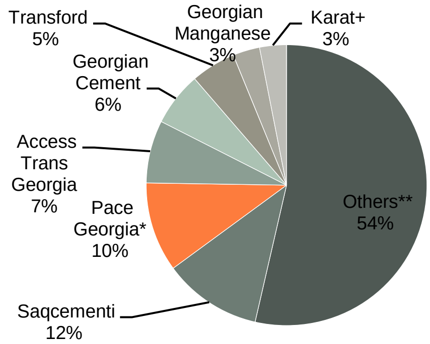
Central Asia. The project is expected to be finalized in 2014. Despite the expansion, we believe GR will retain its current liquid cargo share for the following reasons:

- High sulfur crude and oil products are not suitable for pipelines
- Regional producers do not have equal access to pipelines

Recent investments by Azerbaijan and Kazakhstan into Georgia's transport infrastructure are a good sign of the attractiveness of the country's transportation route. State-owned KazMunaiGas (KMG) owns the Black Sea port in Batumi, while the Kulevi Oil Terminal is owned by Azerbaijan's SOCAR. GR has access to both. SOCAR is also planning to purchase an additional 1,500 tank railcars to support the future growth in production volumes.

Flexibility from fully deregulated tariffs. Georgia's liberalized market allowed GR to sign a number of short-term customer contracts, many with clauses allowing for amendments to terms at a one-month notice. All of GR's customers in the freight segment are required to pre-pay for transportation and station services, eliminating default risks.

Figure 5: Dry cargo customer breakdown in 2011

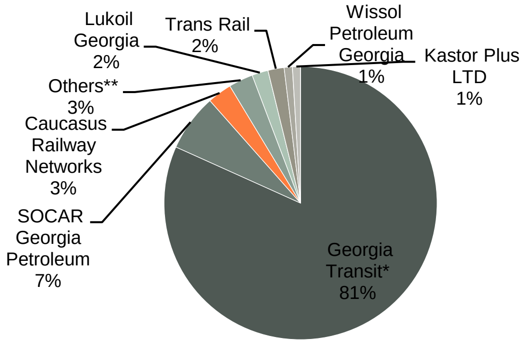


** Freight forwarder*

*** Smaller freight forwarders and cargo owners*

Source: Company data

Figure 6: Liquid cargo customer breakdown in 2011



** Freight forwarder*

*** Smaller freight forwarders and cargo owners*

Source: Company data

Large exposure to single freight forwarder not an issue. Although in 2011, 42% of transported cargo came from a single freight forwarder, we don't believe the customer risk is significant since freight forwarders transport cargo from companies like BP, Chevron, ExxonMobil, SOCAR, KMG, etc. If the freight forwarder were to fail, we believe it would easily be substituted by competitors with little to no effect on GR's operations. Freight forwarders typically set contracts with different carriers like GR and Azerbaijan Railway, which allows the owners of the cargo to transport freight without dealing with several carriers.

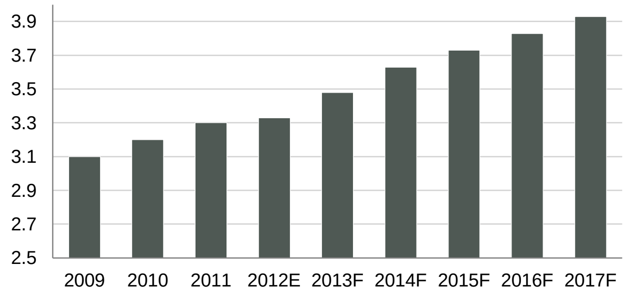
Railcar rentals – secondary but stable. In 1H 2012, freight railcar rentals accounted for 9% of GR's total revenues and we expect this business line to move largely in-line with total freight volumes. This rental segment includes revenues received from railcars leased by GR to customers and regional peer railway operators. In 2011, 61% of total Georgian freight volumes were transported by third-party railcars, with GR's fleet taking the remaining 39%.

Passenger Transportation

Although passenger tariffs are unregulated, the segment is loss-making. The company chooses to cap tariffs owing to the segment's high social importance. Passenger transportation contributed only 3% to 2011 revenues.

GR plans to turn the segment profitable by raising tariffs on the back of a planned fleet modernization. The company expects the strategy to boost per-passenger revenue, attract higher-income commuters, and offer a substitute to automobile travelers.

Figure 7: Number of passengers transported, mn



Source: Company data, Bank of Georgia Research

We see only a 3% annual average increase in passenger volumes until 2017. The Baku-Tbilisi-Kars rail line from Baku through Tbilisi to Turkey (but bypassing Georgia's Black Sea summer destination of Adjara) and further to Europe should support growth, as part of the passengers currently traveling by cars/buses to Turkey will use railway for traveling.

Railway Infrastructure

GR's fleet

GR's principal assets include 1,326 km rail lines, of which 95% is electrified. GR's fully electrified 527 km mainline runs from Azerbaijan and Armenia to the Black Sea, the key direction for freight transportation. As of December 2011 the company owned 139 operational locomotives and 8,122 railcars.

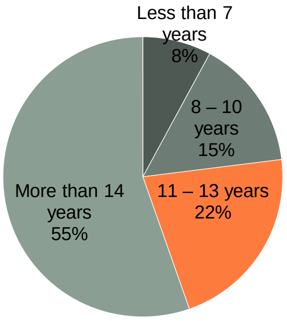
Table 1: GR's rolling stock fleet, end-2011

Locomotives	**139**
Diesel	44
Electric	95
Railcars	**8,122**
Open top boxcars	2,376
Boxcars	1,375
Tank cars	1,430
Grain hoppers	1,052
Platform cars	1,031
Cement hoppers	453
Refrigerator cars	156
Other	249

Source: Company data

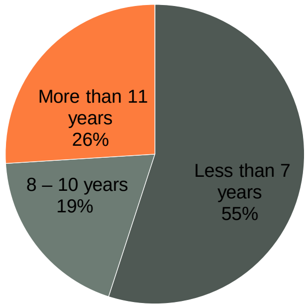
The majority of GR's locomotives are from the Soviet era. At end-2011, 55% had over 14 operating years remaining, while 55% the railcars had less than 7 years remaining. Management believes capital repairs can extend the operating life of GR's railcar fleet around 50% of the expected useful life, which is more cost-efficient than purchasing new rolling stock.

Figure 8: Locomotives' remaining operating lives, end-2011



Source: Company data

Figure 9: Railcars' remaining operating lives, end-2011

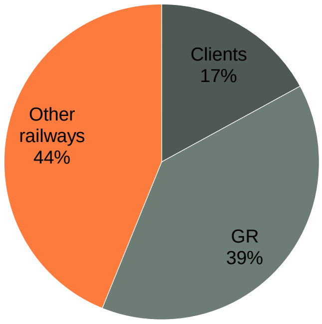


Source: Company data

Current underutilization leaves room for future growth. During the Soviet era, GR annually transported up to 60mn tonnes of cargo, which fell to just 20.1mn tonnes as of 2011. Management estimates that the annual transport capacity of GR's current infrastructure has not changed significantly since the fall of the Soviet Union.

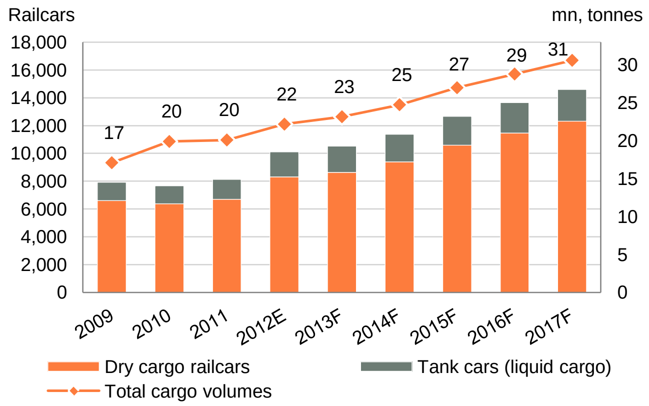
We believe GR will need to expand its railcar fleet to meet the prospective growth of cargo volumes. In 2011, GR transported 39% of total freight volumes using its own fleet, while the rest was transported by railcars owned by clients and other railways. GR's management estimates the utilization rate of its railcar fleet in 2011 at 60% (86% in tank cars, 71% in grain hoppers, and 34-35% in platform cars and box cars). The utilization rate among locomotives was 80% at end-2011.

Figure 10: Total freight breakdown by railcar owners, 2011



Source: Company data

Figure 11: GR's railcar fleet expansion forecast



Source: Bank of Georgia Research

GR will need to add 5,620 dry cargo cars and 850 tank cars by 2017, our calculations show. Our estimate assumes the share of cargo transported by GR's own railcars will remain constant at 39% and GR's clients and other railways will proportionally increase their rolling fleet.

Under management's capex forecasts, GR plans to invest up to US$ 252mn to expand its rolling stock. The company can source additional rolling stock from:

- Own fleet: At end-2011, GR owned 10,526 serviceable railcars (mostly dry cargo cars) and 8,122 operational railcars. Repairs can bring serviceable railcars up to operational status to provide additional capacity.
- Leased fleet: In March 2012, the company signed a tank car lease agreement with one of the biggest owners of tank cars in the Baltic region, AS Spacecom. Under the contract, GR can lease up to 1,000 tank cars.
- Additional purchases: The company also has the option of purchasing additional stock from local manufacturers.

Infrastructure Projects

GR is currently implementing two large-scale infrastructure projects: the Modernization Project, which includes the modernization of the mainline from Tbilisi to the Black Sea coast, and the Tbilisi Bypass Project, which will see the company move its infrastructure from the center of the capital to the city's outskirts.

The Modernization Project is expected to cost US$ 407mn, of which US$ 145mn has already been invested as of end-2011. The remaining will be financed from proceeds of the recent Eurobond sale and internally generated cash flow.

Map 2: Modernization Project Map

Source: Company data, Bank of Georgia Research

The Modernization Project is designed to improve efficiency and cut operating costs. It includes the upgrade of 315 km of line and infrastructure from Tbilisi to Batumi and Poti, including a 40 km gorge in central Georgia. Once works are completed, the average travel speed is expected to increase 34% to 90 km/h. Planned works include flattening the gorge section to reduce wear and tear on wheels and tracks, reducing the number of stops to cool brakes on trains, improving tunnels, bridges, and level crossings, and procuring new rolling stock. Modern rails and electric supply infrastructure have already been installed on a 140 km section, or 44% of the line's total length. Project completion is slated for 2016.

The Tbilisi Bypass Project will see relocate its main hub from the center of Tbilisi to the suburbs, which will free up 73 ha of land in the center of the city. The project was initiated by the Georgian government and part of the relocation costs is being covered by the state.

GR's management estimates the total project cost at US$ 297mn. The government has transferred a 182 ha plot of land required for the relocation, valued at US$ 20mn, to GR. GR bought the remaining section of the land plot (around 60%) from private investors for US$ 16mn. The project is expected to be finalized by the end of 2013.

The Georgian government will cover US$ 141mn of the remaining project costs. Under an agreement signed in April 2012, GR agreed to sell the 73 ha of land to the state for US$ 141mn in funding for the Bypass Project. The remaining project expenses will be financed by the company.

Baku-Tbilisi-Kars Railway Venture. In 2007, the governments of Georgia, Turkey, and Azerbaijan agreed to build a new rail link connecting the three countries, called the Baku-Tbilisi-Kars Railway Venture. In connection with the project, GR transferred a secondary rail line (the Marabda-Akhalkalaki line), which required repairs, to a state-owned Special Purpose Vehicle (SPV). The SPV secured a US$ 775mn loan from the Azeri government to renovate the Marabda-Akhalkalaki line and construct a new Akhalkalaki-Kars railway. The construction of the new line is underway and is expected to be finished in 2013.

Map 3: Baku-Tbilisi-Kars project map

Source: Company data, Bank of Georgia Research

According to GR, the new line will be maintained through a 50/50 joint venture between Azerbaijan Railway and GR. GR will hold the exclusive rights to operate the Georgian section of the new line. GR will be charged for access to the line by its owner (50/50 joint venture), though the structure has yet to be defined. GR expects to have the power to determine the tariff it will charge clients to use the Georgian section of the BTK railway.

In our model we exclude the potential income from the BTK project, as the structure of the future revenue stream is entirely undefined. We also do not consolidate GR's portion of the newly created JV in the company's financials.

We see a minor risk that a limited portion of GR's cargo volumes currently transported through the mainline to the Black Sea and Turkey will be shifted to the BTK line. The risk stems from the fact that GR would be charged fees from the JV for the new BTK line, while the existing mainline is fully owned by GR. If it materializes, we believe the risk will have an insignificant impact on GR's profitability.

GR is also constructing new container terminals, which should also boost the growth of cargo transportation volumes. In 2011, container shipping held just a 7.6% share of GR's total dry cargo volumes. The company is investing up to US$ 3mn to construct container terminals in the ports in Poti and Batumi to accommodate expected future growth. The terminals will be able to accommodate around 63k containers annually.

Ongoing infrastructure projects in Azerbaijan will further increase the attractiveness of the TRACECA corridor. The Azeri government is planning to invest up to US$ 13bn to modernize its transportation infrastructure including roads, railways, and ports. Up to US$ 1.5bn will be spent to modernize the national railway. The government also plans to relocate the country's main international sea port from Baku to Alyat (65km South of Baku). The port's cargo transportation capacity will be increased from 8mn tonnes to 10mn tonnes in 2014 and further to 21-25mn tonnes over the long-term.

New US$ 500mn Eurobond

On July 5, 2012, Georgian Railway placed a US$ 500mn 10-year Eurobond with a 7.75% coupon. The placement was nearly 4x oversubscribed and it is Georgia's first EMBI-eligible benchmark corporate bond, which helped broaden the investor base. The new paper was priced 225bps below GR's shorter-term US$ 250mn 5-year bond issued in 2010.

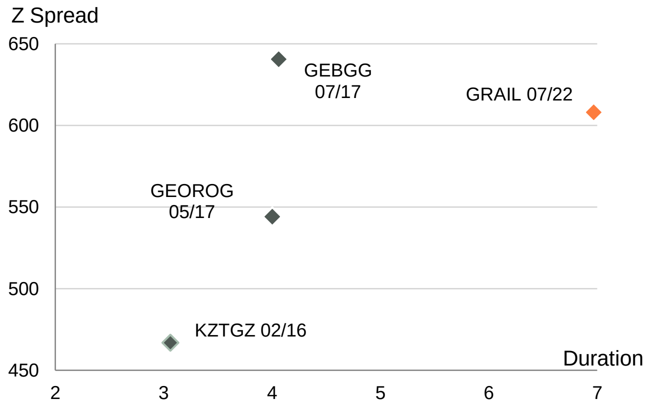
Table 2: Key terms of GR's new Eurobond (GRAIL 07/22)

Ratings	BB- Stable (S&P) / BB- Stable (Fitch)
Issue format	RegS / 144A
Issue size	US$ 500mn
Pricing date	26-June-12
Maturity date	11-July-22
Coupon	7.75%
Price	99.998%
Yield	7.659%
Benchmark	UST 1.750% due 2022
Spread to benchmark	612bps
Spread to mid swaps	598bps
Joint lead managers	Goldman Sachs, J.P. Morgan, BofA Merrill Lynch
Governing law	English
Listing	London Stock Exchange

Source: Bloomberg

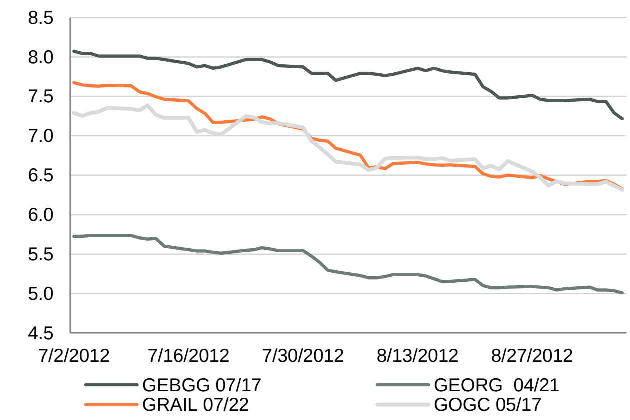
A portion of the proceeds was used to refinance GR's US$ 250mn Eurobonds due 2015, 89% of which were bought back at 111.25% of face value. The balance of the proceeds will be used to pay dividends in respect of cumulative profits. The company will pay out an aggregate US$ 202mn dividend, of which the government will invest US$ 139mn back into GR under the terms of the Tbilisi Bypass Project Memorandum. GR will actually pay out a balance of US$ 63mn in cash.

Figure 12: Comparable Eurobonds



Source: Bloomberg

Figure 13: Georgian Eurobond yields



Source: Bloomberg

Table 3: Comparable Eurobonds

Issuer	Ticker	Amount, US$ mn	Coupon	Maturity date	Ratings (Fitch/S&P/Moody)	Mid price, US$	Mid yield, %	Z-spread
Georgian Railway	GRAIL 07/22	500	7.75%	11/07/2022	BB-/BB-/-	6.33	110.28	607.90
Georgian Oil and Gas Corp	GEOROG 05/17	250	6.88%	16/05/2017	BB-/B/-	6.32	102.22	544.00
Georgia Sovereign	GEORG 04/21	500	6.88%	12/04/2021	BB-/BB-/Ba3	5.01	112.88	348.10
Bank of Georgia	GEBGG 07/17	250	7.75%	05/07/2017	BB-/BB-/Ba3	7.22	102.13	640.40
Kazakhstan Temir Zholy	KAZAKH 10/20	700	6.38%	06/10/2020	BBB-/BBB-/Baa3	4.75	110.77	338.50
Azerbaijan State Railways	KZTGZ 02/16	125	8.25%	18/02/2016	BBB-e/-/-	na	na	466.80

Source: Bloomberg

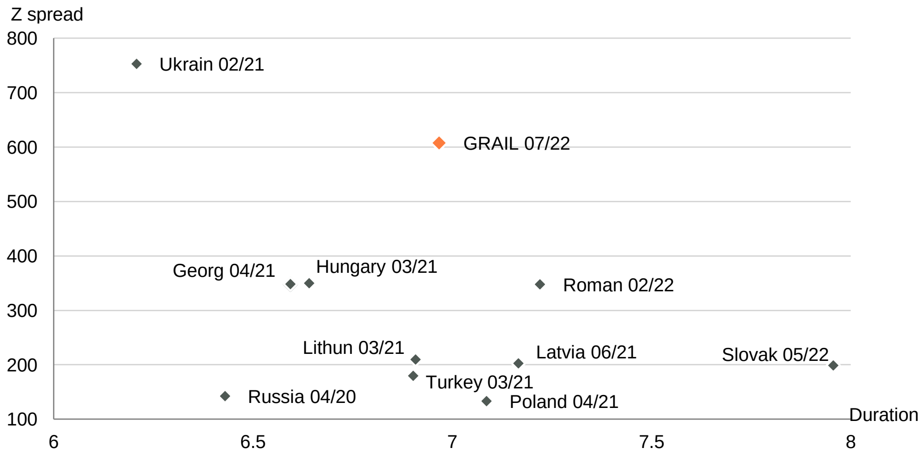
Key covenants

- Notes are unsecured and unsubordinated.
- In case of change of control (if the state sells 50%, directly or indirectly) noteholders have the right to require early redemption.
- Net debt-to-EBITDA capped at 3.5x.
- The company is required to provide full-year audited financial statements within 9 months and interim unaudited financial statements within 45 days.
- GR should not pursue any corporate reorganization against the interests of noteholders.

Georgian yields set to decrease

Georgian issuers are benefiting from active investor interest due to the country's prospects for continued economic growth and its low debt profile. At 34%, Georgia has one of the lowest general government debt-to-GDP levels among Eastern European peers, while the economy expanded 7% in 2011. In 2011, leading rating agencies upgraded the Georgian sovereign from B+ to BB-. Moreover, we view priced-in risk premiums on the back of Europe's debt crisis as excessive and believe Georgia exposure remains attractive. The country recently agreed on a two-year US$ 387mn Stand-By-Arrangement program with the IMF, which the government is treating as precautionary.

Figure 14: Comparison of Z-spread and duration for sovereign bonds and GRAIL



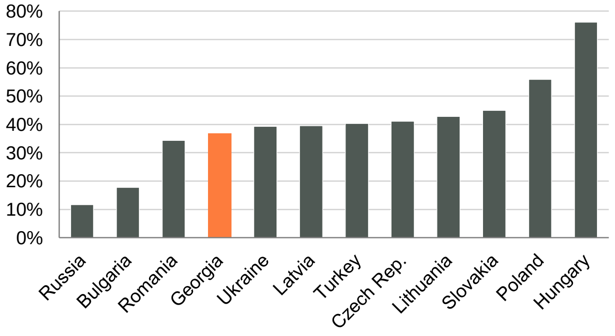
Source: Bloomberg

Table 4: Eastern European sovereign 10-year bond performance

Issuer	Amount, US$ mn	Coupon	Maturity date	Ratings (Fitch/S&P/Moody)	Mid price, US$	Mid yield, %	Z-spread
Bulgaria	323	5.000%	19/07/2021	BBB/-/-	115.6	3.0	-5.1
Czech Republic	2000	3.875%	24/05/2022	A+e/-/A1	111.2	2.6	80.9
Georgia	500	6.875%	12/04/2021	BB-/BB-/Ba3	112.8	5.0	348.5
Hungary	3000	6.375%	29/03/2021	BB+/BB+/Ba1	109.6	5.0	350.1
Latvia	500	5.250%	16/06/2021	BBB-/BBB-/Baa3	112.1	3.6	202.8
Lithuania	1500	6.125%	09/03/2021	BBB/BBB/Baa1	118.0	3.6	209.9
Poland	2000	5.125%	21/04/2021	A-/A-/A2	117.5	2.8	133.4
Romania	2250	6.750%	07/02/2022	BBB-/BB+/Baa3	111.8	5.2	348.0
Russia	3500	5.000%	29/04/2020	BBB/BBB/Baa1	115.1	2.8	142.6
Slovakia	1500	4.375%	21/05/2022	A+/A/A2	105.6	3.7	199.0
Turkey	2000	5.625%	30/03/2021	BB+/BB/Ba1	117.1	3.3	179.9
Ukraine	1500	7.950%	23/02/2021	B/B+/B2	98.6	8.2	753.2

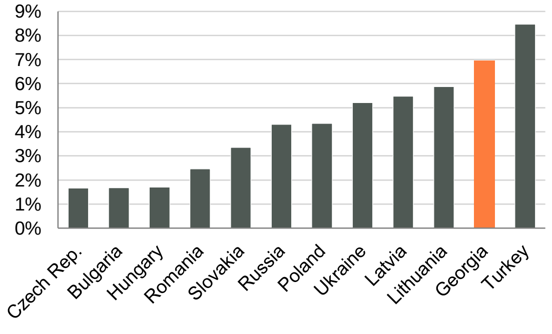
Source: Bloomberg

Figure 15: General government debt as % of GDP, 2011



Source: Bloomberg

Figure 16: GDP growth rate in 2011

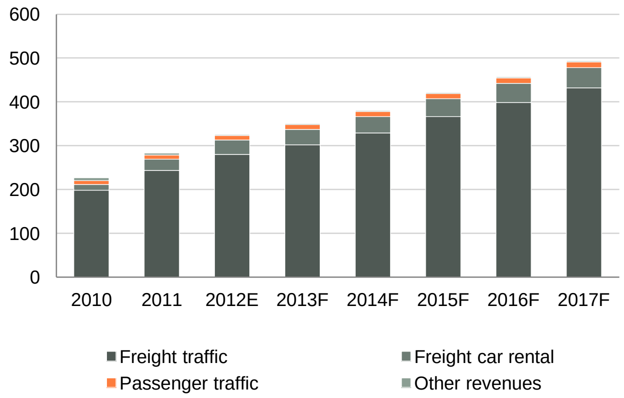


Source: Bloomberg

Financial and Credit Analysis

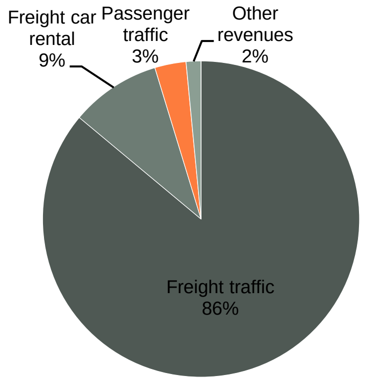
We see revenues growing at a 10% CAGR to 2017, reaching US$494mn. We expect the largest revenue generator, freight traffic (86% of 2011 revenues), to expand on average 9.4% annually over the next 6 years. Increased freight volumes will be the main driver with only slight growth rise in tariffs expected. Revenues from freight car rentals will move largely in-line with freight transportation volumes, in our view.

Figure 17: Revenue growth forecast, US$ mn



Source: Company data, Bank of Georgia Research

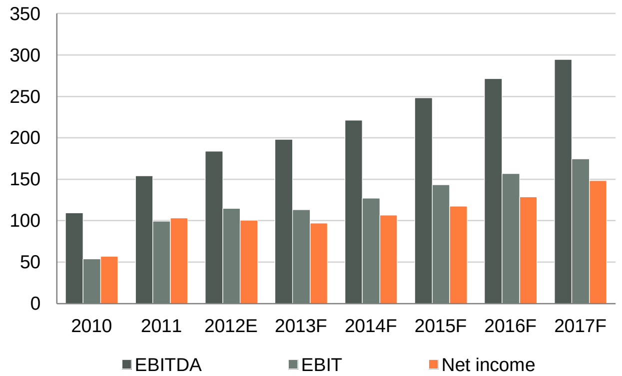
Figure 18: Revenue breakdown, 2011



Source: Company data

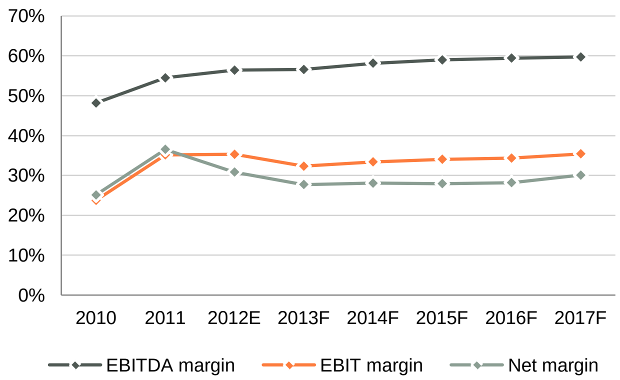
Profitability margins set to widen as operational costs are largely fixed. In 1H 2012, GR's EBITDA margin (excluding a US$ 21mn one-off charge) improved 7ppts y/y to 59% on the back of increased freight revenues and declining employee costs (down 5% y/y). EBIT margin growth was lower, up 3ppts to 35%, as depreciation increased 14% y/y due to intensive capex. The net margin narrowed 10ppts y/y to 32% due to lower net financial income. We expect GR's EBITDA margin to improve further as operating costs should continue lagging behind volume growth. The company boasts the highest EBITDA margin vs. peers (Russian Railway: 21%, Deutsche Bahn: 9%) as its major operating cost item, staff expenses, has remained largely flat while other important cost items (including electricity) have increased only moderately.

Figure 19: Profitability, US$ mn



** Excluding a one-off US$ 21mn for the disposal of a property in Batumi in 2012*
Source: Company data, Bank of Georgia Research

Figure 20: Profitability margins



** Excluding a one-off US$ 21mn for the disposal of a property in Batumi in 2012*
Source: Company data, Bank of Georgia Research

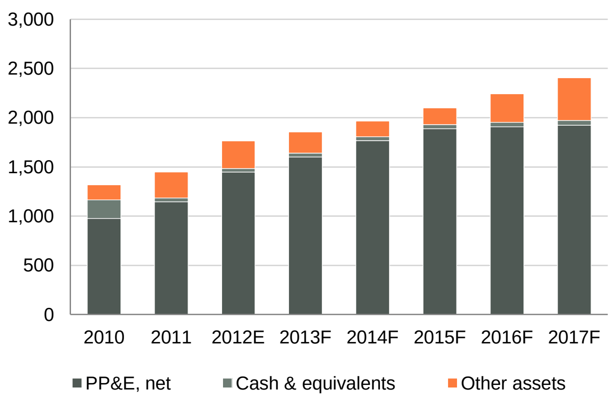
GR's operating costs to remain stable. Employee expenses are one of the company's largest structural costs (32% of 1H 2012 adjusted operating costs). GR is under a hiring freeze for the next few years, and management doesn't foresee the need for a significant wage increase in the near- to mid-term, so we don't see this cost figure growing meaningfully. Electricity and material costs (including fuel) are variable and dependent on transported volumes. They account for 16% of GR's total operating costs. On average, the company consumes 250 GWh of electricity annually at an average tariff of GEL 0.088/KWh (US$ 0.05). In 2011, GR signed a 5-year contract to buy electricity at a fixed tariff, meaning electricity costs will lag revenue growth.

FX mismatch as costs are mostly GEL-denominated, while tariffs are mostly in US$. GR has not actively participated in hedging agreements in the past, but it is now considering currency hedges with the help of a financial advisor. With US$-denominated revenues and Eurobonds, we see little risk related to servicing the Eurobonds.

GR remains moderately leveraged vs. peers (near Russian Railways and Kazakh Temir Zholy, less leveraged than Deutsche Bahn and Hungarian Railways). We project end-2012 net debt-to-assets and net debt-to-equity of 0.3x and 0.4x, respectively. At this stage, we don't see GR raising additional debt until the US$ 500mn Eurobond matures, therefore leverage should remain at around current levels at least until 2017.

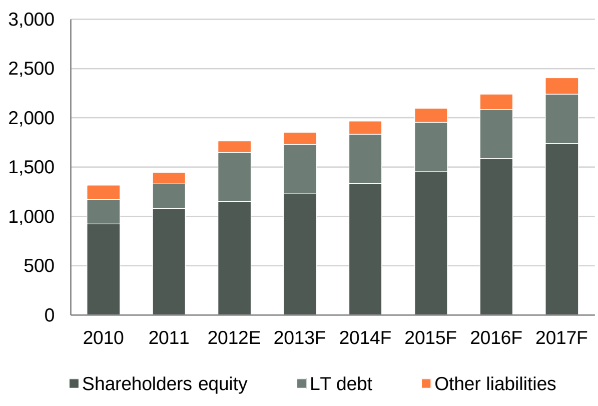
We do not rule out the possible need for additional debt/equity to expand the railcar fleet if the growth of cargo transportation increases at a faster rate than forecasted. If GR comes to require additional financing, we believe it will first consider additional equity through an IPO. In Q1 2012 GR tried to float a 25% stake as Global Depositary Receipts on the London Stock Exchange, but pulled the deal on the back of challenging capital market conditions. The deal was priced in the range of a US$ 800mn to US$ 1bn market capitalization for the company. Eventually, GR raised US$ 500mn Eurobond and paid down US$ 250mn previously (July 2010) issued note.

Figure 21: Asset structure, US$ mn



Source: Company data, Bank of Georgia Research

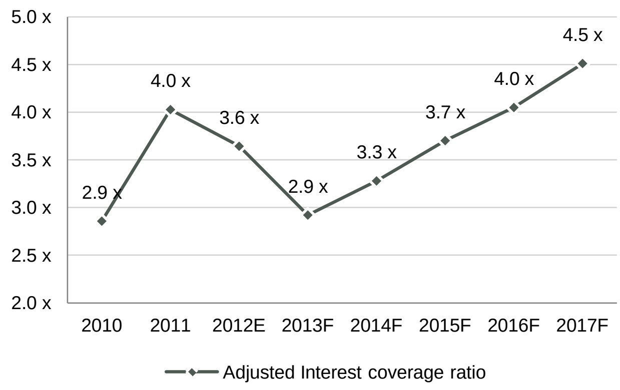
Figure 22: Equity and liabilities structure, US$ mn



Source: Company data, Bank of Georgia Research

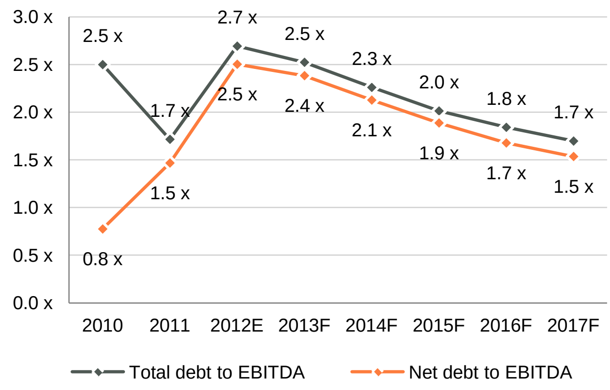
No issues meeting Eurobond covenants. We see end-2012 net debt-to-EBITDA and gross debt-to-EBITDA (excluding the one-off expense on the disposal of the Batumi Tower in 2012) at 2.5x and 2.7x, respectively, and expect the former to gradually decline to 1.7x in 2017. We see the adjusted interest coverage ratio (interest expense includes capitalized Eurobond interest costs, while the one-off charge is excluded from EBIT) should trough at 2.9x in 2013 before increasing to 4.5x in 2017. Higher interest expenses related to the new Eurobond will drive a drop in the adjusted interest coverage in 2012-2013.

Figure 23: Interest coverage ratio



Interest expense includes capitalized Eurobond interest costs
One-off charge related to the disposal of the Batumi tower in 2012 is excluded from EBIT
Source: Company data, Bank of Georgia Research

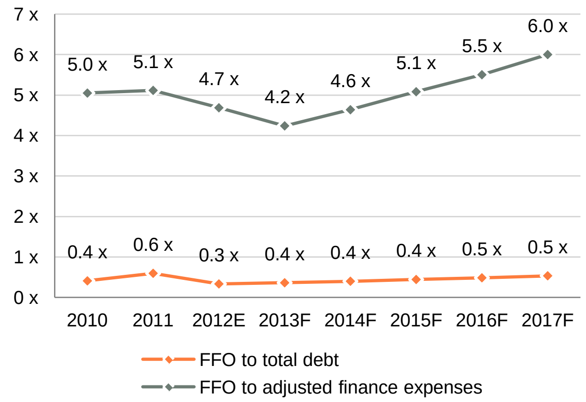
Figure 24: Debt/EBITDA ratios



Interest expense includes capitalized Eurobond interest costs.
One-off charge related to the disposal of the Batumi tower in 2012 is excluded from EBITDA
Source: Company data, Bank of Georgia Research

Increased adjusted finance expenses from new Eurobond will sap liquidity. We see GR's adjusted FFO-to-finance expenses bottoming at 4.2x in 2013 before gradually growing to 6.0x in 2017. Adjusted FFO-to-total debt should also almost halve this year and gradually increase to 0.5x in 2017.

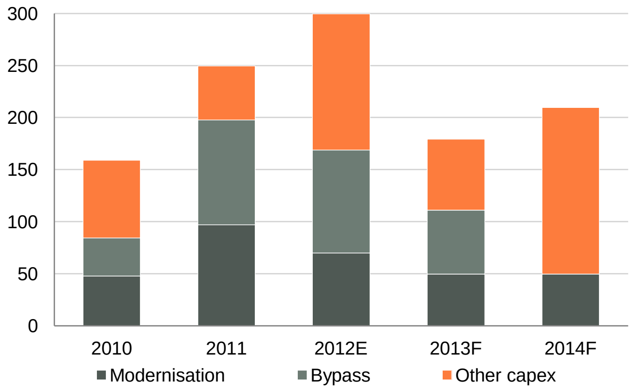
Figure 25: Liquidity



Interest expense includes capitalized Eurobond interest costs
One-off charge related to the disposal of the Batumi tower in 2012 is excluded from FFO
Source: Company data, Bank of Georgia Research

Extensive mid-term capex plans. GR plans to spend up to US$ 689mn to modernize infrastructure and expand its railcar fleet. Funds for the expansion of the railcar fleet are included in other capital expenditures. Capex will be financed partially by proceeds from the two Eurobond placements and internally generated cash flow. The company has already used the lion's share of proceeds from its debut US$ 250mn Eurobond for the Tbilisi Bypass and Modernization projects.

Figure 26: Capex projections, US$ mn



Source: Company data

Our sensitivity analysis suggests GR's financials would remain robust even if freight traffic declines.

Table 5: Freight traffic sensitivity

	2012E	2013F	2014F	2015F	2016F	2017F
Base case						
Freight traffic, mn tonnes	22.2	23.2	24.7	27.0	28.8	30.6
Revenues, US$ mn	325.8	350.5	380.6	421.4	457.0	493.6
EBITDA margin	56.3%	56.5%	58.1%	58.9%	59.4%	59.7%
Net margin	30.8%	27.7%	28.0%	27.9%	28.2%	30.1%
Total debt to EBITDA	2.7 x	2.5 x	2.3 x	2.0 x	1.8 x	1.7 x
Adjusted Interest coverage	3.6 x	2.9 x	3.3 x	3.7 x	4.0 x	4.5 x
Freight transportation decreased 5%						
Freight traffic, mn tonnes	21.1	22.0	23.5	25.6	27.4	29.1
Revenues, US$ mn	311.8	335.3	364.1	403.1	437.1	472.0
EBITDA margin	54.7%	55.0%	56.7%	57.5%	58.0%	58.3%
Net margin	27.7%	25.5%	25.8%	25.7%	26.0%	27.9%
Total debt to adjusted EBITDA	2.9 x	2.7 x	2.4 x	2.2 x	2.0 x	1.8 x
Adjusted Interest coverage	3.2 x	2.6 x	2.9 x	3.3 x	3.6 x	4.0 x
Freight transportation decreased 10%						
Freight traffic, mn tonnes	20.0	20.8	22.3	24.3	25.9	27.5
Revenues, US$ mn	297.8	320.2	347.7	384.8	417.1	450.4
EBITDA margin	53.0%	53.3%	55.1%	56.0%	56.5%	56.8%
Net margin	25.3%	23.1%	23.4%	23.3%	23.6%	25.6%
Total debt to EBITDA	3.2 x	2.9 x	2.6 x	2.3 x	2.1 x	2.0 x
Adjusted Interest coverage	2.8 x	2.2 x	2.5 x	2.8 x	3.1 x	3.5 x
Freight transportation decreased 15%						
Freight traffic, mn tonnes	18.9	19.7	21.0	22.9	24.5	26.0
Revenues, US$ mn	283.8	305.1	331.2	366.5	397.2	428.8
EBITDA margin	51.2%	51.5%	53.3%	54.2%	54.8%	55.1%
Net margin	22.8%	20.4%	20.8%	20.6%	20.9%	23.0%
Total debt to EBITDA	3.4 x	3.2 x	2.8 x	2.5 x	2.3 x	2.1 x
Adjusted Interest coverage	2.4 x	1.9 x	2.1 x	2.4 x	2.7 x	3.0 x

Interest expense includes capitalized Eurobond interest costs

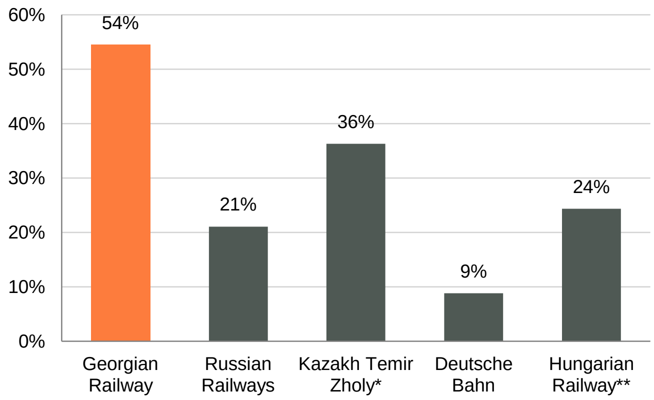
One-off charge related to the disposal of the Batumi tower in 2012 is excluded from EBITDA, EBIT and Net Incomes

Source: Bank of Georgia Research

Peer Railways

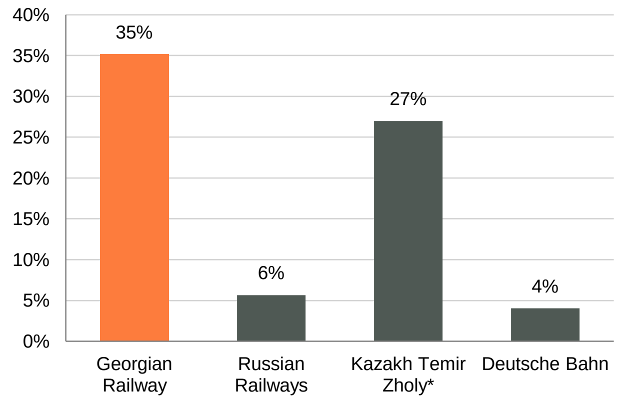
Compared with peer railways, GR's profitability is above-average, while its leverage ratio is largely in-line.

Figure 27: EBITDA margin, 2011



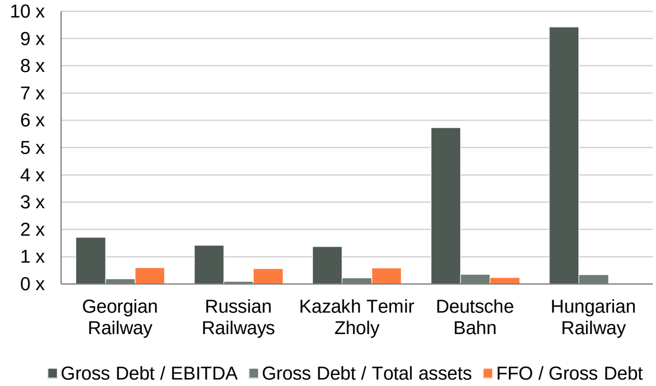
** Annualized 1H 2011 results*
***YE 2010 results*
Source: Bloomberg, Bank of Georgia Research

Figure 28: EBIT Margin, 2011



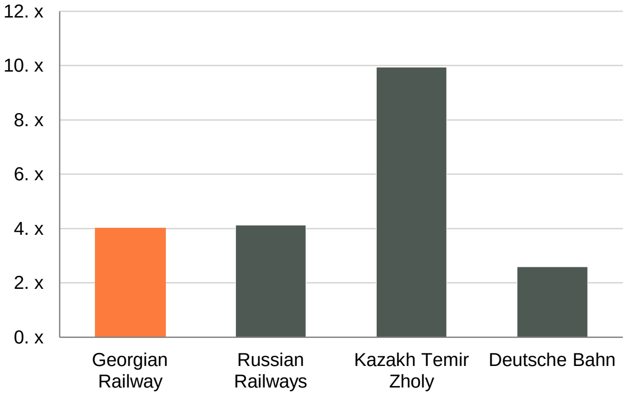
** Annualized 1H 2011 results*
Source: Bloomberg, Bank of Georgia Research

Figure 29: Leverage ratios, 2011



** Annualized 1H 2011 results*
***YE 2010 results*
Source: Bloomberg, Bank of Georgia Research

Figure 30: EBIT / Interest Expense, 2011



** Annualized 1H 2011 results*
***YE 2010 results*
Source: Bloomberg, Bank of Georgia Research

Financials

Income statement, US$ mn

	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
Revenues	227.0	283.1	325.8	350.5	380.6	421.4	457.0	493.6
y/y change	18.9%	24.7%	15.1%	7.6%	8.6%	10.7%	8.4%	8.0%
SG&A	117.7	129.0	162.8	152.3	159.3	173.0	185.5	199.0
EBITDA	109.3	154.2	163.0	198.2	221.3	248.4	271.5	294.6
EBITDA margin	48.1%	54.4%	50.0%	56.5%	58.1%	58.9%	59.4%	59.7%
D&A	55.4	54.6	68.7	85.0	94.2	105.0	114.6	119.8
EBIT	53.9	99.5	94.3	113.2	127.1	143.4	156.9	174.8
EBIT margin	23.7%	35.1%	28.9%	32.3%	33.4%	34.0%	34.3%	35.4%
Financial expenses (income), net	-15.6	-9.8	0.4	-1.1	1.5	4.9	5.4	0.3
PBT	69.5	109.3	93.9	114.3	125.6	138.5	151.5	174.5
Tax expense	12.5	5.9	14.1	17.1	18.8	20.8	22.7	26.2
Net income	57.0	103.4	79.8	97.2	106.7	117.7	128.8	148.3
Net margin	25.1%	36.5%	24.5%	27.7%	28.0%	27.9%	28.2%	30.1%

Balance Sheet

	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
Non-current assets	1,055.9	1,314.8	1,585.0	1,710.5	1,862.5	1,983.8	2,011.6	2,033.1
PP&E, net	973.4	1,145.4	1,423.1	1,556.3	1,710.5	1,832.8	1,857.4	1,876.7
Other	82.5	169.4	161.9	154.3	152.0	151.0	154.2	156.3
Current assets	260.3	131.9	178.6	137.2	94.6	103.2	214.4	351.4
Cash & equivalents	182.7	36.9	33.5	25.9	27.5	29.5	42.7	45.9
Trade receivables & prepayments	39.2	33.0	38.0	40.4	43.9	48.6	52.7	56.9
Other	38.3	62.1	107.1	70.9	23.1	25.1	119.0	248.6
Total assets	1,316.2	1,446.7	1,763.7	1,847.7	1,957.0	2,087.0	2,226.0	2,384.5
Shareholder equity	921.2	1,078.9	1,148.6	1,226.9	1,327.3	1,445.0	1,573.8	1,722.1
Non-current liabilities	284.8	284.4	542.1	544.8	548.6	553.8	558.4	563.0
LT debt	247.3	247.9	500.0	500.0	500.0	500.0	500.0	500.0
Other	37.5	36.5	42.1	44.8	48.6	53.8	58.4	63.0
Current liabilities	110.2	83.4	73.0	76.1	81.2	88.2	93.8	99.3
ST loans	10.9	11.1	0.0	0.0	0.0	0.0	0.0	0.0
Trade payables & prepayments	34.9	27.5	31.7	33.7	36.6	40.6	44.0	47.5
Other	64.4	44.8	41.2	42.4	44.5	47.6	49.8	51.8
Total liabilities and equity	1,316.2	1,446.7	1,763.7	1,847.7	1,957.0	2,087.0	2,226.0	2,384.5

Cash Flow

	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
Cash flows from operating activities	131.3	133.9	149.8	180.8	202.5	227.9	248.6	267.9
Earnings before interest and taxes (EBIT)	53.9	99.5	94.3	113.2	127.1	143.4	156.9	174.8
Depreciation and amortisation	55.4	54.6	68.7	85.0	94.2	105.0	114.6	119.8
Income tax expense	-12.5	-5.9	-14.1	-17.1	-18.8	-20.8	-22.7	-26.2
Change in working capital	24.3	-18.6	0.9	-0.2	0.0	0.3	-0.3	-0.5
Other	10.2	4.2	0.0	0.0	0.0	0.0	0.0	0.0
Cash flows from investing activities	-181.0	-270.6	-341.8	-167.9	-193.8	-226.1	-234.4	-263.5
Capital expenditures	-139.1	-246.9	-303.6	-210.5	-246.1	-226.3	-142.4	-141.3
Finance income	25.5	16.0	3.5	5.3	3.1	0.1	0.1	5.6
Other	-67.4	-39.7	-41.7	37.3	49.2	0.0	-92.1	-127.8
Cash flows from financing activities	217.7	-14.0	188.3	-20.4	-7.0	0.1	-1.0	-1.3
Net borrowings (repayments)	242.1	-24.3	223.7	0.0	0.0	0.0	0.0	0.0
Finance costs	-9.9	-6.2	-3.9	-4.2	-4.6	-5.1	-5.5	-5.9
Dividends paid	-20.2	0.0	-121.1	-61.3	-20.4	0.0	0.0	0.0
Other	5.7	16.5	89.5	45.0	18.0	5.2	4.5	4.7
Net cash inflows (outflows)	167.9	-150.8	-3.7	-7.6	1.6	1.9	13.2	3.2
Beginning cash balance	0.8	182.7	36.9	33.5	25.9	27.5	29.5	42.7
FX effects on Cash	12.9	-5.2	0.0	0.0	0.0	0.0	0.0	0.0
FX translation gain/loss	1.1	10.1	0.3	0.0	0.0	0.0	0.0	0.0
Ending cash balance	182.7	36.9	33.5	25.9	27.5	29.5	42.7	45.9

Source: Company data, Bank of Georgia Research

Ratio Analysis

	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
Profitability								
ROA	4.9%	7.3%	5.0%	5.4%	5.6%	5.8%	6.0%	6.4%
ROE	6.4%	10.2%	7.2%	8.2%	8.4%	8.5%	8.5%	9.0%
Liquidity & Solvency								
Current ratio	2.4 x	1.6 x	2.4 x	1.8 x	1.2 x	1.2 x	2.3 x	3.5 x
Quick ratio	2.3 x	1.4 x	2.2 x	1.6 x	0.9 x	0.9 x	2.0 x	3.3 x
Cash ratio	1.7 x	0.5 x	0.5 x	0.4 x	0.4 x	0.4 x	0.5 x	0.5 x
Total debt/Equity	0.3 x	0.2 x	0.4 x	0.4 x	0.4 x	0.3 x	0.3 x	0.3 x
Net debt/Equity	0.1 x	0.2 x	0.4 x	0.4 x	0.4 x	0.3 x	0.3 x	0.3 x
Total debt/EBITDA[1]	2.5 x	1.7 x	2.7 x	2.5 x	2.3 x	2.0 x	1.8 x	1.7 x
Net debt/EBITDA[1]	0.8 x	1.5 x	2.5 x	2.4 x	2.1 x	1.9 x	1.7 x	1.5 x
Financial Leverage	1.4 x	1.3 x	1.5 x	1.5 x	1.5 x	1.4 x	1.4 x	1.4 x
Adjusted Interest coverage[12]	2.9 x	4.0 x	3.6 x	2.9 x	3.3 x	3.7 x	4.0 x	4.5 x
FFO to total debt[1]	0.4 x	0.6 x	0.3 x	0.4 x	0.4 x	0.4 x	0.5 x	0.5 x
RCF to net debt	2.5 x	-0.6 x	0.1 x	-0.1 x	-0.1 x	0.0 x	0.2 x	0.3 x
FFO to adjusted finance expenses[12]	5.0 x	5.1 x	4.7 x	4.2 x	4.6 x	5.1 x	5.5 x	6.0 x

[1] Excluding disposal of Batumi tower in 2012
[2] Including previously capitalized Eurobond interest expense

Source: Company data, Bank Georgia Research

Contacts

Head of Research
Ekaterina Gazadze | egazadze@bog.ge

Associate Director
George Shengelia | gshengelia@bog.ge

Associate
Giorgi Iremashvili | giremashvili@bog.ge

Analyst
Sopho Khelashvili | skhelashvili@bog.ge

Bank of Georgia Research
29a Gagarin Str. Tbilisi 0160, Georgia
+995 32 2444 444
Research@bog.ge

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