BANK OF GEORGIA RESEARCH

Georgian Railway
FY13 in line with expectations; softer recovery in FY14

Georgia | Transportation
Georgian Railway
July 1, 2014

Georgian Railway last week issued FY13 results, in-line with our most recent post-9M13 projections. Revenues rose slightly despite weaker volumes thanks to higher tariffs. Lower electricity and fuel costs indicate gains in efficiency but profitability was hurt by rise in salaries. In FY14, we expect higher revenues and EBITDA as new liquid cargo contracts contribute to growth and dry cargo volumes recover. We expect revenues to grow by 8.2% in FY14 reaching US$ 312.1mn, with the EBITDA margin expanding back to 50.1%.The Tbilisi Bypass Project is still on hold for three years, pending a final decision, meaning that GR now has access to the remaining US$ 91mn in unused project funds.

Tariffs rescue revenues from volume-driven drop

Georgian Railway's FY13 revenues added 2.1% y/y (in GEL terms) as higher tariffs offset a drop in cargo volumes last year. We now expect two main revenue driving segments, liquid and dry cargo transportation (together accounting for 88.5% of total revenues in FY13), to increase by 15.4% and 11.3% y/y in 2014 respectively, compared to our previous estimates of 26.6% and 11.6% growth.

EBITDA to recover on the back of higher liquid cargo volumes

With higher tariffs already in place, we believe that a recovery of freight transportation will have a positive impact on margins going forward. We now expect a 3.6ppts EBITDA margin expansion in FY14 as new liquid cargo volumes and a recovery in dry cargo will provide a boost to the bottom line. Meanwhile, FY13 EBITDA decreased by 12.1% y/y due to higher salary costs effective as of 4Q12. Total salaries increased by GEL 25.0mn (US$ 14.5mn), or 23.1% y/y. A reduction in income from non-continuing operations also fed into last year's bottom line weakness. This was caused by the reversal of a GEL 15.6mn (US$ 9.5mn) guarantee provision made in 2012 that evaporated other income from non-continuing operations.

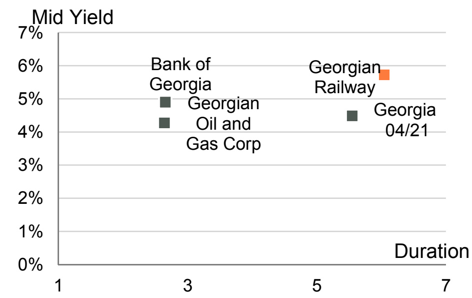
Lower net income in FY13 was due to higher finance costs and FX losses

Net income plunged 32.9% (33.4% in US$ terms) as the above mentioned factors were joined by higher financing costs and lower income. Finance income decreased by GEL 6.8mn (US$ 4.1mn), posting a 35.4% decline compared to FY12, due to decrease in interest rates. Additionally, a GEL 34mn (US$ 20mn) in FX losses were booked in FY13, which expect not to reoccur and net income to reach US$ 72.5mn in FY14 (a 9.6ppts margin expansion).

Cash balance benefits from capex delays

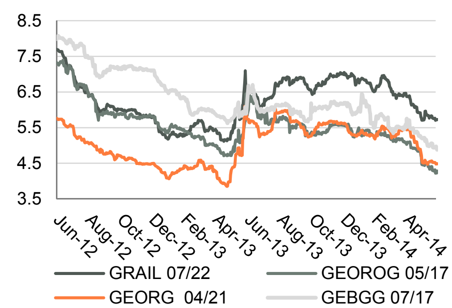
GR's liquidity position was little-changed in 2013 as delays on the Tbilisi Bypass Project cut the size of planned capex outflows. We believe GR will not need additional funding as on average, its funding sources are almost twice as much as uses over the 2014-18 period.

Figure 1: Georgian Eurobond universe



Source: Bloomberg

Figure 2: Georgian Eurobonds, YTM %



Source: Bloomberg

Table 1: Key financials (US$ mn)

	FY13	FY14F	Chg, y/y
EBITDA	134	157	*16.6%*
EBITDA margin	46.5%	50.1%	*3.6 ppts*
EBIT	73	93	*28.0%*
EBIT margin	25.3%	29.9%	*4.6ppts*
Net income	39	73	*85.0%*
Net margin	13.6%	23.2%	*9.6ppts*
Assets	1,662	1,680	*1.1%*
Equity	904	951	*5.2%*
Liabilities	758	729	*(3.8%)*

Source: Company data, BoG Research

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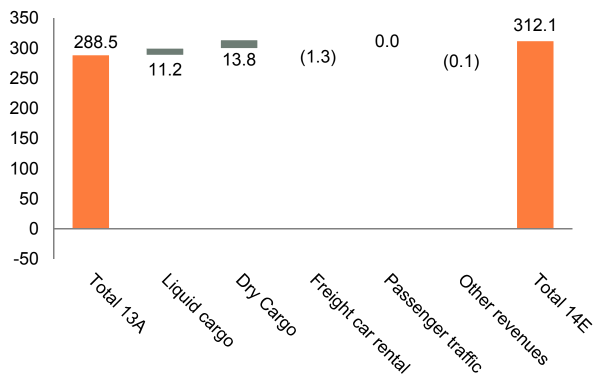
Revenues stable on the back of higher tariffs

Despite a 4.0% y/y drop in volumes, liquid cargo revenues added 18.6% y/y thanks to a hike in tariffs. The decline in liquid cargo volumes in FY13 was mostly temporary and due to maintenance works on oil fields in Kazakhstan. However, GR's acquisition of Georgian Transit LLC, a liquid freight forwarding company, partially compensated the drop in volumes. We now expect FY14 liquid cargo volumes to increase 15.4% y/y including to new volumes from the acquisition of Georgian Transit LLC.

Figure 3: Segment revenue forecast FY13 vs. FY14E, US$ mn



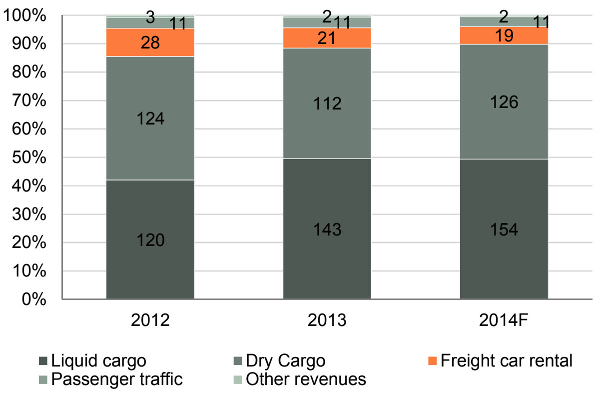
Source: Company data, BoG Research

Dry cargo volumes continued falling on the back of reduced shipments of grain, industrial material, and ores in FY13. Grain shipments fell 33.1% y/y as grain stocks in the region remained high, reducing the need for additional purchase from other regions. In addition high global grain prices likely discouraged buyers from stockpiling reserves. Ore volumes declined 10.1% y/y after low global aluminum prices led Azerbaijani producers to cut output. Changes to aluminum manufacturing processes in Azeri plants also affected volumes. Last year, producers switched from using bauxite to aluminum oxide. The process of aluminum manufacturing requires less aluminum oxide than bauxite, which translated to lower transported ore volumes.

Post-election uncertainty also affects volumes. Management believes temporary stoppages of several construction projects after the 2012 parliamentary elections also negatively affected construction and industrial freight transport volumes, which were down 12.6% y/y last year.

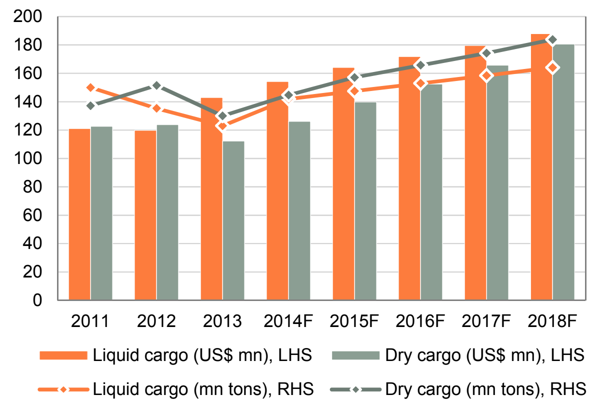
We expect a 7.2% CAGR in dry cargo volumes over 2013 – 2018, reaching 12.9 tons in 2018. This expectation is more modest than our previous estimates, as we believe some volume reduction in FY13 to be permanent. For example, a reduction in the ores segment was caused by changes in aluminum manufacturing processes in factories of Azerbaijan. Previously, these factories used bauxite during manufacturing processes, while at the end of year 2012 they started using aluminum oxide instead of bauxite. Since manufacturing process require lower levels of aluminum oxide compared to bauxite, transportation volume in tons also decreased. We also cut our projections for grain and construction material shipments, as despite the decline in FY13 being temporary we believe the volumes will take longer to recover than it was anticipated by the management.

Figure 4: Revenue breakdown



Source: Company data, BoG Research

Figure 5: Freight transportation volumes and revenues



Source: Company data, BoG Research

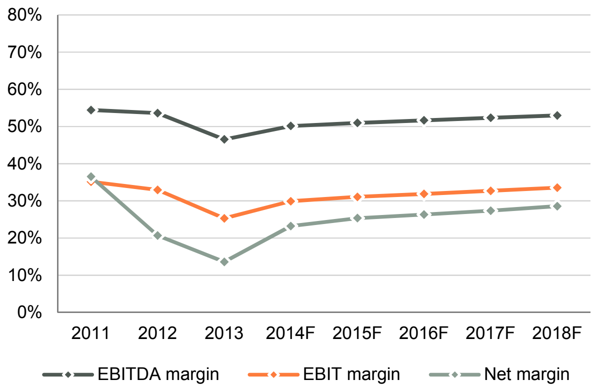
Freight car (railway wagon) rentals, which accounted for 7.1% of total revenues in FY13 fell by GEL 12.1mn (US$ 7.2mn), or 26.0% y/y. Turkmenistan, one of GR's largest markets for freight car rentals, traditionally generates high rental revenues due to stiff delivery delay penalties. In 2013, Turkmenistan Railway acquired new diesel locomotives, which reduced delays and cut GR's revenue. On the positive side, GR now has additional free capacity, which will reduce the need for future investments into rolling stock. Freight car rental revenue was also negatively affected by the expiration of a contract for the exchange of 200 Open Top Box (OTB) railcars for 200 tank cars with Ukrainian Railways. The contract expiration resulted in a decrease in both freight car rental revenue and expense. However, freight car rental expenses decreased only by 12.8% (GEL 3.2mn; US$ 1.9mn), which was not enough to offset fully the extent of decline in freight car rental revenues.

Higher-class ticket sales drive 3.5% y/y growth in passenger revenues. Revenues rose despite a drop in the overall number of passengers as GR sold a higher share of higher-class seats.

Wage hikes having a major impact on profitability

Profitability margins were squeezed mainly from higher salaries and a one-off FX loss booked in FY13. GR's EBITDA margin narrowed 7ppts y/y to 46.5% in 2013, but we expect margins to start recovering in FY14 thanks to higher liquid cargo volumes from projects initiated in FY13. As a result we expect EBITDA margin to expand by 3.6ppts in FY14. We also expect EBIT margin to add 4.6ppts to 29.9% in 2014. We see the net margin adding 9.6ppts in FY14 to 23.2%, as FY14 income statement should be free of the GEL 34mn (US$ 20mn) in FX losses booked in FY13.

Figure 6: Profitability margins



Source: Company data, BoG Research

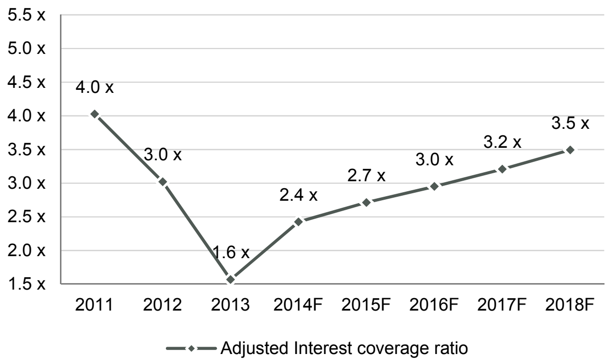
Employee salaries, the largest operating cost item, increased 23.1% y/y (22.1% in US$ terms). The average salary per employee rose to US$ 519 in 2013 from US$ 410 in 2012. As part of the salary and staff optimization project that was launched in 2012, the company upped salaries but halted planned lay-offs due to the election period and a round of employee strikes. Going forward, the Baku-Tbilisi-Kars (BTK) project is slated to be completed in 2015 and management plans to direct existing surplus staff to that project once it becomes operational.

On the upside, GR cut electricity and fuel costs 8.2% in 2013. Although the main driver was the decrease in cargo volumes, the company also increased the average weight of train cargo from 2,050 tons to 2,250 tons, which cut the average electricity expense per gross ton-km of cargo. Georgian Railway also benefited from a lower average fuel purchase price.

Coverage and liquidity ratios are sound

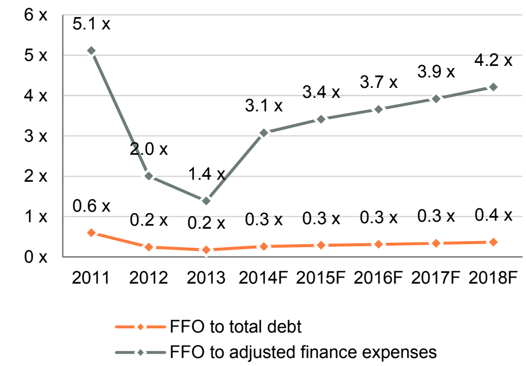
GR's liquidity position is sound. Current capex financing needs are far from demanding after GR delayed one of its major projects, the Tbilisi Bypass Project (TBP). As it currently stands, TBP maybe postponed for 3 years. If cancelled eventually, the company will not face any monetary penalties (it does have a GEL 232mn advance from the government as a liability on its balance sheet, which will be added back to retained earnings if the project is cancelled). We are now assuming the eventual cancellation of TBP as our base case for the projections going forward. Consequently, we believe that GR will not require any additional funding as on average, its funding sources exceed its uses by almost twice as much during 2014-18 period.

Figure 7: Interest coverage ratio



Source: Company data, BoG Research

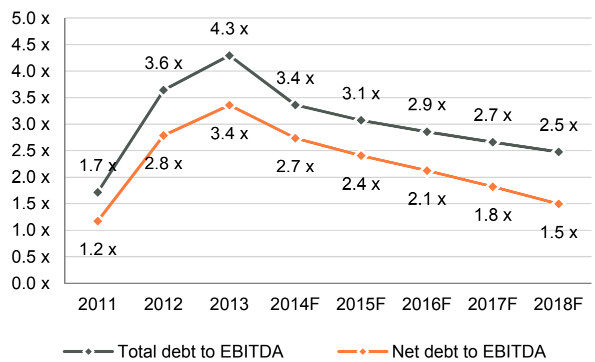
Figure 8: Liquidity



Source: Company data, BoG Research

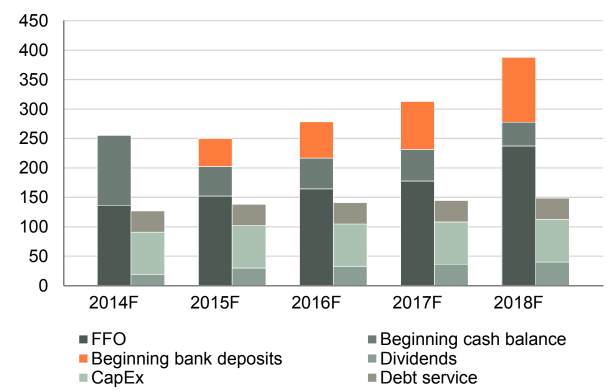
We see net debt-to-EBITDA gradually declining starting this year after approaching the Eurobond covenant in 2013. Last year's increase to 3.4x was caused mainly by a drop in EBITDA as wages rose dramatically due to the company's new employment policy. In addition, net debt-to-EBITDA experienced negative FX affects following depreciation of Lari at the end of 2013.

Figure 9: Debt/EBITDA ratios



Note: Net debt includes short term bank deposits as cash equivalents
Source: Company data, BoG Research

Figure 10: Funding sources (inflows and outflows), assuming TBP cancellation, US$ mn



Source: Company data, BoG Research

GR paid out just GEL 25mn (US$ 15mn) in dividends last year after paying GEL 151mn (US$ 91mn) in an extraordinary dividend in 2012. In our model, we assume a 35% dividend payout ratio going forward (except in 2014 when the ratio will be below 35% as per the Eurobond covenant), the same as our assumption for another quasi-sovereign, Georgian Oil and Gas Corporation (GOGC). As a state-controlled entity, GR is supported by a strict performance-based dividend policy and dividends can be retained if needed.

Financials

Income statement, US$ mn

	2011	2012	2013	2014F	2015F	2016F	2017F	2018F
Revenues	283.1	284.7	288.5	312.1	335.9	356.4	377.6	400.9
y/y change	24.7%	0.6%	1.3%	8.2%	7.6%	6.1%	5.9%	6.2%
SG&A	129.0	132.1	154.2	155.6	164.6	172.2	179.8	188.4
EBITDA	154.2	152.7	134.2	156.5	171.3	184.2	197.8	212.5
EBITDA margin	54.4%	53.6%	46.5%	50.1%	51.0%	51.7%	52.4%	53.0%
D&A	54.6	58.8	61.3	63.1	66.9	70.6	74.3	78.0
EBIT	99.5	93.8	73.0	93.4	104.5	113.6	123.5	134.6
EBIT margin	35.1%	32.9%	25.3%	29.9%	31.1%	31.9%	32.7%	33.6%
Financial expenses (income), net	(9.8)	24.4	27.2	8.0	4.2	3.3	1.9	(0.3)
PBT	109.3	69.5	45.8	85.3	100.3	110.4	121.6	134.8
Tax expense	5.9	10.5	6.6	12.8	15.0	16.6	18.2	20.2
Net income	103.4	58.9	39.2	72.5	85.2	93.8	103.4	114.6
Net margin	36.5%	20.7%	13.6%	23.2%	25.4%	26.3%	27.4%	28.6%

Balance sheet, US$ mn

	2011	2012	2013	2014F	2015F	2016F	2017F	2018F
Non-current assets	1,314.8	1,521.3	1,456.9	1,492.4	1,528.3	1,564.8	1,597.1	1,625.3
PP&E, net	1,145.4	1,348.0	1,351.8	1,386.3	1,427.6	1,465.2	1,499.2	1,529.4
Other	169.4	173.3	105.1	106.1	100.7	99.6	97.9	95.9
Current assets	131.9	215.9	204.8	187.1	209.7	236.1	272.8	321.1
Cash & equivalents	36.9	70.6	120.4	50.4	52.1	54.0	56.1	58.4
Trade receivables & prepayments	33.0	61.9	52.9	54.6	58.8	62.4	66.1	70.2
Other	62.1	83.4	31.5	82.1	98.7	119.7	150.7	192.6
Total assets	1,446.7	1,737.1	1,661.7	1,679.5	1,737.9	1,800.9	1,869.9	1,946.4
Shareholder equity	1,078.9	939.1	903.7	950.5	1,005.9	1,066.9	1,134.1	1,208.6
Non-current liabilities	284.4	711.6	693.0	665.7	666.6	666.9	667.0	667.2
LT debt	247.9	534.3	525.9	500.0	500.0	500.0	500.0	500.0
Other	36.5	177.3	167.1	165.7	166.6	166.9	167.0	167.2
Current liabilities	83.4	86.4	65.0	63.3	65.4	67.1	68.8	70.6
ST loans	11.1	20.5	19.4	19.3	19.3	19.3	19.3	19.3
Trade payables & prepayments	27.5	50.1	32.3	31.2	33.6	35.6	37.8	40.1
Other	44.8	15.8	13.2	12.8	12.6	12.2	11.8	11.3
Total liabilities and equity	1,446.7	1,737.1	1,661.7	1,679.5	1,737.9	1,800.9	1,869.9	1,946.4

Cash flow, US$ mn

	2011	2012	2013	2014F	2015F	2016F	2017F	2018F
Cash flows from operating activities	133.9	145.3	131.4	137.0	152.1	163.9	175.6	187.9
Earnings before interest and taxes (EBIT)	99.5	93.8	73.0	93.4	104.5	113.6	123.5	134.6
Depreciation and amortisation	54.6	58.8	61.3	63.1	66.9	70.6	74.3	78.0
Income tax expense	(5.9)	(10.5)	(6.6)	(12.8)	(15.0)	(16.6)	(18.2)	(20.2)
Change in working capital	(18.6)	(43.1)	(21.6)	(6.8)	(4.1)	(3.7)	(3.9)	(4.3)
Other	4.2	46.2	25.3	0.0	0.0	0.0	0.0	0.0
Cash flows from investing activities	(270.6)	(247.5)	(24.5)	(157.4)	(112.9)	(120.6)	(128.3)	(136.0)
Capital expenditures	(246.9)	(229.8)	(91.3)	(110.0)	(102.8)	(107.1)	(106.5)	(106.2)
Finance income	16.0	11.6	7.4	0.0	4.3	5.6	7.3	9.9
Other	(39.7)	(29.3)	59.4	(47.5)	(14.5)	(19.1)	(29.1)	(39.8)
Cash flows from financing activities	(14.0)	130.6	(55.7)	(48.6)	(37.4)	(41.4)	(45.2)	(49.6)
Net borrowings (repayments)	(24.3)	426.1	25.0	(21.8)	0.0	0.0	0.0	0.0
Finance costs	(6.2)	(35.9)	(34.6)	(8.0)	(8.5)	(8.8)	(9.2)	(9.6)
Dividends paid	0.0	(91.3)	(16.4)	(18.6)	(29.8)	(32.8)	(36.2)	(40.1)
Other	16.5	(168.2)	(29.7)	(0.1)	0.9	0.3	0.2	0.1
Net cash inflows (outflows)	(150.8)	28.4	51.2	(69.0)	1.8	1.9	2.1	2.3
Beginning cash balance	182.7	36.9	70.6	120.4	50.4	52.1	54.0	56.1
FX effects on Cash	(5.2)	1.7	3.8	0.0	0.0	0.0	0.0	0.0
FX translation gain/loss	10.1	3.7	(5.2)	(0.9)	0.0	0.0	0.0	0.0
Ending cash balance	36.9	70.6	120.4	50.4	52.1	54.0	56.1	58.4

Source: Company data, BoG Research

Ratio analysis

	2011	2012	2013	2014F	2015F	2016F	2017F	2018F
Profitability								
ROA	7.3%	3.7%	2.3%	4.4%	5.0%	5.3%	5.6%	6.0%
ROE	10.2%	5.8%	4.2%	7.9%	8.7%	9.1%	9.4%	9.8%
Liquidity & Solvency								
Current ratio	1.6 x	2.5 x	3.2 x	3.0 x	3.2 x	3.5 x	4.0 x	4.5 x
Quick ratio	1.4 x	2.2 x	2.8 x	2.5 x	2.7 x	3.0 x	3.5 x	4.0 x
Cash ratio	0.5 x	0.8 x	1.9 x	0.8 x	0.8 x	0.8 x	0.8 x	0.8 x
Total debt/Equity	0.2 x	0.6 x	0.6 x	0.6 x	0.5 x	0.5 x	0.5 x	0.4 x
Net debt/Equity	0.2 x	0.5 x	0.5 x	0.5 x	0.4 x	0.4 x	0.3 x	0.3 x
Total debt/EBITDA[1]	1.7 x	3.6 x	4.3 x	3.4 x	3.1 x	2.9 x	2.7 x	2.5 x
Net debt/EBITDA[1]	1.2 x	2.8 x	3.4 x	2.7 x	2.4 x	2.1 x	1.8 x	1.5 x
Financial Leverage	1.3 x	1.8 x	1.8 x	1.8 x	1.7 x	1.7 x	1.6 x	1.6 x
Adjusted Interest coverage[12]	4.0 x	3.0 x	1.6 x	2.4 x	2.7 x	3.0 x	3.2 x	3.5 x
FFO to total debt[1]	0.6 x	0.2 x	0.2 x	0.3 x	0.3 x	0.3 x	0.3 x	0.4 x
RCF to net debt	-0.6 x	0.1 x	0.0 x	0.0 x	0.0 x	0.0 x	0.1 x	0.1 x
FFO to adjusted finance expenses[12]	5.1 x	2.0 x	1.4 x	3.1 x	3.4 x	3.7 x	3.9 x	4.2 x

[1] Excluding disposal of Batumi tower
[2] Including previously capitalized Eurobond interest expense
Note: Net debt includes short term bank deposits as cash equivalents
Source: Company data, BoG Research

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