Georgian Railway
9M15 Freight Transportation Dynamics

Georgia | Transportation
Georgian Railway
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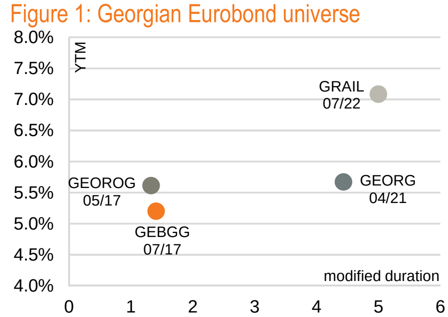
S&P BB- / Fitch BB-

With GR's recent release of the 9M15 Management Discussion and Analysis, we offer a breakdown of 9M15 freight transportation. Both liquid and dry cargo categories posted decreases, down 2.6% y/y and 7.4% y/y, respectively. The weak performance comes against a backdrop of pressure from continued weak market fundamentals on freight transportation and regional currency weakness.

GR's 9M15 freight transportation revenue decreased 4.8% y/y as its constituents, liquid and dry cargo categories, decreased 2.6% y/y and 7.4% y/y, respectively. The cargo mix continues to shift, as crude oil is being replaced by the more profitable oil products category. Increased volumes of heavy black oil from Kazakhstan drove revenue from oil products transportation up 9.5% y/y. Crude oil revenues, on the other hand, dropped 45.1% y/y, as pipelines continue to replace the railways for shipments stemming from Kazakhstan and Azerbaijan.

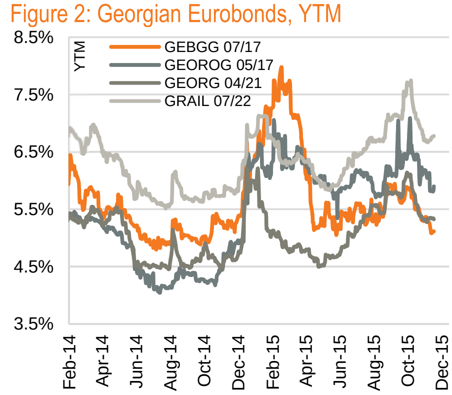
Most dry cargo categories posted y/y decreases in revenue. Exceptions were the ferrous metals and scrap and 'other' categories, expanding 27.2% y/y and 16.2% y/y, respectively. Notably, the increase in ferrous metals and scrap was due to higher average revenue per ton-km, as transportation volume decreased 9.8% y/y. Similarly, the 'other' category transportation volume only increased 2.3% y/y, meaning the freight transported generated much higher revenues per ton-km, in comparison to last year. Ores, grain, sugar, and construction freight revenues decreased 27.1% y/y, 12.5% y/y, 19.7% y/y, and 25.5% y/y, respectively. Even more dramatic were the decreases in industrial freight (61.5% y/y) and cement (65.9% y/y) categories, but their shares in total freight revenues are insignificant.

Figure 1: Georgian Eurobond universe



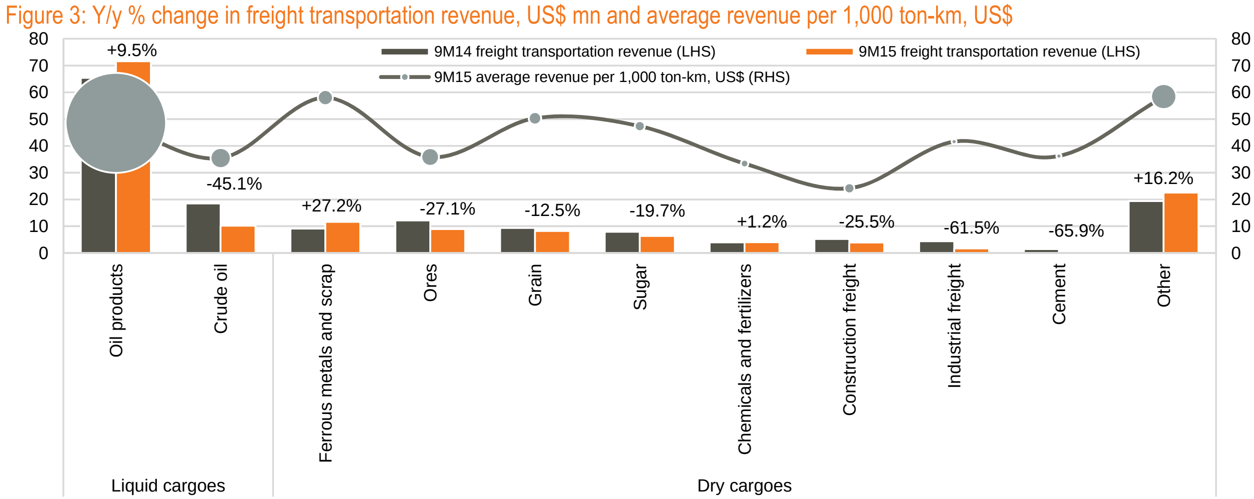
Source: Bloomberg

Figure 2: Georgian Eurobonds, YTM



Source: Bloomberg

Figure 3: Y/y % change in freight transportation revenue, US$ mn and average revenue per 1,000 ton-km, US$



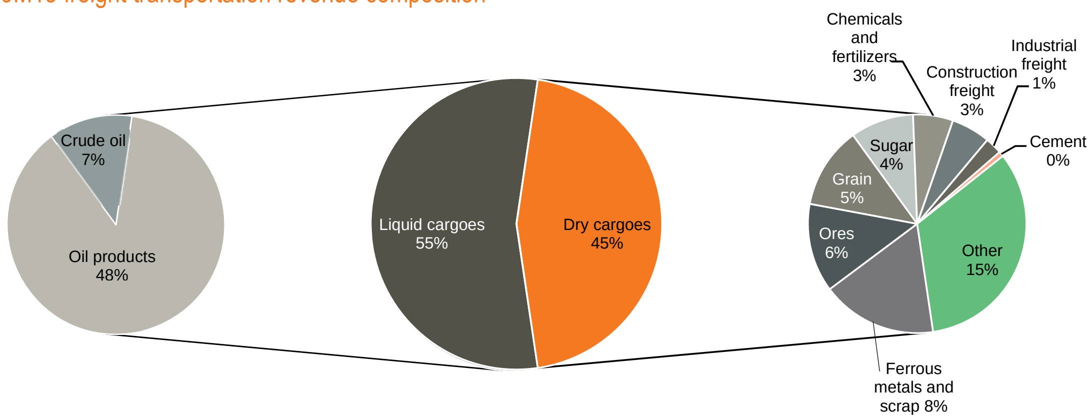
Source: Company data, Galt & Taggart Research
Note: Marker size indicates freight volume in ton-km

Nino Papava
Head of Research | n.papava@gt.ge | +995 32 2401 111 ext. 4693

David Ninikelashvili
Senior Analyst | dninikelashvili@gt.ge | +995 32 2401 111 ext. 8137

Due to the drop in dry cargo transportation, GR's 9M15 freight mix tilted further toward the liquid cargo category, accounting for 54.7% of total freight vs. 53.4% in 9M14. Dry cargoes made up the rest - 45.3% vs. 46.6% in 9M14.

Figure 4: 9M15 freight transportation revenue composition



Source: Company data, Galt & Taggart Research

We believe the significant declines, particularly in 3Q15, were due to the regional turbulence, and to a lesser degree, weaker global demand for oil and related products. While we do not expect a rebound in freight in the short term, we believe GR has sufficient flexibility to remain stable and service its obligations without any major difficulties.

As reported in our previous update, GR's 9M15 total revenue decreased 8.3% y/y to US$ 194.5mn. At the same time, operating expenses, which are mostly GEL-denominated, decreased 18.8% y/y to US$ 127.6mn, resulting in a 4.4% y/y increase in adjusted EBITDA to US$ 111.7mn. Similarly, 9M15 adjusted EBITDA and EBIT margins widened to 57.4% and 38.9% in 9M15 from 50.4% and 30.0% in 9M14, respectively.

On December 11, S&P Ratings affirmed Georgian Railway's long-term issuer default credit rating at BB-/Stable/B. The affirmation reflects S&P's view of GR's business risk as weak and financial risk as significant. The stable outlook on GR reflects S&P's view that GR will continue to prudently control its capital spending, while expanding revenues and maintaining sound operational performance, with an EBITDA margin of about 50%.

In addition, S&P Ratings lowered the long-term issuer default credit rating on Azerbaijan Railways to BB-/Negative from BB+/Negative reflecting S&P's revised assessment of AZ Railway's liquidity as 'less than adequate.' S&P also placed the rating on CreditWatch with negative implications. According to S&P, the CreditWatch reflects that S&P may lower the rating by a further two notches if the transfer of the company to the Cabinet of Ministers does not result in improved governmental oversight.

On the same day, Fitch Ratings revised the outlook for railway companies in FSU countries from Stable to Negative, reflecting the pressure from continued weak market fundamentals on freight transportation volumes and rates and local currencies' weakness. Fitch expects pressure on volumes and rates to continue in most FSU countries in 2016 because of challenging market fundamentals and increasing use of pipelines for crude oil transportation.

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Head of Research
Nino Papava | n.papava@gt.ge

Chief Economist
Koba Gvenetadze | kgvenetadze@gt.ge

Economist
Eva Bochorishvili | evabochorishvili@gt.ge

Economist
Alim Hasanov | ahasanov@gt.ge

Senior Associate
Giorgi Iremashvili | giremashvili@gt.ge

Senior Analyst
David Ninikelashvili | dninikelashvili@gt.ge

Analyst
David Kutidze | dkutidze@gt.ge

Analyst
Tamara Kurdadze | tamarkurdadze@gt.ge

Address: 79 D. Agmashenebeli Avenue, Tbilisi 0102, Georgia
Tel: + (995) 32 2401 111
Email: research@gt.ge