

Kazakhtelecom (JSC)

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Kazakhtelecom (JSC)

Major Rating Factors

Strengths:

- Strong incumbent position in key segments.
- Leading network quality and reach.
- Moderate debt levels and conservative inorganic growth strategy.

Weaknesses:

- Low growth of consumer-related sectors.
- Low telephony penetration and limited disposable income.
- Weakening profitability driven by rising costs.
- High exposure to foreign exchange risk.

Corporate Credit Rating

BB/Stable/--

Kazakhstan National Scale Rating

kzA/--/--

Rationale

The 'BB' rating on telecommunications operator Kazakhtelecom (JSC) is based on the company's stand-alone credit profile, which we assess at 'BB-', and on our view that there is a "moderately high" likelihood that the government of the Republic of Kazakhstan (foreign currency BBB-/Stable/A-3; local currency BBB-/Stable/A-3; Kazakhstan national scale 'kzAAA') would provide timely and sufficient extraordinary support if the company were to encounter periods of financial distress.

In accordance with our criteria for government-related entities, our view of a "moderately high" likelihood of extraordinary government support is based on our assessment of Kazakhtelecom's:

- "Strong" link with the state, primarily because the government defines Kazakhtelecom's strategy and financial policy and is unlikely, in our view, to reduce its majority ownership stake in the medium term; and
- "Important" role as Kazakhstan's sole provider of essential services in many regions of the country. The company exclusively owns and continuously invests in the telecoms infrastructure. Moreover, Kazakhtelecom is one of the largest employers in Kazakhstan, explaining the importance of the company for the country.

Kazakhtelecom's stand-alone credit profile is constrained by weak macroeconomic conditions in Kazakhstan, where growth is limited in the consumer-oriented segments, and its own relatively weak operating performance and declining profitability. In addition, it reflects the company's exposure to foreign exchange and interest rate risk. On June 30, 2010, the company's adjusted debt was Kazakhstani tenge (KZT) 78 billion (\$0.5 billion).

The key supporting factor for the rating is Kazakhtelecom's dominant market position in its most important revenue segments, which include local and long-distance telephony, data transmission, internet, and other value-added services. Kazakhtelecom's improved, expanded network and vertically integrated business model support its market leadership, which will be hard for any potential competitors to challenge over the next three years.

Key business and profitability developments

In line with our expectations, the weakening macroeconomic environment in Kazakhstan continues to affect the company's growth, which decreased to 4% in 2009 compared with steady 12%-14% growth in 2008 and 2007. In

2010, revenue has started a gradual recovery, highlighted by 7%-8% growth in the first half of 2010 as a result of an increase in the company's broadband subscriber base.

The weakening profitability continues to weigh on the company's business risk profile. In 2009 and 2010, Kazakhtelecom lowered prices in its most lucrative segment of long-distance telecoms services as a result of regulation. This, together with inefficient cost control, resulted in a decline of the company's unadjusted EBITDA margin to below 30% in the first half of 2010 compared with 33% in the second half of 2009.

Kazakhtelecom recently sold its 51% stake in the country's third-largest mobile GSM operator, Mobile Telecom Services, to Sweden's Tele2. Although Mobile Telecom Services is significantly smaller than Kazakhstan's two largest operators, Tele2 saw the license that came with the acquisition of the stake in the company as its only means of entry into the lucrative Kazakh market.

Key cash flow and capital structure developments

Kazakhtelecom's financial profile has strengthened recently as the company continues to reduce its leverage and improve its liquidity. The company's adjusted debt declined to KZT78 billion as of June 30, 2010 and represented 1.3x its EBITDA, compared with 1.8x a year earlier. Importantly, Kazakhtelecom continues to receive dividends from its 49%-owned mobile subsidiary GSM-Kazakhstan (operating under the K-Cell brand), which positively affects cash flow protection ratios. The company's funds from operations (FFO) to total debt amounted to 72.5%, which is strong for the current ratings.

In 2009 and the first half of 2010, Kazakhtelecom improved its free operating cash flow (FOCF) generation by reducing its investment program. For the 12 months ended June 30, 2010, FOCF amounted to KZT35.6 billion, which allowed the company's cash and equivalents to reach KZT56 billion as of June 30, 2010. In the next 12 months we expect the company to increase the pace of investments as it currently does not face any financial pressure and its liquidity remains adequate.

Liquidity

As of June 30, 2010, Kazakhtelecom's liquidity was adequate as cash and equivalents of KZT56 billion fully covered its short-term debt of KZT14 billion. This reflects the refinancing of the largest maturity in the second half of 2009 as well as the company's strongly positive free cash flow generation.

We expect Kazakhtelecom to enjoy sound liquidity in the next 24 months because the company is self-sufficient in financing its investments, and its short-term debt maturities will be minimal over the next two years.

Recovery analysis

The issue rating on Kazakhtelecom's local currency unsecured debt issue is 'BB', the same as the corporate credit rating. The recovery rating on these notes is '3', indicating our expectation of meaningful (50%-70%) recovery in an event of payment default. This incorporates a jurisdiction-related recovery rating cap.

We have valued the business as a going concern because we believe that Kazakhtelecom's business model would remain viable after default due to its significant market position, valuable nationwide backbone network, and customer base. We believe that a hypothetical default would most likely be driven by significant leverage (as a result of an assumed strong currency depreciation) combined with operational underperformance, driven by deterioration in economic conditions in Kazakhstan.

The issue-level and recovery ratings on the unsecured debt take into account the nature of Kazakhtelecom's assets,

the probability of a restructuring or going-concern sale, and the likelihood of insolvency proceedings being adversely influenced by Kazakhtelecom being domiciled in Kazakhstan.

Our analysis is based on the current capital structure. However, we believe that additional debt could be raised on the path to default, which could have a negative impact on the recovery outcome.

Outlook

The stable outlook reflects our expectation that Kazakhtelecom will continue to generate stable and predictable cash flows, based on its dominant position in a market with very limited competition. We also expect the company to carefully manage its capital-expenditure budget to allow positive FOCF generation. At the present rating level we expect the company to maintain a ratio of debt to EBITDA of less than 2.0x.

An increasingly aggressive appetite for investments, including acquisitions, that leads to meaningfully negative FOCF would likely lead us to lower the ratings. We would also likely lower the ratings if the company's operating performance were to remain weak, and particularly if profitability were to be further eroded.

The possibility of an upgrade is limited over the next 12 months. In the longer term, it would require stability of free cash flow generation, moderation of investment appetite, and prudent financial policy management.

Business Description

Kazakhtelecom is a national vertically integrated telecoms operator in Kazakhstan. The company is 51% owned by national state-owned supra-holding Samruk-Kazyna, which fully controls Kazakhtelecom from a financial and strategic standpoint. Kazakhtelecom provides traditional telephony services to more than 3.3 million subscribers in a country with a population of more than 15 million. The company also derives revenues from leased-line, internet, and data transmission services. In addition, it owns a 49% interest in GSM Kazakhstan, a leading mobile operator in the country.

Business Risk Profile: Weak, Owing To Poor Performance, Despite Strong Position As The Incumbent Telecoms Operator

We assess Kazakhtelecom's business risk profile as weak, owing to the following risks:

- Kazakhstan's economy is weak and lacks diversity. This negatively affects the performance of major telecom-consuming sectors. In addition, the low disposable incomes of the general population limit demand for telecoms services.
- The company has social functions, requiring that it invests in projects with low profitability and/or a long payback period. In the past several years, Kazakhtelecom has kept its investment budget at a fairly high level, compared with its actual business requirements. We understand that some of the investment projects are dictated by the state.
- Operating performance is weakening. As the regulator is pushing for lower prices, the company's EBITDA margin is declining. Kazakhtelecom's inefficient cost management, driven among other things by inability to reduce headcount, adds to the erosion of profitability.

These risks are partly offset by:

- The company's strong incumbent position and exclusive ownership of infrastructure with high quality and reach. In many areas of the country the company is the sole provider of telecoms services. Besides, Kazakhtelecom heavily invests in its infrastructure, which is now capable of providing virtually any type of fixed-line telecoms services.
- Limited competition in key segments. Kazakhtelecom enjoys a dominant position in its key revenue segments, including domestic and international telephony, as well as internet. The potential for intensifying competition in the sector in the current macroeconomic environment is very limited.

Financial Risk Profile: Aggressive, Owing To Appetite For Investments

We assess Kazakhtelecom's financial risk profile as significant, owing to the following main weaknesses:

- The company's aggressive investment appetite limits its free cash flow generation. In 2009, given the need to repay a certain portion of its debt, Kazakhtelecom substantially reduced its capital spending. Still, given its previous track record and the state's commitment to invest in telecoms infrastructure, we expect investments to return to their previous aggressive levels over the medium to long term.
- The company is exposed to interest rate and foreign exchange risk. Even after refinancing, the company is exposed to foreign exchange risk because the amount of the largest bond is tied to the U.S. dollar/tenge exchange rate. In addition, the bond carries a floating coupon rate, linked to LIBOR, which exposes the company to interest rate risk.
- Local financial markets are weak. The local financial markets, including the banking system, are weak and do not allow any major refinancing opportunities for Kazakhstani corporates. Kazakhtelecom consequently needs to fund itself externally. Although the KZT45.5 billion bond was issued locally, the funds originally came from overseas.

These weaknesses are partly offset by:

- Moderate financial leverage. Debt to EBITDA has been below 2x over the past three years and is declining, such that Kazakhtelecom is well positioned to sustain the weakening business environment. Moreover, the company has the capacity to decrease its leverage should it decide to maximize its free cash flow generation.
- Strong predictability of financial decisions. As it is beneficially owned by the state holding Samruk-Kazyna, Kazakhtelecom's financial policy is supervised and controlled by its parent. There is very low risk of any major merger or acquisition because the company is not pursuing any growth opportunities outside Kazakhstan. The company's dividend payments are limited and there is little chance of any increase.

Financial statistics/adjustments

Kazakhtelecom reports on an annual basis under International Financial Reporting Standards, with some limited quarterly disclosure. We made various adjustments to the company's financial statements for financial 2009 (see table 1).

We do not treat the company's share in the profit of GSM Kazakhstan, in which it holds a 49% economic interest, as part of the company's operating income. At the same time, the part of this profit, which is paid as dividends, is included in operating income and increases EBITDA.

Table 1

Reconciliation Of Kazakhtelecom (JSC) Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. KZT)*

--Fiscal year ended Dec. 31, 2009--

Kazakhtelecom (JSC) reported amounts

	Debt	Shareholders' equity	Operating income (before D&A)	Operating income (before D&A)	Operating income (after D&A)	Interest expense	Cash flow from operations	Cash flow from operations	Capital expenditures
Reported	90,595.4	209,071.9	56,352.6	56,352.6	31,813.6	6,903.0	52,833.2	52,833.2	33,271.7

Standard & Poor's adjustments

Operating leases	1,430.6	--	664.1	123.8	123.8	123.8	540.4	540.4	128.2
Postretirement benefit obligations	3,046.9	--	293.5	293.5	293.5	293.5	(9.3)	(9.3)	--
Capitalized interest	--	--	--	--	--	96.9	(96.9)	(96.9)	(96.9)
Reclassification of nonoperating income (expenses)	--	--	--	--	23,155.8	--	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	--	--	--	12,740.0	12,740.0	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	(944.9)	--
Minority interests	--	515.9	--	--	--	--	--	--	--
Reclassification of dividends received	--	--	12,740.0	12,740.0	387.1	--	--	--	--
Total adjustments	4,477.5	515.9	13,697.6	13,157.2	23,960.1	514.2	13,174.2	12,229.2	31.2

Standard & Poor's adjusted amounts

	Debt	Equity	Operating income (before D&A)	EBITDA	EBIT	Interest expense	Cash flow from operations	Funds from operations	Capital expenditures
Adjusted	95,073.0	209,587.8	70,050.2	69,509.8	55,773.7	7,417.1	66,007.3	65,062.4	33,302.9

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts.

Table 2

Kazakhtelecom (JSC) -- Peer Comparison*

	Kazakhtelecom (JSC)	North-West Telecom (JSC)	Uralsvyazinform (OJSC)	Kazakhstan Electricity Grid Operating Co. (JSC)†
Rating as of Dec. 15, 2010	BB/Stable/--	BB-/Positive/--	BB-/Positive/--	BB+/Stable/--

--Fiscal year ended Dec. 31, 2009--

(Mil. \$)

Revenues	969.6	882.4	1,342.3	220.1
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Table 2

Kazakhtelecom (JSC) -- Peer Comparison* (cont.)				
Net income from cont. oper.	218.1	86.1	121.4	(30.0)
Funds from operations (FFO)	438.7	334.8	450.0	56.0
Capital expenditures	223.4	273.0	186.2	126.0
Debt	640.3	704.5	869.2	385.0
Equity	1,411.6	1,031.4	839.7	724.8
Adjusted ratios				
Oper. income (bef. D&A)/revenues (%)	48.7	45.3	41.8	30.0
EBIT interest coverage (x)	9.2	3.0	2.4	2.1
EBITDA interest coverage (x)	9.4	6.8	4.6	3.5
Return on capital (%)	22.0	10.0	15.6	3.9
FFO/debt (%)	68.4	47.5	51.8	14.5
Debt/EBITDA (x)	1.4	1.8	1.6	5.8

*Fully adjusted (including postretirement obligations). †Fully adjusted.

Table 3

Kazakhtelecom (JSC) -- Financial Summary*					
	--Fiscal year ended Dec. 31--				
	2009	2008	2007	2006	2005
Rating history	BB/Stable/--	BB/Stable/--	BB/Stable/--	BB/Stable/--	BB/Stable/--
(Mil. KZT)					
Revenues	143,966.0	138,449.9	127,762.1	113,912.6	99,558.3
EBITDA	69,509.8	53,974.3	45,336.6	45,088.2	39,063.0
Net income from continuing operations	32,387.3	31,804.9	32,970.2	35,259.2	30,910.5
Funds from operations (FFO)	65,062.4	45,480.5	49,417.0	44,829.6	33,901.3
Capital expenditures	33,302.9	41,075.1	45,180.2	30,614.6	23,415.1
Free operating cash flow	32,704.4	4,578.4	5,922.1	9,737.8	10,009.6
Discretionary cash flow	27,371.7	(1,581.7)	5.5	4,796.6	5,783.4
Debt	95,073.0	99,072.3	88,366.9	63,326.6	31,215.5
Equity	209,587.8	192,115.4	167,236.7	135,198.4	107,057.6
Adjusted ratios					
Oper. income (bef. D&A)/revenues (%)	48.7	39.2	35.5	39.6	39.2
EBIT interest coverage (x)	7.5	7.3	7.9	11.6	22.6
EBITDA interest coverage (x)	9.4	9.1	8.3	11.8	20.5
Return on capital (%)	17.9	14.8	17.3	23.9	32.1
FFO/debt (%)	68.4	45.9	55.9	70.8	108.6
Debt/EBITDA (x)	1.4	1.8	1.9	1.4	0.8

*Fully adjusted (including postretirement obligations).

Ratings Detail (As Of December 15, 2010)*

Kazakhtelecom (JSC)

Corporate Credit Rating

BB/Stable/--

Kazakhstan National Scale Rating

kzA/--/--

Ratings Detail (As Of December 15, 2010)* (cont.)	
Senior Unsecured (1 Issue)	BB
<i>Kazakhstan National Scale Rating</i> (1 Issue)	kzA
Corporate Credit Ratings History	
15-Dec-2009	BB/Stable/--
12-May-2009	BB/Negative/--
19-Aug-2005	BB/Stable/--
28-Oct-2009 <i>Kazakhstan National Scale Rating</i>	kzA/--/--
Business Risk Profile	Weak
Financial Risk Profile	Significant
*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.	

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