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Credit Opinion: National Company Food Contract Corporation JSC

Global Credit Research - 11 Jul 2014

Astana, Kazakhstan

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Ba3
Senior Unsecured -Dom Curr	Ba3/LGD4

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Key Indicators

National Company Food Contract Corporation JSC[1]

	2013	2012	2011	2010	2009	2008
EBIT Margin	20.0%	23.4%	19.6%	20.9%	26.3%	16.0%
EBIT / Interest Expense	0.9x	1.2x	1.5x	1.7x	2.5x	2.1x
Debt / EBITDA	11.7x	9.7x	13.5x	5.8x	10.3x	9.6x
FFO / Debt	-0.4%	3.1%	-0.7%	7.0%	4.4%	4.6%
(Cash from Operations - Dividends) / Net Debt	55.7%	12.5%	-63.2%	114.7%	-58.5%	-71.0%
Free Cash Flow / Debt	43.2%	9.5%	-60.6%	68.7%	-53.9%	-70.7%

[1] Annual ratios as adjusted by Moody's

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Inherent volatility of the company's revenues, operating profit and cash flows

- Dependence on government budget programme for agricultural segment

- High leverage

- History of strong government support

Corporate Profile

Headquartered in Astana, Kazakhstan, JSC National Company Food Contract Corporation (FCC) is fully owned by the state of Kazakhstan through JSC National Holding Company KazAgro. By virtue of its current ownership structure, we consider FCC to be a government-related issuer (GRI).

FCC is the largest grain trader in Kazakhstan. Its principal mandate is to maintain state grain reserves at levels required to supply the Kazakh population and to ensure timely grain replenishment. The company is also responsible for keeping accounting records and monitoring the quality, quantity and security of state grain resources. Since 2002, the company has been permitted to perform commercial operations on behalf of the state related to grain sales.

FCC also acts as the main governmental tool in development and supporting the stability of the country's grain market, and grain prices in particular, through large-scale purchases and sales of grain on the domestic market. In 2005, the company began providing loans to farmers as another form of support to domestic agricultural producers. In addition, as part of the state's initiative to develop domestic grain sector, starting June 2013, the company has been acting as a managing company of the newly established United Grain Holding (UGH) which includes grain producers, including small and medium farmers, on a voluntary principle. Members of UGH benefit from (1) priority access to FCC's financing programs; (2) guaranteed purchase of grain which FCC then will sale on the open market, including on the domestic market and for export; and (3) distribution of income between members of the UGH, who had supplied grain to FCC.

FCC has 11 regional offices in Kazakhstan, as well as foreign representations in Russia and China. The company has four subsidiaries specialised in the purchase, storage of grain and logistics, six bread depots countrywide and a grain terminal in the Aktau Port on the Caspian Sea with transshipment capacity of 500,000 metric tonnes (mt) per annum. In addition it holds a 50% stake in the grain terminals in Amirabad (Iran) and Baku (Azerbaidzhan).

At the end of December 2013, FCC reported revenues of KZT48.3 billion (approximately $265 million) and adjusted EBIT of KZT9.6 billion (approximately $53 million).

SUMMARY RATING RATIONALE

FCC's Ba3 corporate family rating is determined in accordance with our rating methodology for GRIs (Government-Related Issuers: Methodology Update, published in July 2010), which comprises the following inputs (1) a baseline credit assessment, or BCA - a measure of the company's underlying fundamental credit strength, excluding any government support - of b3; (2) the Baa2 local currency rating of the government of Kazakhstan; (3) high default dependence between the GRI and the government; and (4) the probability of strong support from the government.

The b3 BCA is constrained by FCC's (1) volatile revenues, operating profit and cash flows; (2) high dependence on the state for funding; and (3) history of weak credit metrics in particular high gearing, with a substantial proportion of its loans being short term in nature.

However, FCC's ratings benefit from the state support it receives on an ongoing basis, mainly in the form of shareholder loans, loans from the Ministry of Agriculture of Kazakhstan, and, to a lesser extent, equity injections. The ratings also factor in (1) the company's more than 10-year track record of operations in domestic and international grain markets; and (2) its long-term relationships with grain storage companies in Kazakhstan, grain traders and foreign banks.

We also take into account that FCC's weak operating and financial profile is mainly driven by the company's mandate to maintain state grain reserves and act as a government's arm to regulate domestic grain prices, which often implies operating against the market trends, i.e., selling grain at below-the-market prices and buying grain at above-the-market prices.

DETAILED RATING CONSIDERATIONS

STRONG GOVERNMENT SUPPORT EXPECTED TO BE MAINTAINED

As per our GRI rating methodology, FCC's ratings incorporate uplift to the company's standalone credit quality, measured by a BCA of b3. The uplift to the BCA is driven by the credit quality of the state as the sole shareholder, and our assessment of strong support from its ultimate shareholder in the event of financial distress, as well as high default dependence between the company and the state.

The high level of default dependence reflects (1) FCC's full state ownership, and its high reliance on the government for operational support, both directly and indirectly as the company acts as a government agent; (2) the high concentration (around 90%) of the company's revenues in the domestic market; and (3) the sensitivity of FCC's financials to the same sources of risk as the government, as political events might affect the willingness of the government to support the company (or even willingness to support the continued existence of the company).

Strong support is predicated on (1) the significance of agriculture to the Kazakh economy, as well as the sector's contribution to national exports, albeit secondary to the importance of the oil and gas sector; (2) the threat of reputation risk to the state if it failed to service the company's financial debts (via a fully owned state agency) in a timely manner; (3) the role played by the company in underpinning national economic growth that favours non-oil-related sectors; and (4) the actual state support that FCC has received to date, in the form of interest-free loans, capital injections and subsidies.

The degree of support is constrained by the lack of an explicit guarantee of FCC's financial liabilities by Kazakhstan, although we expect the government will ensure that FCC is in a position to honour its financial obligations in a timely manner.

COMPANY'S REVENUES, OPERATING PROFIT AND CASH FLOWS ARE INHERENTLY VOLATILE

The company's earnings and cash flow remain inherently volatile, as grain prices vary owing to imbalances between demand and supply. These imbalances are driven by weather conditions and exacerbated by the application of outdated technologies by Kazakh farmers and the overall undeveloped nature of the grain sector in the country. This volatility is further reinforced by the company's special mandate to maintain state grain reserves and regulate domestic grain prices, which often implies selling grain at below-the-market prices and buying grain at above-the-market prices, as well as significant investments in working capital explained by the nature of the company's mandate and industry seasonality.

In 2013, the company's revenues declined by more than 30% mainly as a result of (1) large sales of grain (more than 50% of company's total sales volume of 1.5 million mt in 2013) in H1 2013 at reduced prices to stabilise the market following a weak grain harvest (around 12.2 million mt in net weight) in Kazakhstan in 2012 (2011: around 27 million mt) as a result of droughts in several districts of the country; (2) lower average market price and overall reduced sales volumes (2 million mt in 2012) owing to healthy 2013 harvest (18.2 million mt in net weight). These factors together with loss-making non-core businesses also led to weaker gross margin (21.6% in 2013 vs. 34.4% in 2012), which was however partly compensated by savings in administrative expenses (mainly bad debt provision). As a result, reduced operating profit was not sufficient to cover substantial financial expenses of the company and led to negative pretax income and funds from operations (FFO).

Despite negative FFO, FCC's cash flow from operations turned positive to around KZT52 billion on the back of decrease in its working capital of around KZT52.6 billion as a result of (1) decrease in inventories (purchases amounted to only around 164 thousand mt vs.1.5 million mt of grain sales in 2013) for the second consecutive year after record-high purchases in 2011 (around 5.2 million mt); (2) reduced loans to farmers compared with 2012; and (3) lower trade receivables owing to a decline in sales volumes.

In FY 2014, we expect that the company's grain sales will remain at or slightly below the 2013 level, while at the same time, the share of more profitable export sales is going to visibly increase. However, FCC's financial results will continue to be negatively affected by large grain sales at prices below the market in order to support the domestic market following the sharp devaluation of Kazakh tenge in February 2014. Still low level of purchases from the market under the Kazakh government's expectation of a grain harvest of around 19 million mt as well as stable level of loans to farmers and accounts receivables should support the company's cash flow generation.

DEPENDENCE ON FINANCIAL SUPPORT FROM GOVERNMENT AND SHORT-TERM COMMERCIAL BANK LOANS TRANSLATES INTO HIGH LEVERAGE AND ONGOING REFINANCING PRESSURE

FCC is highly dependent on the government's financial support in performing its main functions as a regulator of domestic grain prices and provider of financing to farmers. Although FCC's ratings benefit from the ongoing state support, we note that it mainly comes in the form of short-term reduced-interest shareholder loans and interest-free loans from the Ministry of Agriculture of Kazakhstan, and, to a lesser extent, in the form of equity injections. As of end-FY 2013, FCC's interest-free loans amounted to KZT5 billion (approximately $27 million; around 4% of total reported borrowings), and reduced-interest loans from the holding company KazAgro amounted to KZT42 billion (approximately $230 million; around 42% of total borrowings). In addition, FCC is reliant on short-term commercial bank loans to fund its high working capital requirements, with total short-term debt accounting for around 60% of the company's borrowings.

Overall, the company's balance sheet remains highly indebted, although its adjusted debt position slightly decreased to KZT120 billion, or approximately $0.7 billion (2012: KZT177 billion), while its adjusted equity remains stable at around KZT61 billion. As a result, as of year-end 2013, the company's adjusted gearing (measured as adjusted debt/book capitalisation) was 66%, decreasing from 74% in 2012. At the same time, leverage (measured by debt/EBITDA) increased to 11.7x (9.7x in 2012), driven by the decrease in the company's EBITDA, which was underpinned by lower sales and profitability. However we consider that leverage is a less appropriate measure of risk for FCC considering that it is not a cash-flow driven business model. The main risk for the company is the risk of equity not being sufficient to cover an increasing balance sheet, and in particular increased inventories, or to be affected by losses on inventories. As a result, FCC's credit standing is primarily driven by the capacity of its equity base to represent a sufficient cushion to cover its debt. We expect that the company's gearing and leverage will remain elevated, owing to specifics of the company's business model. We understand that none of FCC's existing debt facilities have financial covenants.

Liquidity Profile

STATE FUNDING IS CRITICAL TO LIQUIDITY

We expect that the company will be able to maintain a satisfactory liquidity position over the next 12 months, based on the assumption of planned support from the Kazakhstan government in the form of interest-free loans from Kazakhstan's Ministry of Agriculture, as well as loans from KazAgro to finance grain purchases and provide financing to the country's farmers.

We note that FCC remains highly reliant on timely state funding, as well as on its ability to roll over short-term working capital facilities with banks. However, the history of regular government support, FCC's critical role in the Kazakh agricultural sector and the company's long-established relationships with banks provide some comfort that it will maintain satisfactory liquidity.

Rating Outlook

The outlook on FCC's rating is stable, reflecting our expectation that the banks and government will remain supportive of the company in meeting its future financial commitments in a timely manner.

What Could Change the Rating - Up

Upward pressure is unlikely to be exerted on the rating over the intermediate term in light of FCC's weak balance-sheet structure, reflected in the company's BCA.

What Could Change the Rating - Down

Downward pressure could be exerted on the rating if support from the Kazakh government fails to materialise in a timely manner when needed. In addition, any downgrade of the sovereign rating could have a direct effect on FCC's CFR. Increased gearing to above 70% on sustained basis could exert negative pressure on the BCA and, in turn, on the rating.

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