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Research Update:

Transnet SOC Ltd. 'BB-' Ratings Affirmed; Outlook Negative; SACP Revised To 'b' On Reassessed Competitive Position

November 13, 2023

Rating Action Overview

- We think Transnet SOC Ltd.'s competitive position has weakened due to persisting structural operational challenges and expect its earnings recovery to remain constrained, given the deteriorating performance of Transnet Freight Rail (TFR), its largest division.
- We expect slow revenue growth, lower margins, and high capital expenditure (capex) requirements for fiscal years 2024-2026 (year ending March 31) to lead to annual S&P Global Ratings-adjusted negative free operating cash flow (FOCF) ranging from South African rand (ZAR) 6.6 billion to ZAR15.2 billion.
- We lowered our assessment of Transnet's stand-alone credit profile (SACP) to 'b' from 'b+'. However, this has no impact on the issuer credit rating, because we maintain our view that Transnet has a very high likelihood of receiving extraordinary support from the South African government.
- We therefore affirmed our 'BB-' issuer credit ratings on Transnet, our 'BB-' issue rating on the company's senior unsecured debt, our 'BB' issue rating on its ZAR3.5 billion government-guaranteed debt, and our 'zaAA-/zaA-1+' South Africa national scale ratings on the group.
- The negative outlook on Transnet reflects our view that persisting operational challenges, and ongoing liquidity and funding constraints, remain significant.

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Rating Action Rationale

We lowered our assessment of Transnet's SACP to reflect weakening competitive position relative to similarly rated peers. In our view, Transnet's competitive position has weakened amid ongoing structural operational challenges. The underperformance of TFR, its largest division, inefficiencies at ports, and underperformance relative to its corporate plan, in our opinion, has reduced cash flow and affected the stability of profitability. We think Transnet is increasingly more vulnerable to potential operational disruptions or country-specific risks and is less able to capitalize on existing business demand. With this backdrop, the company's earnings stability and preservation will increasingly rely on management's ability to recalibrate its operating cost structure through cost-cutting and efficiency initiatives as well as deploying significantly higher capital expenditure (capex) compared with what management has spent in the past three years. While we acknowledge the shareholder's continuing efforts in initiating rail, port, and road reforms, we think that the cumulative value of sectorwide reforms, a fundamental change of Transnet's operating model and the business' long-term repositioning will take more time than we had expected. Moreover, Transnet's role and reach will likely evolve given the anticipated increased private sector participation. Considering these collective factors, and relative to international peers with similar business segments, we now assess the company's competitive position as fair (compared with satisfactory previously), resulting in our view that the business' medium-to-long-term prospects are less favorable.

Notwithstanding the challenges facing Transnet, we think the company continues to play an instrumental role in South Africa's transport industry and by extension its economic growth, due to its control of all major logistics infrastructure. While we anticipate high barriers to entry in its business segments will gradually erode with reforms, Transnet has a dominant position in rail freight and monopoly positions in regulated port and pipeline activities. Consequently, it enjoys good diversity and some revenue visibility due to TFR's take-or-pay contracts and pipelines and national ports regulated tariff linked revenue.

We now assess Transnet's financial risk as highly leveraged, from aggressive before, due to more stringent financial thresholds now applicable following our revised business assessment. With the business assessment revision to fair from satisfactory, we now apply higher financial thresholds to the company's cash flow ratios when assessing its metrics. While we generally view the transportation infrastructure industry as exhibiting low cyclicality relative to other industries in terms of revenue and profitability, we think Transnet's operational challenges, which remain largely unresolved, will lead to weaker operational performance and heightened cash flow volatility than we had anticipated. Operational challenges, which include volume growth, constraining its main revenue and EBITDA generating division, and the effects of a relatively fixed cost structure lead us to think Transnet will continue to face significant obstacles to its recovery, pressuring profitability and free cash flow. Therefore, we revised down our base-case projections, leading to weaker forecast operating metrics. We now expect the company to post S&P Global Ratings-adjusted EBITDA margins of 34%-38% over the next two years relative to our previous expectation of 35%-40%. We underpin these expectations on Transnet's high fixed-cost base, which is not indexed to the company's activity level and the strain on costs from operational issues (for instance, higher security and incidence costs). We now forecast S&P Global Ratings-adjusted annual funds from operations (FFO) of ZAR12 billion-ZAR14 billion for fiscal years 2024-2026, versus our previous expectation of ZAR16 billion-ZAR22 billion. At the same time, we expect annual capex requirements will remain significant (ZAR19 billion-ZAR29 billion) given the large maintenance backlog. With management's decreasing ability to further delay maintenance capex, we expect Transnet's S&P Global Ratings-adjusted FOCF to be under pressure, turning to negative ZAR6.6 billion in fiscal 2024 relative to positive ZAR7.1 billion in fiscal 2023. With capex requirement expected to peak at ZAR29 billion in fiscal 2026, we expect negative FOCF to worsen to ZAR15 billion by then. While Transnet is exploring private sector participation transactions to augment its key infrastructure development, it remains unclear how these initiatives will influence the utility's self-funded capital requirements.

Transnet's liquidity remains less than adequate due to lower cash generation and not-secured long-term committed funding coinciding with significant debt maturities and elevated capex requirements. Following the inaugural 8.5% $1 billion five-year bond under the global medium-term notes (GMTN) program, the company settled the ZAR12.6 billion bridge-to-bond facility due February 2023, reducing looming refinancing risk and the receipt of ZAR5.8 billion from Treasury towards the end of fiscal 2023 improved the strained liquidity. We understand that Transnet is exploring funding initiatives, which could see it establishing a ZAR5 billion liquidity buffer. However, absent additional long-term committed funding being secured to date, we maintain our assessment of less than adequate liquidity. We also consider that the company's cash flow will remain constrained as initiatives to improve TFR's capacity and efficiency will likely take time to yield the desired effects. At the same time, the company's uses of liquidity for the 12 months started Oct. 1, 2023, remain significant with ZAR14 billion required for debt maturities (after rolling over ZAR4.6 billion of the ZAR7 billion TN23 bond that was due Nov. 6) and about ZAR18.4 billion for capex. While the company's annual capex has been in the ZAR11 billion-ZAR12 billion range, we think Transnet has diminished optionality to use capex as a liquidity management lever given the significant maintenance capex backlog (estimated to be near ZAR50 billion) and the negative effect less-than-optimal capex will continue exert on cash flow. Our assessment of less than adequate liquidity is neutral for the rating level, but should material operational underperformance, especially at TFR, or an inability to refinance short-term facilities with longer-term debt materialize over the next 12 months, we might reassess Transnet's liquidity as weak, cap its SACP at 'b-', and lower the issuer credit rating.

Our fair management and governance assessment on Transnet reflects the significant steps the company has taken to remediate the material weakness in its internal controls. We recognize that the previous executive team achieved some progress in laying a solid foundation to bring back a culture of integrity and heightened control, preventing and mitigating corruption and public finance management act (PFMA)-related irregularities. However, the task of achieving a complete company turnaround remains substantial. Given persisting operational constraints and funding limitations, in our view, management's ability to effectively control the execution of Transnet's strategy has weakened. Therefore, we will continue to monitor the extent to which the incoming management will influence the execution of the company's revised corporate plan.

We could revise our assessment of very high government support downward if Transnet's cash flow remains suboptimal and liquidity continues to deteriorate without an adequate response from the government. We continue to see a very high likelihood of Transnet receiving extraordinary support from the government based on the company's very important role for South Africa (foreign currency rating: BB-/Stable/B; local currency rating: BB/Stable/B). We base this on the company's position as the monopoly provider of port and pipeline infrastructure, dominant position in port operations and freight rail, and very strong link with the government, which fully owns Transnet and oversees its strategy, funding plans, and regulation. Our assessment of the likelihood of extraordinary government support results in an uplift of the SACP and our issuer credit rating to 'BB-'. Given Transnet's weakening cash flow, linked to operational challenges that remain unresolved, along with increased capex requirements (ZAR122.7 billion from fiscal years 2024-2028) and debt repayment of ZAR14 billion in the next 12 months, we consider the potential need for government support as elevated. Should the government not either support Transnet in its short-term refinancing undertakings or support the company's liquidity if it cannot raise sufficient funding on its own balance sheet, we could revise our assessment of a very strong link with the government downward, reducing the uplift government support has on our ratings.

Outlook

The negative outlook on Transnet reflects our view that persisting operational challenges, as well as ongoing liquidity and funding constraints, remain significant.

Downside scenario

We could downgrade Transnet if its SACP weakens to 'b-' from 'b' due to:

- Liquidity deteriorates from lower cash generation and a failure to secure long-term funding to support capex requirements and settle debt maturities;
- We lowered our business risk profile to weak due to further reduced operating efficiency, higher-than-expected profit volatility, or concessions that decrease its monopolistic advantages; or
- We view government's efforts to stabilize Transnet's operational challenges as neither timely nor sufficient.

Upside scenario

We could raise the rating if Transnet's cash flow improves. This could happen if the company addresses operational challenges faster than expected, leading to enhanced cash flow, and it secures additional long-term funding while maintaining manageable leverage. We could also raise the rating if we take a similar action on South Africa.

Company Description

Transnet, which is wholly state-owned via the Department for Public Enterprise (DPE), owns and operates integrated rail freight, port, and pipeline infrastructure in South Africa. The company's main objectives include constructing an efficient rail freight system to reduce reliance on road transport, and operating ports efficiently to reduce ocean freight costs. These objectives reflect the government's strategic initiative to improve the efficiency and competitiveness of the South African economy for the bulk and manufacturing sectors.

Freight rail is the largest of Transnet's six core operating divisions, contributing 44% of fiscal 2023 revenue and 29% of EBITDA. Regulated activities, which are subject to the National Energy Regulator for pipelines or the Port Authority Regulator for the National Ports Authority business, account for 24% of the company's revenue and 54% of EBITDA. About 65% of Transnet's rail freight volumes are from take-or-pay contracts, so about 60% of its revenue is either regulated or based on predictable volumes and prices. The remainder of the freight rail unit's business is exposed to competition.

Transnet also provides cargo-handling services and container activities in ports, which accounted for about 21% of fiscal 2023 revenue and 26% of EBITDA.

Our Base-Case Scenario

Assumptions

- South African real GDP growth of 0.8% in 2023, 1.7% in 2024, and 1.7% and 2025.
- Revenue increasing modestly by 2.2% in fiscal 2024 relative to our previous expectation of about 8%, then rising 2%-4% in fiscal years 2025 and 2026.
- S&P Global Ratings-adjusted EBITDA margin of 34%-35% over the coming two years relative to our previous expectation of 36%-38%. Our lower EBITDA expectations are underpinned by Transnet's high fixed-cost base and the strain on costs from operational issues.
- Annual capex of ZAR19 billion-ZAR29 billion in fiscal years 2024-2026.
- No dividend distributions in the forecast period.

Key metrics

Transnet SOC Ltd.--Forecast summary

	--Fiscal year ended March 31--				
(Mil. ZAR)	**2021a**	**2022a**	**2023e**	**2024f**	**2025f**
Revenue	67,273	68,459	68,877	70,374	72,026
EBITDA	18,415	23,342	24,284	24,287	25,449
Funds from operations (FFO)	4,916	10,933	10,645	12,569	12,551
Debt	124,363	129,053	129,235	135,687	148,131
Adjusted ratios					
Debt/EBITDA (x)	6.8	5.5	5.3	5.6	5.8
FFO/debt (%)	4.0	8.5	8.2	9.3	8.5

All figures are adjusted by S&P Global Ratings, unless stated as reported. ZAR--South African rand. a--Actual. e--Estimate. f--Forecast.

Liquidity

We consider the group's liquidity less than adequate, based on constrained financial headroom and our estimate that the ratio of liquidity sources to uses will be less than 1.2x in the next 12 months. Our assessment of liquidity as less than adequate (as opposed to weak) considers the supportive nature of Transnet's banking relationships, as seen in lenders granting waivers for financial and nonfinancial covenant breaches several times over the past few years. It also considers that the company is pursuing several funding initiatives. Therefore, we do not consider the improved liquidity as exclusively depending on low probability, unforeseen events--an important consideration for assessing liquidity as weak, under our criteria.

We estimate that principal liquidity sources over the 12 months started Oct. 1, 2023, will include:

- Cash and liquid investments and committed undrawn bank lines maturing beyond 12 months of about ZAR15.3 billion

- Expected average annual cash FFO of about ZAR12.7 billion

For the same period, we estimate principal liquidity uses will include:

- Short-term debt maturities of ZAR14 billion
- Negative working capital of about ZAR500 million
- Annual maintenance capex of ZAR18.4 billion
- No dividends, acquisitions, or mergers

Covenants

At March 31, 2023, approximately 39% of Transnet's total debt contained rating-related covenants. From 2017-2021, the ratings on South Africa were on a downward trajectory, and Transnet successfully negotiated with its lenders regarding covenant triggers for facilities. This could have led to interest rate increases, posting of additional guarantees, and, in limited cases, debt acceleration. More recently, rating pressure on Transnet has emanated from the company's weaker cash flow and constrained liquidity buffer. Should there be any negative rating actions on Transnet, we expect the company will be able to negotiate with banks, given its track record of supportive relationships in the credit markets. However, we would also evaluate the potential impact of further negative rating actions on Transnet's liquidity position.

In addition, some loans contain a leverage covenant stipulating debt to debt plus equity of 60% and cash interest coverage (CIC) of 2.5x. As of March 31, 2023, Transnet's leverage covenant was within the debt covenant requirement at 43.6% and the CIC was 2.1x, breaching covenants on 11 loans, with a total capital balance of ZAR35 billion. After fiscal year-end 2023, Transnet secured waivers from all lenders affected by the breach. Based on our current forecasts, we expect headroom on the CIC covenant through fiscal 2024 to be limited due to constrained cash flow and high debt funding. If we expect coverage covenants will be breached with no credible plan to mitigate this, such as obtaining covenant lifts or waivers, we would reassess the company's liquidity as weak, which could result in our SACP assessment being capped at 'b-'.

Environmental, Social, And Governance

Social and governance factors are negative considerations in our credit rating analysis of Transnet. Social risks are more prevalent in emerging economies such as South Africa. Underlying social tensions and inequalities, which in 2021 manifested as severe social unrest that interrupted national supply chains, translate into weaker business and investment conditions, affecting operating efficiency. Infrastructure damage from human encroachment and criminality elevates safety risk and undermines Transnet's ability to operate at planned capacity. For example, in 2021, train derailments affected the company's dedicated coal line, and a cyberattack complicated port and railway operations. Floods in parts of South Africa in 2022 also damaged infrastructure, hitting operating efficiency in rail, port, and pipeline operations. Transnet also has a weaker governance structure and risk management framework relative to peers'. Governance failures and irregularities, allegedly involving the company's former board and executive team, enabled operational mismanagement and misconduct related to procurement processes before 2019. Although there has been progress in the past three years, governance challenges will take time to remediate, and recent executive management churn will place focus on how the entity's governance structure and risk management framework is further strengthened.

Issue Ratings--Subordination Risk Analysis

Capital structure

We align our issue ratings on Transnet's debt with the respective issuer credit ratings due to the low amount of secured and priority debt issued by the operating entities.

Analytical conclusions

Accordingly, our ratings on the senior unsecured debt are at the same level as the respective long-term issuer credit ratings.

We equalize our ratings on two debt instruments (maturing in 2028 and 2029) guaranteed by South Africa with the respective long-term sovereign ratings.

Ratings Score Snapshot

Issuer Credit Rating	BB-/Negative/--
Business risk:	Fair
Country risk	Moderately high
Industry risk	Low
Competitive position	Fair
Financial risk:	Highly leveraged
Cash flow/leverage	Highly leveraged
Anchor	b
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Less than adequate (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Neutral
Stand-alone credit profile:	b
Group credit profile	b
Related government rating	Foreign currency: 'BB-'; local currency: 'BB'
Likelihood of government support	Very high (+2 notches)

Related Criteria

- General Criteria: National And Regional Scale Credit Ratings Methodology, June 8, 2023
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10,

2021

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Various Rating Actions Taken On Three South Africa Issuers; National Scale Ratings Removed From UCO, July 5, 2023
- Transnet SOC Ltd. Proposed Senior Unsecured Notes Assigned 'BB-' Ratings, Jan. 31, 2023
- Transnet SOC Ltd. 'BB-' Ratings Affirmed; Outlook Remains Negative, Nov. 29, 2022

Ratings List

Ratings Affirmed	
Transnet SOC Ltd.	
Issuer Credit Rating	BB-/Negative/--
South Africa National Scale	zaAA-/--/zaA-1+
Senior Unsecured	BB*
Senior Unsecured	BB-

*Guaranteed by Republic of South Africa

Regulatory Disclosures

Transnet SOC Ltd.

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Rating Committee Chairperson: G. Andrew Stillman

Date initial rating assigned: Sep. 04, 1997

Date of previous review: Jul. 05, 2023

Disclaimers

This rating has been determined by a rating committee based solely on the committee's independent evaluation of the credit risks and merits of the issuer or issue being rated in accordance with S&P Global Ratings published criteria and no part of this rating was influenced by any other business activities of S&P Global Ratings.

This credit rating is solicited. The rated entity did participate in the credit rating process. S&P Global Ratings did have access to the accounts, financial records and other relevant internal, non-public documents of the rated entity or a related third party. S&P Global Ratings has used information from sources believed to be reliable but does not guarantee the accuracy, adequacy, or completeness of any information used.

Materials Used In The Credit Rating Process: Sufficient information in general consists of both (i) financial statements that describe the Issuer's financial condition, results of operations and cash-flows, and (ii) a description of the activities and obligations of the entity including of its governance and legal structure.

This credit rating was disclosed to the rated entity or related third party before being issued.

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Glossary

- Anchor: The starting point for assigning an issuer a long-term rating, based on its business risk profile assessment and its financial risk profile assessment.
- Business risk profile: This measure comprises the risk and return potential for a company in the market in which it participates (its industry risk), the country risks within those markets, the competitive climate, the company's competitive advantages and disadvantages (its competitive position).
- Comparable rating analysis: This involves taking a holistic review of a company's stand-alone credit risk profile (SACP), because each of the subfactors that ultimately generate the SACP can be at the upper or lower end, or at the midpoint, of such a range. It may also touch upon the overall comparative assessment of an issuer in relation to its peers across industry and

jurisdiction and may capture some factors not (fully) covered, such as a short operating track record, entities in transition, unusual structures, or contingent risk exposures.

- Competitive advantage: The strategic positioning and attractiveness to customers of the company's products or services, and the fragility or sustainability of its business model.
- Competitive position: Our assessment of a company's: competitive advantage; operating efficiency; scale, scope, and diversity; and profitability.
- Corporate Industry and Country Risk Assessment (CICRA): Derived by combining an issuer's country risk assessment and industry risk assessment.
- Country risk: This measures a country's influence on the overall credit risks for a rated company with regards to a country's economic, institutional and governance effectiveness, financial system, and payment culture/rule of law risks.
- CreditWatch: This highlights the potential direction of a short- or long-term rating over the short term, typically less than three months. Ratings may be placed on CreditWatch where, in our view, an event or a deviation from an expected trend has occurred or is expected and additional information is necessary to determine the rating impact.
- Creditworthiness: Ability and willingness of a company to meet its debt and debtlike obligations; measured by assessing the level current and future resources relative to the size and timing of its commitments.
- Diversification/portfolio effect: Applicable to conglomerates. An assessment of the extent to which an entity's multiple core business lines are correlated and whether each contributes a material source of earnings and cash flow.
- Earnings: Proxy for profit or surplus yielded by an entity after production and overhead costs have been accounted for in a given period.
- EBITDA margin: This is EBITDA as a fraction of revenues.
- EBITDA: This is earnings before interest, tax, depreciation, and amortization.
- Economies of scale: This is the cost advantage that arises with increased size or output of a product.
- Efficiency gains: Cost improvements.
- ESG credit factors: Those environmental, social, and governance (ESG) factors that can materially influence the creditworthiness of a rated entity or issue and for which we have sufficient visibility and certainty to include in our credit rating analysis. These credit factors can have a negative or positive impact on creditworthiness, depending on whether they represent a risk or an opportunity.
- Financial headroom: Measure of deviation tolerated in financial metrics without moving outside or above a predesignated band or limit typically found in loan covenants (as in a debt-to-EBITDA multiple that places a constraint on leverage) or set for the respective rating level. Significant headroom would allow for larger deviations.
- Financial risk profile: This measure comprises our assessment of a company's cash flow/leverage analysis. It also takes into account the relationship of the cash flows the organization can achieve given its business risk profile. The measure is before assessing other financial drivers such as capital structure, financial policy, or liquidity.
- Free operating cash flow: Cash flow from operations minus capital expenditure.
- Funds from operations: EBITDA minus interest expense minus current tax.

- Government-related entity: An entity that could, under stress, benefit from extraordinary government support in order to meet its financial obligations; or conversely an entity controlled by a government that could be subject to negative extraordinary government intervention if the government is under stress.
- Group rating methodology: The assessment of the likelihood of extraordinary group support (or conversely, negative group intervention) that is factored into the rating on an entity that is a member of a group.
- Industry risk: This addresses the major factors that affect the risks that companies face in their respective industries.
- Issue credit rating: This is a forward-looking opinion about the creditworthiness of an obligor with respect to a specific class of financial obligations or a specific financial program.
- Issuer credit rating: This is a forward-looking opinion of an obligor's overall creditworthiness.
- Leverage: The level of a company's debt in relation to its earnings before interest, tax, depreciation, and amortization.
- Liquidity: This is the assessment of a company's monetary flows, assessed over a 12-to-24-month period. It also assesses the risk and potential consequences of a company's breach of covenant test, typically tied to declines in EBITDA.
- Management and governance: This addresses how management's strategic competence, organizational effectiveness, risk management, and governance practices shape the issuer's competitiveness in the marketplace, the strength of its financial risk management, and the robustness of its governance.
- Operating efficiency: The quality and flexibility of the company's asset base and its cost management and structure.
- Outlook: This is the assessment of the potential direction of a long-term issuer rating over the short to intermediate term (typically six months to two years).
- Stand-alone credit profile (SACP): S&P Global Ratings' opinion of an issue's or issuer's creditworthiness, in the absence of extraordinary intervention or support from its parent, affiliate, or related government or from a third-party entity such as an insurer.