RUSSIAN RAILWAYS (Baa1/BBB/BBB) vs. GAZPROM (Baa1/BBB/BBB) – DIFFERENT CREDIT STORIES?

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It looks logical to us that the maiden benchmark eurobond of Russian Railways (RZhD), Russia's railway monopolist, is meeting with a good response from investors. The roadshow for the new issue was launched on Monday, and its book is due to close on Friday 26 March, with oversubscription already anticipated.

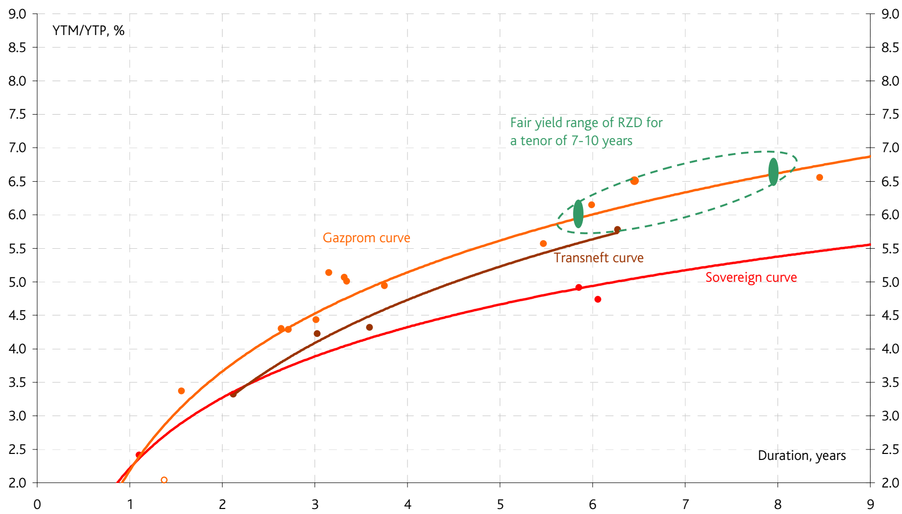
One can easily find lots of factors contributing to the investment attractiveness of the company's new issue. Firstly, RZhD is a 100% federally-owned company with a 'natural monopoly' status, more than 1.0 mln employees under its wing and a 2.4% contribution to the country's GDP – certainly a strategically crucial enterprise which can count on state support until the very last. Secondly, the company's standalone profile also looks rather solid, with its Debt/EBITDA ratio, for instance, standing at just 2.2x as of 1H 2009 under IFRS, which is less than the level of most of its international peers in the capital-intensive railway transport industry. Finally, we do not know many eurobonds offering exposure to the credit risks of the national transport operator of an emerging-market economy with issuer's ratings in the 'triple-B' category, which by itself makes the expected placement quite interesting.

From what we understand, the pricing of the new deal is going to be quite aggressive – the eurobond may be placed below the yield curve of Russia's benchmark issuer, Gazprom (like those of another transport monopolist, Transneft). In this report we briefly compare the key aspects of the credit standing of RZhD and Gazprom and arrive at the conclusion that as far as fundamentals are concerned we would expect a marginal spread (if any) between the two companies' eurobonds.

Gazprom is the country's most important enterprise with excellent lobbying power and the ability to tap international debt markets under almost any conditions. However, RZhD is a company with somewhat greater room for maneuver and which has traditionally enjoyed greater direct support from the state. Marginal differences in the issuers' credit strengths mean that at current levels a 7-year RZhD eurobond should yield YTM 5.75%-6.25% @ Mar 2017 – somewhere in-between the issues **Gazprom 2016** (YTM 5.5% @ Nov 2016) and **Gazprom 2018** (YTM6.0% @ Apr 2018).

However, in the present environment, with high demand for the debt of high-quality corporate issuers in general and on the issue being placed in particular, we can imagine a scenario where the actual yield will turn out to be a bit lower than the abovementioned range. Today's pricing of the eurobond gives yield of 250-260 bp over swaps, which corresponds to YTM 5.73-5.83% @ Mar 2017 – at the lower end of our range.

EXHIBIT 1. FAIR POSITIONING OF THE NEW RZhD EUROBOND



Source: Bloomberg, TRUST

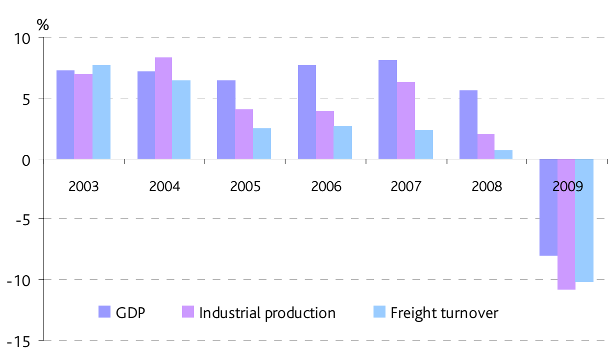
The **STRATEGIC IMPORTANCE** of RZhD looks well established, both now and for the foreseeable future. In view of the long distances involved in transporting many cargos and passengers throughout Russia, railway transport is an unusually dominant component of the country's transport mix, making up 84.8% of total cargo turnover (excluding pipelines) and 37.7% of total passenger turnover in 2009. The company also makes a notable contribution to Russia's GDP: in FY 2009 it contributed 2.4% of GDP, and RUB40.0 trln (comparable to Russia's annual GDP) of benefits for the country are expected to be realized from the company's strategy for the domestic railway transport sector through to 2030. Moreover, RZhD is the country's largest employer – a fact which perfectly highlights its huge social importance.

However, we are convinced that Gazprom has an even more vital influence on Russia's economy, given its dominance on the domestic market, its exclusive right to export gas, its contribution of around 10.0% of GDP and its immense significance for the budget (it made cash payments of over RUB1.4 trln of tax and duties in FY 2008 under IFRS – almost 10 times the figure for RZhD, according to our estimates, or around 9.0% of Russia's consolidated budgetary income for the year). Gazprom has also traditionally been one of Russia's key instruments for furthering the country's geopolitical interests in the external arena. This is definitely not the case for RZhD – a largely domestically-oriented enterprise.

Still, in speaking of the strategic importance of the companies and the consequent likelihood of them receiving support from the state, we should stress that, if economic conditions were to deteriorate to the point of either RZhD and Gazprom needing urgent help from the government as a last resort, the creditworthiness of the state itself would already probably be in peril.

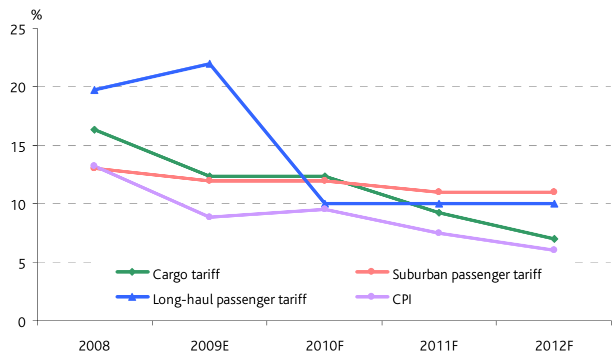
The **OPERATING POSITIONS** of RZhD are expected to remain quite solid in the coming years. Traditionally, the situation in the transportation industry correlates pretty well with the overall macroeconomic environment (see Exhibit 2). Still, whatever happens, we do not see many alternatives in Russia to the company's services in the cargo transportation segment (contributing 73.1% of the group's revenues as of 1H 2009 under IFRS), which is demonstrated by the fact that Russia's official sector development strategy foresees a CAGR of 1.5-2.0% for railway cargo turnover through to 2030. Pricing for freight transportation will continue to be set for the company on a 'cost-plus' basis by the Federal Tariff Service (FTS). This method is supposed to allow revenues to cover the company's operating, investment and debt-related expenses and is therefore beneficial for RZhD[1] (see Exhibit 3).

EXHIBIT 2. MACRO INDICATORS AND FREIGHT TURNOVER



Source: FSSS

EXHIBIT 3. TARIFF DYNAMICS VS. INFLATION, 2008-2012F



Source: the Ministry of Economic Development, Company data

In the passenger transportation segment (13.5% of revenues as of 1H 2009) the situation does not look as straightforward though. The company is already feeling increased competition from other modes of transportation and additional hikes in tariffs on the group's services could make alternative forms of transport look even more comparatively attractive. So much will depend on how RZhD manages to increase the efficiency of its business and the quality of the services it renders.

Gazprom's situation is in many ways alike. Its dominance on the domestic gas market is unquestionable, while in Europe gas monopolists' current positions are likely to be pressured by deliveries of shale gas and coalbed methane (nonetheless, many sources still estimate Gazprom's share of the European gas market at over 30.0% in 2020). Domestic gas prices are expected to rise in the medium term on the back of the price liberalization process (whose implementation has now been postponed until 2014), while in Europe, at least for the foreseeable future, downward pressure from much lower spot prices will be felt (the company is already reviewing some of its price-setting mechanisms).

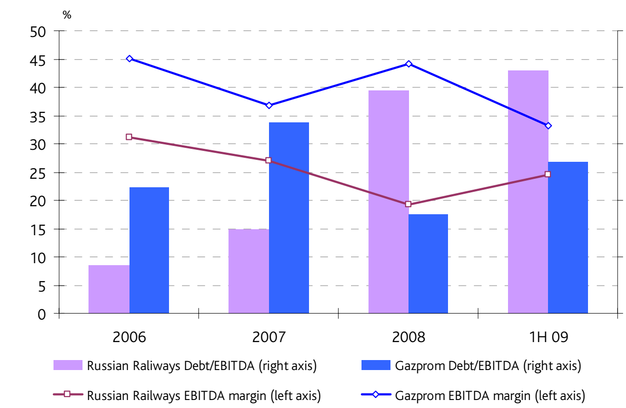
[1] Currently the tariff on the company's freight transport services comprises 3 components: a charge for locomotive traction, infrastructure services (85% of the tariff between them) and a railcar payment, which is charged if the customer prefers to use RZhD's railcars (the remaining 15%). Under ongoing railway sector reform, the company is expected to transfer all of its railcars to its subsidiary companies Freight One and Freight Two, whose services are unregulated by the FTS. Therefore, in the medium to long term RZD will no longer receive this railcar tariff component. Still, from what we understand, RZhD will be compensated for this by not having to make such big investments in railcar purchases and modernization.

The **INVESTMENT NEEDS** of RZhD look massive in absolute terms, with RUB2.5 trln of investments planned for the period 2008-15 and more than RUB250.0 bln of annual capex scheduled for 2010-12. However, we need to point out that the company's ability to manage and amend its plans is quite high (for instance, with the onset of the crisis RZhD's investment program for 2009-11 was cut by 2.4x). We also highlight the fact that RZhD has traditionally received a substantial portion of funds for its capex directly from the government (for 2010-11 half of its investment program will be subsidized), giving it more financial freedom and helping it to maintain low leverage. At the moment the company is trying to negotiate an additional RUB400.0 bln of capital-related subsidies until 2015 from the government; and its supply of public debt in the coming years will in many ways be dependent on the success of these negotiations.

Gazprom's investment pressures are even greater, with annual capex in the range of RUB600.0 bln to RUB800.0 bln until 2030, less ample opportunities to postpone key investment projects and the necessity of finding sources for its capex largely on its own. Even though this situation is not anything new for the monopoly, it ensures that in the years to come Gazprom will have to remain Russia's largest borrower.

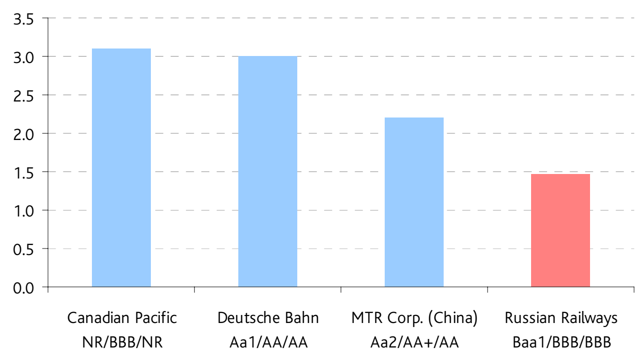
The **FINANCIAL STANDING** of RZhD in the medium to long term will, in our view, be primarily defined by a combination of two factors. On the one hand, the company itself looks fully committed to keeping its leverage under control (its cap for its Net debt/EBITDA ratio is set at 2.0x) and optimizing its debt portfolio structure (target foreign currency debt exposure of no more than 20%; target share of long-term indebtedness at 80%). On the other hand, the company's investment needs, as already indicated, are immense and its leverage will in many ways be dependent on what sources these investments are funded from. For now, RZhD expects to finance the bulk of its capex from operating cash flows, subsidies and funds from asset sales. However, should the Russian economy recover at a slower pace than the company hopes or the government turns against endowing the company with double-digit tariff increases or large volumes of subsidies, it may still be forced to resort to debt, thus putting upward pressure on its leverage.

EXHIBIT 4. RUSSIAN RAILWAYS VS. GAZPROM KEY INDICATORS



Source: Gazprom, Russian Railways data, TRUST

EXHIBIT 5. NET DEBT/EBITDA OF RUSSIAN RAILWAYS AND ITS INTERNATIONAL PEERS, 2008



Source: Company data, TRUST

For Gazprom, the situation is not too different in our view. So far the company has been managing to keep its Debt/Equity ratio (its target indicator) below 40% and its Debt/EBITDA no higher than 2.0x. However, challenging conditions for the company on the EU and USA gas markets could cause its leverage to move upwards (as of 9M 2009 the company's total debt under IFRS had already reached RUB1.8 trln, or more than half of the group's 12-month revenues). Still, it should not be forgotten that both companies operate in highly capital-intense industries, and that therefore even a surge in leverage over the benchmark level of 2.0x would be acceptable, especially given a comparison to the firm's international peers.

For neither of the two companies is the **CREDITWORTHINESS OF PRINCIPAL SUBSIDIARIES** (RZhD: TransCreditBank (Ba1/BB/NR), Transcontainer (Ba2/NR/BB+), TransTelecom (NR/NR/B+); Gazprom: Gazprom Neft (Baa3/BBB-NR), Mosenergo (NR/BB-/NR), etc.) a bothersome issue. Moreover, RZhD is currently considering the idea of selling a stake in around 30 of its more than 150 subsidiary enterprises, which means they could also turn out to be an additional source of liquidity for the parent company.

Still, we should not forget that sometimes a 'call of duty' from the government obliges the companies to participate in socially or strategically important projects even if they are not fully consistent with the interests of the companies themselves. One obvious example is the sanation of the troubled banks KIT Finance (RZhD) and Soyuz (Gazprom).

The **CREDIT RATINGS** of RZhD and Gazprom currently match Russia's sovereign rating (Baa1/BBB/BBB) and for RZhD are reflective of the massive governmental support it enjoys, which is expected to increase in the years to come. We should note that historically RZhD's ratings were no weaker than those of Gazprom, and moreover until 2009 Fitch repeatedly assessed the railway monopoly's credit quality as the stronger one.

EXHIBIT 6. RUSSIAN RAILWAYS KEY FINANCIALS

IFRS, RUB bln	2006	2007	1H 08	2008	1H 09	*Chg.***
Revenues	878	1,016	576	1,203	532	*-7.6%*
EBITDA	274	274	153	232	131	*-14.9%*
Net income	140	145	68	76	23	*-65.7%*
Net operating cash flow	247	290	94	283	83	*-11.6%*
Capex	208	283	179	405	149	*-16.9%*
Assets	1,603	1,997		2,601	2,637	1.4%
Equity	1,236	1,394		1,526	1,550	1.6%
Gross debt	116	204		457	449	-1.8%
Short-term debt	27	97		250	214	-14.3%
Cash & cash equivalents	17	24		117	60	-48.4%
Ratios						
EBITDA margin (%)	31.2	27.0	26.7	19.3	24.5	
EBITDA/Interest incurred* (x)	210.5	30.7	18.9	13.0	8.6	
Debt/EBITDA (x)	0.4	0.8		2.0	2.2	
Net debt/EBITDA (x)	0.4	0.7		1.5	1.9	
Liquid funds/Short-term debt (%)	94.5	73.6		71.2	67.5	
Debt/Equity (x)	0.1	0.1		0.3	0.3	

** including net interest and other financial expenses*
*** P&L changes are for 1H 2009 vs. 1H 2008; balance sheet changes are between end 1H 2009 and YE 2008*
Source: Company information, TRUST estimates

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REUTERS: TRUST

TRUSTBND/RUR1	OFZs
TRUSTBND/RUR2	Subfederal bonds
TRUSTBND/RUR3	Telecommunications bonds
TRUSTBND/RUR4	Corporate eurobonds
TRUSTBND/RUR5	Corporate eurobonds
TRUSTBND/EUR1	Sovereign and subfederal eurobonds
TRUSTBND/EUR2	Corporate eurobonds (oil & gas, telecoms)
TRUSTBND/EUR3	Corporate eurobonds (industry)
TRUSTBND/EUR4	Corporate eurobonds (banks & finance)
TRUSTBND/EUR5	Corporate eurobonds (banks & finance)
TRUSTBND/EUR6	Corporate eurobonds (banks & finance)
TRUSTBND/RF30	Russia 30

BLOOMBERG: TIBM

TIBM11. Corporate ruble bonds
TIBM12. Sovereign debt
TIBM13. Corporate external debt
TIBM4. Macroeconomics and money market
TIBM2. Russia & CIS Credit Daily
TIBM3. Issuer analysis

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