Oil and Gas
KazTransOil

KazTransOil –
The prospect of new tariffs

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Ticker	KZTO KZ
Rating	**Buy**
Current price, ₸/share	1 011
12-month target price, ₸/share	1 300
Potential upside	**29%**

Dividends	
Dividend per share (2019), ₸/share	140,6
Dividend yield	**14%**

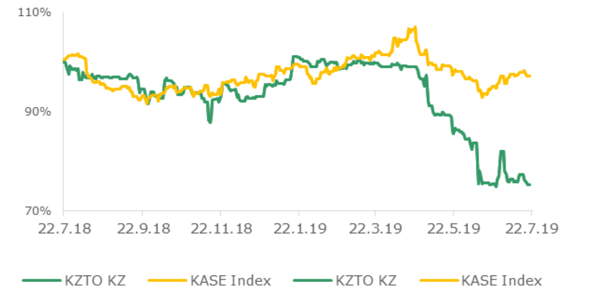
Information	
Number of common shares, mn	385
Average daily trading volume (3 mon, ₸ mn)	32
Free float	10%
Market capitalization ($ mn)	386

Major shareholders	
NC KazMunayGaz	90%

Financials (₸ bn)	2018A	2019F	2020F
Sales	225	241	227
EBITDA	102	120	100
Net income	38	54	42
Equity	625	643	634
EPS (₸)	100	141	109
Dividend per share (₸)	104	141	109

Multiples	2018A	2019F	2020F
P/E (x)	10,1	7,2	9,3
P/B (x)	0,6	0,6	0,6
EV/EBITDA (x)	n/a	3,2	3,9
Dividend yield	n/a	13,9%	10,8%
RoE	6,2%	8,4%	6,6%

Share price performance	KZTO KZ
1M	-12,8%
3M	-24,7%
12M	-27,4%
52-week high	1 430
52-week low	1 000



Source: Bloomberg, Company data, Halyk Finance estimates

A 25% correction for 3M due to the negative newsflow background forms a favorable moment for the purchase of KazTransOil shares. Considering the risks of reducing and freezing domestic tariffs by regulator since 2020, the export direction is the main link in the stability of financial indicators, the tariff policy of which is free from the regulation of the antimonopoly committee. We are confident in the continued demand for the KTO pipeline system due to its uniqueness with respect to the eastern direction and we assess the strategic importance of the export potential for the country as a guarantee of steady demand for KTO services. We recommend to ***Buy*** *KazTransOil shares from 12M TP T1300/share and growth potential of 29%.*

The risk of reducing domestic tariffs is offset by the possibility of higher export prices. KazTransOil submitted an application for approval by the antimonopoly committee of new tariff levels for the domestic transportation. Taking into account the concerns of the company regarding the reduction of tariffs to the level of zero profit, we take into account in our assessment a reduction within 10%, counting revenue in the domestic market based on the level of 4,250 tenge/ton*km up to 2023 (0% growth) with the resumption of growth in 2023-2026 by 10%. At the same time, the company faces the need to increase the export tariff, which, according to our estimates, will amount to 8% yoy to 2022 with a gradual narrowing of growth to 4% by 2026, since the potential for an increase in fees for export shipments is limited to company's belonging to the KMG group.

Stable freight turnover regardless of Tengiz and Kashagan. In Kazakhstan a significant increase in oil production is expected due to Tengiz and Kashagan, oil from these fields goes mainly through the CPC pipeline. Investments in the amount of $600mln that CPC will use to improve pipeline capacity will focus on Tengiz oil after the expansion program. Thereby, our previous assumptions regarding partial surcharges on oil volumes to current KTO volumes after the expansion of Tengiz may not be realized, and we expect a reduction in the share of oil transported by KTO from all Kazakhstan oil from the current 50% to 35% by 2026, from 45 million tons up to 36 million.

The monopolistic position of the KTO guarantees high demand. Being the operator of a strategically important asset of the country for KTO the pipeline's occupancy with oil is paramount. We believe that problems with unloaded capacity of KTO are unlikely even under the condition of expansion of the CPC system. The fact that the KTO pipeline system has access to the Chinese market is a unique advantage making export and transit transportation attractive, which in addition, are charged in US dollars and in conditions of weak tenge make it possible to service foreign currency loans.

Recommendation to Buy from 12M TP 1300KZT/share. We recommend to Buy KazTransOil shares. We assess the status of the company's assets as a rather important aspect in the country's export potential. With all the risks, our 12M target price amounted to 1300/share and provides a 29% increase.

Fig 1. 2018 results

₸ bn	2017	2018	yoy
Revenue	**222.4**	**225.4**	**1%**
Cost of sales	-146.6	-152.4	4%
Gross profit	75.9	73.0	-4%
General and administrative costs	-16.0	-16.9	5%
Other operational income	2.4	1.1	-55%
Other operational expenses	-1.0	-3.2	227%
Impairment of PP&E, net	-0.04	-2.65	6931%
Operating profit	**61.3**	**51.4**	**-16%**
Foreign exchange loss	-0.7	2.6	n/a
Financial income	4.9	2.8	-43%
Financial costs	-3.1	-2.6	-16%
Impairment of investments	-3.7	0.0	n/a
Share in profit of JV	7.1	-2.1	n/a
PBT	65.9	52.2	-21%
Income tax	-15.8	-13.7	-13%
Net profit	**50.1**	**38.5**	**-23%**

Source: Company data

Fig 2. 1Q2019 results

₸ bn	1Q2018	1Q2019	yoy
Revenue	**52.3**	**59.8**	**14%**
Cost of sales	-34.1	-35.6	4%
Gross profit	18.2	24.2	33%
General and administrative costs	-3.4	-5.3	57%
Other operational income	0.3	0.2	-45%
Other operational expenses	-0.2	-1.0	473%
Operating profit	**15.0**	**18.2**	**21%**
Foreign exchange loss	-0.8	-0.4	-56%
Financial income	0.8	0.6	-18%
Financial costs	-0.6	-0.9	47%
Share in profit of JV	5.3	4.2	-21%
PBT	19.6	21.7	11%
Income tax	-3.5	-3.7	4%
Net profit	**16.1**	**18.1**	**12%**

Source: Company data

Financial results for the 1Q2019

For the 1Q2019 revenues from crude oil transportation increased by 13% exceeding ₸50bn and having the main effect on revenue growth up to ₸59.8bn (+ 14% yoy). Noting the decline in consolidated turnover in 1Q2019 within 2%, we believe that the tariff for export transportation in the reporting period was significantly higher.

The increase in cost was 4% yoy (₸35.6bn), while for general administrative expenses there was a significant increase - by 57% yoy (₸5.3bn). The company associates more than ₸2bn of general administrative expenses with the provision of charitable assistance which greatly exceeds (by 30 times) social expenses, also attributable to general administrative expenses.

Nevertheless, the operating profit (due to revenue growth) amounted to ₸18bn, strengthened by 21%.

The exchange loss decreased by 56% yoy financial expenses increased by 47% yoy and the share in profit of the joint ventures amounted to ₸4.2bn decreased by 21% yoy.

Net income increased by 12% yoy and amounted to ₸18bn.

Operational results for the 1H2019

In the 1H2019 separate KazTransOil (KTO) volume of oil transportation was 22.2mn tons, continuing to show a decline this time by 1% yoy. Oil turnover on a separate basis increased slightly (+ 0.3% yoy) and amounted to 18.9mn tons*km. In terms of consolidated oil turnover, a similar dynamic is developing (+ 0.2% yoy) to 22.9mn tons.

The volume of oil transportation to the domestic market in the 1H2019 amounted to 8.2mn tons of oil (+7% yoy) or 37% of KTO volumes. Export deliveries account for about 41% and transit transport for 22%.

Tariffs

The tariffs for which KTO supplies oil to the domestic market have been approved by the antimonopoly committee for a period of 5 years and expire this year. Thereby, KazTransOil announced the filing of an application for approval of new tariff levels for 2020-2025, which the antimonopoly committee should consider within 90 days. Based on the statements of the company, there is a risk of reduction of tariffs on the domestic market to the level of zero profit. Volumes of supplies to the domestic market in physical terms make up about 36% and in monetary terms about 26% (2018) and a decrease in the profit rate for transportation in the domestic market can have a noticeable effect on the revenue figure.

We believe that in order to maintain revenue at a stable level with a conditional decrease in the domestic tariff in 2020 by 10% to 4250 tenge/ton*km, the export tariff, according to our calculations, should be increased by at least 8% to 6879 tenge/ton*km. Assuming a reduction in tariffs by the regulator we still do not expect a reduction in tariff in 2020 by more than 10% and we calculate revenue in the domestic market based on the level of 4250 tenge/ton*km (-10% relative to the current level) up to 2023 (0% growth) and expect the resumption of the annual growth rate in 2023-2026 by 10%.
At the same time, the inevitable increase in the export tariff according to our calculations should remain at the level of 8% yoy to 2022 with a gradual narrowing of growth to 4% by 2026, providing a consensus level for KTO consumers.
We believe that the potential for increasing fees for export shipments is quite high from a market point of view but rather

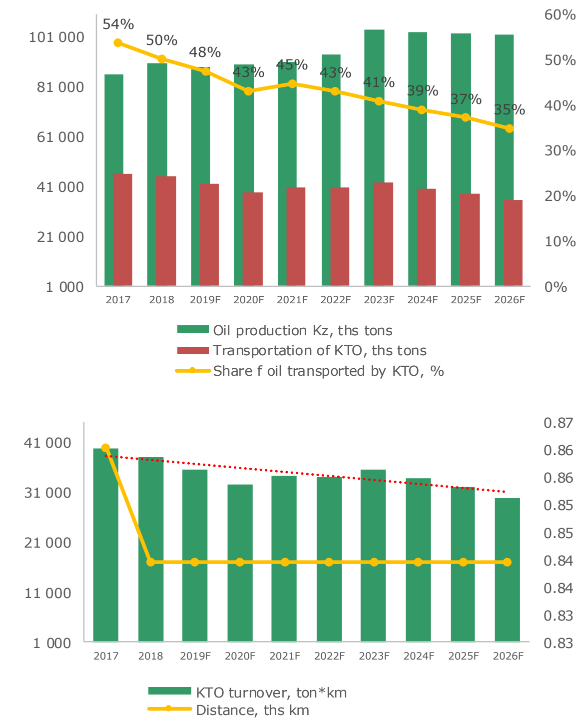
limited from a political one.

Fig. 1. Tariffs

₸/ton*1000km	2017	2018	2019	2020F	2021F	2022F	2023F	2024F	2025F	2026F
Domestic	3 902	4 292	4 722	4 250	4 250	4 250	4 250	4 590	4 957	5 353
change, %	*10%*	*10%*	*10%*	*-10%*	*0%*	*0%*	*0%*	*8%*	*8%*	*8%*
Export	5 817	6 399	6 399	6 879	7 395	7 949	8 506	8 974	9 377	9 724
change, %	*0.4%*	*10%*	*0%*	*8%*	*8%*	*8%*	*7%*	*5%*	*4%*	*4%*

Source: Forecasts HF

Fig. 3. Operating indicators of KTO



Source: Halyk Finance forecasts

The oil turnover volumes

The KTO pipeline accounts for half of the oil produced in the country. The increase in Kazakhstan oil production in the future will be stimulated mainly by Tengiz and Kashagan, oil from these fields goes mainly through the CPC pipeline. Considering the new investments that CPC is making to prepare its facilities for higher volumes of oil, our assumptions about the benefits for KTO from partially transporting volumes due to the lack of capacity at CPC are losing relevance. Growth in volumes from old fields may bring a positive, given the success of exploration at Emba, at which according to plans, production will reach 11mn tons by 2032 at current 2.3mn tons (EMG data). However, in our opinion, such terms are too distant prospect.

Our previous assumptions regarding the partial surcharge in terms of oil to the current volumes of KTO after the expansion of Tengiz may not be realized due to the adequacy of the throughput capacity of the CPC and additional investments in the further improvement of the latter. After upgrading (2H2022) CPC intends to improve its capacity to more than 72mn tons against the current 60mn tons, for which $600mn will be invested in 2019-2024, of which in Kazakhstan a little more than $156mn. Optimization of the current capacity of the CPC pipeline does not allow us to expect an increase in transportation volumes from oil from Tengiz and Kashagan, which we expected given the likely increase in demand for KTO capacity, and therefore we expect a reduction in the share of oil transported by KTO from the current 50% to 35 % by 2026, from 45mn tons to 36mn tons.

We do not expect changes on the average pumping distance and lay a constant value of 840km for the entire forecast period. According to our expectations, oil turnover will decrease in 2020 with a gradual recovery by 2023. However, in general, there will be a downward trend from 38ths ton*km in 2018 up to 29.9ths ton*km by 2026.

Financial performance forecast

Based on the above assumptions, we expect EBITDA reduction in 2020 by 13% yoy to 100bn tenge, with further indicator's fluctuation under the pressure of low volumes of oil turnover and an increase in cost and general administrative expenses at a level exceeding inflation rates by 2pp.

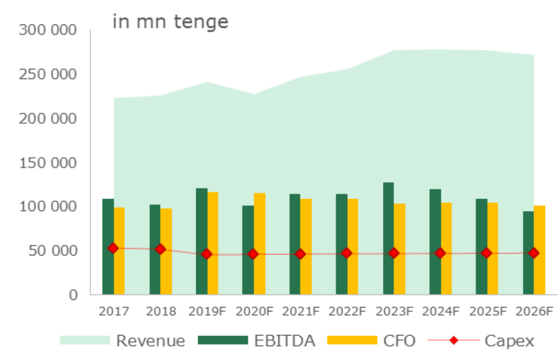
According to our forecasts, the net profit margin will be in the range of 19%-24%, showing a decrease to 16% in 2026.

The dynamics of the operating cash flow will be subjected to a downward trend from 116bqn tenge in 2019 up to 101bn tenge by 2026.

We expect positive free cash flow throughout the entire forecast period, taking into account the stable trend of capital expenditures at the level of 45-47 bn tenge, due to the company's lack of capacity needs.

We adjusted the dividend forecast to reflect the company's decision to pay dividends for 2018 that did not meet our expectations. We have used the payment of 100% of the net profit of the group excluding part of retained earnings, the

Fig. 4. Financial indicators

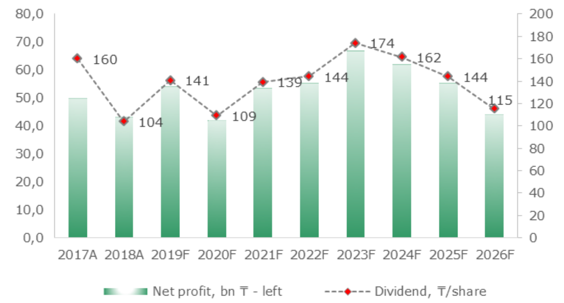


Source: Halyk Finance forecasts

payment of which the company practices at its discretion, in connection with which our forecast for dividends has decreased and in 2019 we expect a dividend of T141/share.

Discount Cash Flow Method (DCF)

Fig. 5. Dividends



Source: Halyk Finance forecasts

According to our estimate, the forecast of a long-term growth of the economy of Kazakhstan remains unchanged at 3.7%.

The discount rate was 12%. For calculating the WACC we used: current rate of government bonds (2037) of the Republic of Kazakhstan (8.7%), the annual yield of the KASE index (+4.2%), the value of the adjusted Beta at 0.787.

Fig. 6. Target price calculation

₸ bn	2019F	2020F	2021F	2022F	2023F	2024F	2025F	2026F
EBITDA	**100.3**	**100.3**	**113.9**	**114.4**	**127.3**	**119.2**	**108.9**	**94.1**
- Capex	45.6	45.8	46.1	46.3	46.5	46.7	47.0	47.2
- Change in NWC	4.4	4.9	1.5	4.0	2.9	5.3	5.6	6.3
- Income tax	14.3	11.3	14.1	14.6	17.5	16.3	14.6	11.9
Free cash flow	55.8	38.3	52.3	49.4	60.4	50.8	41.7	28.8
WACC	**12%**							
Risk free rate	*8.70%*							
Market risk premium	*4.20%*							
Beta	*0.787*							
DCF	**53**	**32.5**	**39.7**	**33.5**	**36.5**	**27.4**	**20.1**	**12.4**

	₸ bn
Long term growth rate	3.7%
First stage DCF	255
Terminal value	359
PV of terminal value	154
Number of common shares (mn)	385
Fair value, ₸/share	1 300
Potential upside	29%
Rating	**Buy**

Source: Halyk Finance estimates

Our target price of 1300 tenge/share provides growth potential of 29% to the current price. We believe that the following growth factors will contribute to the stability of the company's financial condition despite the vulnerable situation of KTO with oil volumes and tariffs:

- being the operator of a strategically important asset of the country, for KTO filling pipelines with oil is paramount and in our opinion problems with unloaded capacity of KTO are unlikely.

- stimulating oil exports is a priority for Kazakhstan due to the direct dependence of GDP on the primary sector.

- even with the full modernization of the CPC pipeline system for volumes from Kashagan and Tengiz, the KTO pipeline system remains in demand and unique, having an access to the Chinese market. This makes the transit transportation attractive, which are charged in US dollars and in conditions of weak tenge provide an opportunity for the joint venture to service foreign currency loans.

Fig. 7. Sensitivity of TP to tariffs

External Tariff \ Domestic tariff	-10.00%	-5.00%	0.00%	5.00%	10.00%
-10.0%	950	1006	1062	1117	1173
-5.0%	1071	1127	1183	1237	1291
0.0%	1192	1246	1300	1356	1412
5.0%	1310	1366	1421	1477	1533
10.0%	1431	1487	1542	1598	1654

Source: Halyk Finance forecasts

We recommend to **Buy** KazTransOil shares, assessing the status of the company's assets as a rather important aspect in the country's export potential. Taking into account all the risks our 12M TP is **1300 tenge/share**.

Under the assumption of reduction of the tariffs set by us by 10% the target price will be T950/share (-37% to 12M TP).

Assuming an increase in tariffs set by us by 10% the target price will be T1654/share (+ 27% to 12M TP).

Appendix 1. Forecast of company's financial indicators, in bn tenge

Income statement	**2017A**	**2018A**	**2019F**	**2020F**	**2021F**	**2022F**	**2023F**	**2024F**	**2025F**	**2026F**
Revenue	222.4	225.4	240.8	226.9	246.5	255.1	276.7	277.6	276.5	271.3
Cost of sales (excl. depreciation)	98.9	101.6	107.1	112.7	118.2	126.0	134.2	142.8	151.5	160.6
Gross Profit	123.6	123.8	133.7	114.2	128.3	129.1	142.5	134.8	125.0	110.7
SG&A	16.0	16.9	15.7	16.2	16.7	17.2	17.7	18.3	18.9	19.4
Impairment of FA and IA	0.0	-2.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other operating expenses	1.5	-2.0	2.1	2.3	2.4	2.5	2.6	2.7	2.8	2.9
EBITDA	109.0	102.2	120.1	100.3	113.9	114.4	127.3	119.2	108.9	94.1
Depreciation	47.7	50.8	53.7	53.1	52.5	52.0	51.5	51.1	50.8	50.5
EBIT	61.3	51.4	66.4	47.2	61.4	62.4	75.8	68.1	58.1	43.7
Net interest income	-4.9	-2.8	1.1	-3.0	-3.1	-4.7	-5.6	-7.3	-8.7	-9.5
Net interest expence	3.1	2.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign exchange effect	0.7	-2.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other non operating gain/(loss)	3.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gain / (loss) from JVs	7.1	-2.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Pretax Income	51.7	56.3	62.2	47.1	61.5	64.0	78.3	72.3	63.8	50.0
Income tax	15.8	13.7	14.3	11.3	14.1	14.6	17.5	16.3	14.6	11.9
Net income	**35.9**	**42.6**	**47.9**	**35.8**	**47.3**	**49.4**	**60.8**	**56.0**	**49.2**	**38.2**

Balance sheet	**2017A**	**2018A**	**2019F**	**2020F**	**2021F**	**2022F**	**2023F**	**2024F**	**2025F**	**2026F**
Current assets	99	89	120	122	147	163	188	196	202	204
Cash & cash equivalents	41	33	24	23	25	26	26	17	14	14
Bank deposits	28	25	67	71	92	106	127	145	154	156
Working capital assets	58	55	96	99	122	137	161	179	188	190
Noncurrent assets	665	715	704	697	691	685	680	675	672	668
PPE	619	672	664	656	650	644	639	635	631	628
Other long-term assets	46	43	41	41	41	41	41	41	41	41
Total assets	**764**	**803**	**824**	**819**	**837**	**848**	**868**	**872**	**874**	**872**
Current liabilities	66	68	72	76	79	85	90	96	102	108
Short-term debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0
Working capital liabilities	66	68	72	76	79	85	90	96	102	108
Noncurrent liabilities	99	110	110	110	110	110	110	110	110	110
Long-term debt	0	0	0	0	0	0	0	0	0	0
Other long-term liabilities	99	110	110	110	110	110	110	110	110	110
Total liabilities	**165**	**178**	**182**	**185**	**189**	**194**	**200**	**206**	**211**	**218**
Total equity	600	625	643	634	648	653	668	666	662	654
Capital	62	62	62	62	62	62	62	62	62	62
Other capital reserves	259	283	283	283	283	283	283	283	283	283
Retained earnings	279	280	298	289	303	308	323	321	317	309
Total liabilities and equity	**764**	**803**	**824**	**819**	**837**	**848**	**868**	**872**	**874**	**872**

Cash flow statement	**2017A**	**2018A**	**2019F**	**2020F**	**2021F**	**2022F**	**2023F**	**2024F**	**2025F**	**2026F**
Operating cash flow	99	97	116	115	108	108	103	104	105	101
Investment cashflow	-67	-45	-86	-63	-64	-54	-47	-47	-46	-46
Financial cash flow	-60	-62	-40	-54	-42	-54	-56	-67	-62	-55
Net change in cash	-28	-9	-9	-1	2	1	1	-9.38	-3	0
Beginning cash	69	41	33	24	23	25	26	26	17	14
Foreign exchange gain (loss)	-0.5	1.37	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Ending cash	**41**	**33**	**24**	**23**	**25**	**26**	**26**	**17**	**14**	**14**

Source: Company data, Halyk Finance forecasts

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