

New Wave of Privatization in Kazakhstan

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Continued low oil prices and weakened external demand slashed Kazakhstan's real GDP growth from 4.1 percent in 2014 to 1.2 percent in 2015 and pushed the current account into deficit for the first time since 2009. This was accompanied by the move to a floating exchange-rate regime in August 2015, which led to a sharp depreciation of the tenge and negatively affected private domestic demand and intensified inflationary pressures. Growth is expected to remain low, pushing the authorities to intensify their efforts on structural reforms and diversification of the economy.

A new privatization plan for 2016-2020, approved in December 2015, is considered an instrumental part of this economic transformation, aimed to support growth in a low commodity prices environment. The main objective of the privatization program was announced to be an increase of asset management efficiency by reducing state control, as the assets of Samruk-Kazyna (major holder of the state-owned assets) account for more than half of the economy of Kazakhstan.

This is the third wave of privatization in Kazakhstan since 2012. Started with the "People's IPO" in 2012, it was followed by the 2014-2016 privatization plan, currently being transformed into the 2016-2020 program. However, unlike the previous waves, this time its scale is unprecedented, as almost all the companies controlled by state and quasi-sovereign structures are put for sale.

Privatization list and potential investors. The privatized state property objects include the largest companies, owned by the state directly or through Samruk-Kazyna, Baiterek and KazAgro holdings. The owners will take the decision on placement term, size of sold shares, as well as the terms of sale according to the recommendation of independent consultants and in coordination with the State Commission. Smaller assets will be sold through electronic auctions using an electronic platform of the state property register of the Ministry of Finance.

Ten largest companies owned by Samruk-Kazyna will be publicly listed via an IPO. These include KazMunaiGas national oil and gas company, Kazakhstan Temir Zholy railway operator, Kazatomprom nuclear company, Kazpost national operator of postal network, Air Astana national air carrier, as well as 5 companies belonging to Samruk-Energy (GRES-1 and GRES-2 power plants; Bogatyr-Komir coal deposit) and Tau-Ken Samruk (Kazzinc and ShalkiyaZinc base metals producers). In accordance with the decree of the President of the Republic of Kazakhstan "On Astana International financial center", it is determined that shares of at least five most attractive companies of Samruk-Kazyna will be listed there in the amount of at least 25% of the total issued shares. IPO will be available for a wide range of investors (domestic and international) in the organized market of the Republic of Kazakhstan.

With regards to direct sale of assets, Chinese companies have already expressed their desire to participate in the privatization in Kazakhstan. This was recently confirmed by the Ambassador of China in Kazakhstan. In the context of the outflow of foreign investments from emerging markets, Chinese investors remain the most creditworthy customers. However, the most affordable way to participate in the privatization program for a wide range of investors, in our opinion, will be through the IPO.

Based on the financial results, as well as taking into account the companies' business models, we believe that the highest investment attractiveness in "as is now" state belongs to Kazatomprom, Air Astana and Kazzinc. Subject to certain conditions (including large-scale restructuring of non-core assets, increase in operational efficiency and stabilization of financial situation), KazMunaiGas, Kazakhstan Temir Zholy, Samruk-Energo and Kazpost can also become strong investment stories.

NC KazMunaiGas controls more than a quarter of Kazakhstan's oil and gas production and holds a dominant position in oil refining and oil and gas transportation. High leverage and low oil prices are the main risks for the company. Moreover, on its way to IPO the company will have to complete fairly large restructuring of its massive asset portfolio. The main step in this direction should be the buyout of KMG EP from the public market.

Kazatomprom is a national uranium producer, consistently developing a full cycle of fuel production for nuclear power stations. The company controls all uranium deposits in the country through joint ventures with major global players, such as Cameco, Areva, and Rosatom. Thanks to the use of technologies that do not require conventional ore mining, Kazatomprom has very low costs of uranium production, ensuring stable operating cash flows and a positive trend of financial ratios.

Air Astana is a national carrier, which has a monopoly among domestic companies for international flights. This right may be lost due to the loss of state control as a result of the privatization. The company flies to more than 60 domestic and international destinations and has a fleet of 30 aircrafts including Boeing 767-300ER, Boeing 757-200, Airbus A320 and Embraer E190. Lower oil prices have a positive effect on the profitability of the company thanks to lower jet fuel costs.

Kazakhstan Temir Zholy is the monopoly operator of railways in Kazakhstan, the leader in freight and passenger transportation. The Company is the sole owner and operator of the railway infrastructure and the largest operator of the locomotive fleet in Kazakhstan. Thus, the company has a strategic importance for the economy, carrying almost 40% of freight turnover in Kazakhstan.

Kazzinc is a major producer of zinc, copper, gold and associated metals. Low leverage ensures stable financial position, and the devaluation of Tenge in 2015 should have a positive impact on the company's profitability due to the reduction of operating costs. Controlled by the largest international commodity trader, Glencore, the company has a long experience in international management and improvement of operational efficiency.

Possible schedule of privatization and IPO. At the moment, the government is defining consultants to lead assets sale, whilst completion of first state property sales transactions is expected during 2016. At the moment exact timing of each company's IPO is not defined. It is possible that a massive listing of companies will be timed to the factual opening of the Astana International financial center, scheduled for early 2018. In addition, the economic situation and oil prices can improve in the next two years, positively affecting the valuation of listed companies, hit by a crisis and low commodity prices and motivating the companies' management to postpone public listing.

Currently, the companies designated for an IPO are in the process of large-scale asset restructuring and reorganization. Depending on the scale of restructuring and asset size, this process may take quite a long time, from a few months to several years.

Despite the fact that more than four months have passed since the initial announcement of a new stage of privatization, there are still many uncertainties about particular mechanism and terms of its implementation. In general, it seems that regardless of the level of preparedness for public offering, IPO of all participating companies in the privatization program will start in 2018.

Major execution risks of privatization program. In our opinion, success of the program can be obstructed by many problems resulting from external and internal factors.

The unfavorable economic situation in Kazakhstan and in the whole world has a negative impact on the investment attractiveness of the privatized assets. As a result, their sales price may be significantly lower than in the period of high prices for oil and other natural resources.

Due to deteriorating financial condition of the domestic investors, both individual and corporate, we expect relatively low demand on their part. Also, low demand from domestic investors will be affected by the amplifying negative expectations about the prospects for the development of the economy and lack of confidence in the national currency. We also do not expect a very high demand from foreign investors (both strategic and portfolio), which is associated with a high level of uncertainty both domestically and in our largest neighbors, Russia and China. In addition, the interest in the privatized assets and companies from the Chinese investors can cause some concerns over the fact that it may not represent the interest from private investors, but was rather originated by the companies associated with the state. In this case, there is a risk of substitution of the Kazakh state control of the economy to government participation on the part of China.

Furthermore, not all the objects of privatization, in particular - the "second tier" companies, can be equally attractive to investors due to the different characteristics of their operations and efficiency. This can lead to an uneven demand and adversely affect valuations. Also, the level of preparation for the IPO, is different for each company, and some of them need serious restructuring and business optimization to be able to improve their investment attractiveness.

In addition, investors already have a negative experience associated with the execution of the previous large-scale listing program in the framework of the People's IPO, especially since the main acting names remain the same. The People's IPO deadlines have been constantly delayed, and only two companies out of five were able to get public listing – KazTransOil and KEGOC. IPOs of the other companies, Samruk-Energo, Kazatomprom and KTZ, has been constantly postponed until the introduction of a new program.

The dynamics of an ambitious 2014-2016 privatization program has been also negative. As of the end of March 2016, less than 40% of the total number of the participating companies were privatized. It is possible that behind the schedule realization of the 2014-2016 privatization program became one of the main reasons for the adoption of the new privatization program, extended until 2020.

Our view. We believe the privatization to be an important part of the structural reforms currently undertaken by the government. Key objectives of privatization are to reduce the state's share in the market economy, to strengthen the role of private initiative and competition, to develop securities market, to increase the efficiency of the privatized companies, to reduce of government spending aimed to support the state-owned companies, to attract foreign investment, and so on.

Due to the unfavorable economic situation in Kazakhstan, the selling price of privatized assets will be significantly lower than in the period of high oil prices. We believe that this should not be an obstacle to privatization. Low oil prices could stay in place on a long run. However, we believe that the delay of privatization may adversely affect the course of structural reforms and growth of non-oil economy sector in Kazakhstan.

In general, given the past experience of public listings of state-owned companies, as well as high risks of execution of the new program, there are still many ambiguities and misunderstandings of individual nuances of the program on the part of the various departments. In particular, although the official decree stipulated that not less than 25% share of each the most investment-attractive companies should be offered to the market, direct executors have already voiced an alternative view, according to which the investors will be able to get hold of no more than 25%.

However, this time weakening macroeconomic indicators due to a sharp decline in oil and other commodity prices, main export items of Kazakhstan, put additional pressure on the decision-makers. And if the negative results of two previous privatization efforts have been compensated by high oil prices, this time the diversification of the economy of Kazakhstan is necessary to survive the expected long period of the low oil prices. Of course, potential sharp increase in oil prices may lower the importance of structural reforms and move the privatization out of the state agenda, but we would rather consider this as the last warning of the necessary country transformation from the pure resource play to something more adequate to the challenges of the contemporary world.

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