Georgian Railway LLC

Condensed Consolidated Interim Financial Statements for the nine-month periods ended 30 September 2011 and 2010

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Independent Auditors' Report on Review of Condensed Consolidated Interim Financial Statements

To the Management Board
Georgian Railway LLC

Introduction

We have reviewed the accompanying condensed consolidated interim statements of financial position of Georgian Railway LLC (the "Company") and its subsidiaries (the "Group") as at 30 September 2011 and 30 September 2010 and the related condensed consolidated interim statements of comprehensive income for the three- and nine-month periods ended 30 September 2011 and 30 September 2010 and the related condensed consolidated interim statements of changes in equity and cash flows for the nine-month periods ended 30 September 2011 and 30 September 2010. Management is responsible for the preparation and presentation of these condensed consolidated interim financial statements in accordance with International Financial Reporting Standard IAS 34 *Interim Financial Reporting*. Our responsibility is to express a conclusion on these condensed consolidated interim financial statements based on our reviews.

Scope of Reviews

We conducted our reviews in accordance with the International Standard on Review Engagements 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*. A review of condensed consolidated interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our reviews, nothing has come to our attention that causes us to believe that the condensed consolidated interim financial statements as at 30 September 2011 and 30 September 2010, and for the three- and nine-month periods ended 30 September 2011 and 30 September 2010 are not prepared, in all material aspects, in accordance with International Financial Reporting Standard IAS 34 *Interim Financial Reporting*.

Tbilisi branch of KPMG CIS Limited

Tbilisi Branch of KPMG CIS Limited
8 November 2011

KPMG CIS · TBILIS · 204428146

'000 GEL	Note	30 September 2011 Unaudited	31 December 2010	30 September 2010 Unaudited
ASSETS				
Non-current assets				
Property, plant and equipment	11	1,818,451	1,725,633	1,695,875
Investment property		6,838	9,926	9,926
Other non-current assets	11	230,088	136,375	11,714
Total non-current assets		**2,055,377**	**1,871,934**	**1,717,515**
Current assets				
Inventories		30,917	17,992	16,730
Current tax assets		6,621	-	-
Trade and other receivables		23,472	26,913	31,282
Prepayments and other current assets		68,061	42,665	74,072
Bank deposits		54,098	38,021	17,500
Cash and cash equivalents	13	199,246	335,855	458,156
Total current assets		382,415	**461,446**	**597,740**
Total assets		**2,437,792**	**2,333,380**	**2,315,255**
EQUITY AND LIABILITIES				
Equity	12			
Charter capital		1,009,447	985,376	977,490
Non-cash owner contribution reserve		35,404	35,404	35,404
Retained earnings		734,072	612,261	573,750
Total equity		**1,778,923**	**1,633,041**	**1,586,644**
Non-current liabilities				
Loans and borrowings	13	411,474	438,383	446,422
Trade and other payables		45	45	2,244
Deferred tax liabilities		63,686	66,521	68,209
Total non-current liabilities		**475,205**	**504,949**	**516,875**
Current liabilities				
Loans and borrowings	13	8,496	19,259	8,371
Trade and other payables		100,471	61,886	65,799
Liabilities to owner	14	14,968	29,241	29,262
Provisions		22,376	21,597	21,911
Other taxes payable		30,749	27,236	31,568
Other current liabilities		6,604	15,018	42,862
Current tax liabilities		-	21,153	11,963
Total current liabilities		**183,664**	**195,390**	**211,736**
Total liabilities		**658,869**	**700,339**	**728,611**
Total equity and liabilities		**2,437,792**	**2,333,380**	**2,315,255**

The condensed consolidated interim statements of financial position are to be read in conjunction with the notes to, and forming part of, the condensed consolidated interim financial statements set out on pages 8 to 16.

'000 GEL	Note	Three-month period ended 30 September 2011	Nine-month period ended 30 September 2011	Three-month period ended 30 September 2010	Nine-month period ended 30 September 2010
		Unaudited	**Unaudited**	**Unaudited**	**Unaudited**
Revenue	6	134,875	358,990	109,573	298,670
Other income		1,966	9,699	2,760	6,792
Employee benefits expense		(26,157)	(78,928)	(26,733)	(80,335)
Depreciation and amortization expense		(21,529)	(67,806)	(25,427)	(74,802)
Electricity and materials used	7	(10,990)	(33,345)	(11,488)	(31,053)
Other expenses	8	(19,793)	(59,472)	(28,083)	(58,665)
Results from operating activities		**58,372**	**129,138**	**20,602**	**60,607**
Finance income	9	3,593	29,499	29,814	30,427
Finance costs	9	(20,149)	(7,523)	(10,588)	(14,395)
Net finance (costs)/income		**(16,556)**	**21,976**	**19,226**	**16,032**
Profit before income tax		**41,816**	**151,114**	**39,828**	**76,639**
Income tax income/(expense)	10	9,165	(6,571)	(5,868)	(12,121)
Profit and total comprehensive income for the period		**50,981**	**144,543**	**33,960**	**64,518**

These condensed consolidated interim financial statements were approved by the Management Board on 8 November 2011 and were signed on its behalf by:

Irakli Ezugbaia
General Director

Amiran Tevzadze
Acting Chief Accountant

The condensed consolidated interim statements of comprehensive income are to be read in conjunction with the notes to, and forming part of, the condensed consolidated interim financial statements set out on pages 8 to 16.

'000 GEL	Charter capital	Non-cash owner contribution reserve	Retained earnings	Total equity
Balance at 1 January 2010	967,207	25,311	556,165	1,548,683
Total comprehensive income for the period				
Profit and total comprehensive income for the period (unaudited)	-	-	64,518	64,518
Transactions with owner, recorded directly in equity				
Dividends to owner (unaudited)	-	-	(37,496)	(37,496)
Non-cash distributions to owner (unaudited)	6,392	10,093	(5,546)	10,939
Transfer of retained earnings to charter capital (unaudited)	3,891	-	(3,891)	-
Balance at 30 September 2010 (unaudited)	**977,490**	**35,404**	**573,750**	**1,586,644**
Balance at 1 January 2011	**985,376**	**35,404**	**612,261**	**1,633,041**
Total comprehensive income for the period				
Profit and total comprehensive income for the period (unaudited)	-	-	144,543	144,543
Transactions with owner, recorded directly in equity				
Non-cash contributions by and distributions to owner (unaudited)	4,071	-	(22,732)	(18,661)
Cash contributions by owner (unaudited)	20,000	-	-	20,000
Balance at 30 September 2011 (unaudited)	**1,009,447**	**35,404**	**734,072**	**1,778,923**

The condensed consolidated interim statements of changes in equity are to be read in conjunction with the notes to, and forming part of, the condensed consolidated interim financial statements set out on pages 8 to 16.

'000 GEL	Nine-month period ended 30 September 2011	Nine-month period ended 30 September 2010
	Unaudited	**Unaudited**
Cash flows from operating activities		
Cash receipts from customers	369,759	317,968
Cash paid to suppliers and employees	(160,312)	(136,059)
Cash flows from operations before income taxes and interest paid	**209,447**	**181,909**
Income tax paid	(30,259)	(2,351)
Interest paid	(43,058)	(2,163)
Net cash from operating activities	**136,130**	**177,395**
Cash flows from investing activities		
Acquisition of property, plant and equipment	(279,145)	(149,689)
Increase in term deposits	(16,077)	(17,500)
Decrease in restricted cash	11,912	-
Proceeds from sale of property, plant and equipment	143	-
Interest received	6,124	1,776
Net cash used in investing activities	**(277,043)**	**(165,413)**
Cash flows from financing activities		
Proceeds from borrowings	989	455,109
Repayment of borrowings	-	(28,975)
Cash contribution by owner	20,000	-
Net cash from financing activities	**20,989**	**426,134**
Net (decrease)/increase in cash and cash equivalents	**(119,924)**	**438,116**
Cash and cash equivalents at 1 January	323,943	1,361
Effect of exchange rate fluctuations on cash and cash equivalents	(4,773)	18,679
Cash and cash equivalents at 30 September	**199,246**	**458,156**

The condensed consolidated interim statements of cash flows are to be read in conjunction with the notes to, and forming part of, the condensed consolidated interim financial statements set out on pages 8 to 16.

1 Background

(a) Business environment

Georgian business environment

The Group's operations are located in Georgia. Consequently, the Group is exposed to the economic and financial markets of Georgia which display characteristics of an emerging market. The conflict between Georgia and the Russian Federation has created additional uncertainty in the environment. The legal, tax and regulatory frameworks continue development, but are subject to varying interpretations and frequent changes which together with other legal and fiscal impediments contribute to the challenges faced by entities operating in Georgia. The condensed consolidated interim financial statements reflect management's assessment of the impact of the Georgian business environment on the operations and the financial position of the Group. The future business environment may differ from management's assessment.

(b) Reporting entity

Georgian Railway LLC (the "Company") and its subsidiaries (the "Group") comprise Georgian limited liability and joint stock companies as defined in the Civil Code of Georgia.

The Group's principal activity is the operation of a nationwide railway system providing freight and passenger transportation services, maintenance and development of railway infrastructure and construction of railway lines within Georgia.

The Group is wholly owned, directly and indirectly, by the State of Georgia represented by the State Enterprise Management Agency of the Ministry of Economy and Sustainable Development of Georgia.

2 Basis of preparation

(a) Statement of compliance

These condensed consolidated interim financial statements have been prepared in accordance with International Financial Reporting Standard IAS 34 *Interim Financial Reporting*. They do not include all of the information required for full annual financial statements and should be read in conjunction with the consolidated financial statements of the Group as at and for the years ended 31 December 2010 and 2009.

(b) Functional and presentation currency

The national currency of Georgia is the Georgian Lari ("GEL"), which is the Company's functional currency and the currency in which these condensed consolidated interim financial statements are presented. All financial information presented in GEL has been rounded to the nearest thousand.

(c) Use of estimates and judgments

The preparation of interim financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expense. Actual results may differ from these estimates.

In preparing these condensed consolidated interim financial statements, the significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty were the same as those that applied to the consolidated financial statements as at and for the years ended 31 December 2010 and 2009.

3 Significant accounting policies

The accounting policies applied by the Group in these condensed consolidated interim financial statements are the same as those applied by the Group in its consolidated financial statements as at and for the years ended 31 December 2010 and 2009.

4 Financial risk management

The Group's financial risk management objectives and policies are consistent with those disclosed in the consolidated financial statements as at and for the years ended 31 December 2010 and 2009.

5 Operating segments

(i) Information about reportable segments (unaudited)

	Freight transportation				Passenger transportation				Total			
'000 GEL	Three-month period ended 30 September 2011	Nine-month period ended 30 September 2011	Three-month period ended 30 September 2010	Nine-month period ended 30 September 2010	Three-month period ended 30 September 2011	Nine-month period ended 30 September 2011	Three-month period ended 30 September 2010	Nine-month period ended 30 September 2010	Three-month period ended 30 September 2011	Nine-month period ended 30 September 2011	Three-month period ended 30 September 2010	Nine-month period ended 30 September 2010
External revenues	128,247	341,280	100,044	276,403	6,538	13,690	6,563	13,579	134,785	354,970	106,607	289,982
Reportable segment profit/(loss) before infrastructure costs, central overheads, net finance income or costs and income tax	91,110	227,315	65,270	174,450	692	(7,075)	(1,332)	(7,238)	91,802	220,240	63,938	167,212
Reportable segment assets	369,648	369,648	378,489	378,489	87,438	87,438	106,050	106,050	457,086	457,086	484,539	484,539

(ii) Reconciliation of reportable segment profit or loss (unaudited)

'000 GEL	Three-month period ended 30 September 2011	Nine-month period ended 30 September 2011	Three-month period ended 30 September 2010	Nine-month period ended 30 September 2010
Total profit or loss for reportable segments	91,802	220,240	63,938	167,212
Other profit or loss	(3,462)	(2,298)	(233)	(668)
Payroll expenses – infrastructure and headquarters	(13,383)	(38,323)	(11,839)	(34,741)
Depreciation expenses – infrastructure and headquarters	(10,650)	(33,785)	(12,599)	(37,533)
Net finance (costs)/income	(16,556)	21,976	19,226	16,032
Other net unallocated expenses	(5,935)	(16,696)	(18,665)	(33,663)
Consolidated profit before income tax	**41,816**	**151,114**	**39,828**	**76,639**

There has been no change in the basis of segmentation or the measurement basis for segment profit or loss since 31 December 2010 and 31 December 2009.

6 Revenue

'000 GEL	Three-month period ended 30 September 2011	Nine-month period ended 30 September 2011	Three-month period ended 30 September 2010	Nine-month period ended 30 September 2010
Freight traffic	116,110	308,751	94,419	259,812
Freight car rental	12,190	32,512	6,324	16,969
Passenger traffic	5,274	11,744	5,433	11,472
Communication services	-	-	-	4,413
Other	1,301	5,983	3,397	6,004
	134,875	**358,990**	**109,573**	**298,670**

Railroad transportation in Georgia is a natural monopoly; however, prices are not subject to government regulation. According to clause 64 of the Railway Code of Georgia, which came into force on 1 July 2005, the Government of Georgia allowed the Group to set prices for all services provided, including freight transportation, freight transportation-related additional services, and passenger and luggage transportation.

Tariffs for freight transportation are based on the International Rail Transit Tariff. The Group is a co-signatory of the Tariff Agreement together with CIS countries, Latvia, Lithuania and Estonia. The parties to the Agreement hold annual conferences to determine the tariff policy for the following year: each party declares tariffs denominated in Swiss Francs for railway transportation and states the general rules that apply to and modify tariffs. The agreed tariffs indicate the maximum level of tariffs applicable.

7 Electricity and materials used

'000 GEL	Three-month period ended 30 September 2011	Nine-month period ended 30 September 2011	Three-month period ended 30 September 2010	Nine-month period ended 30 September 2010
Electricity	4,640	17,901	3,723	13,892
Materials	3,623	7,917	5,115	9,865
Fuel	2,727	7,527	2,650	7,296
	10,990	**33,345**	**11,488**	**31,053**

8 Other expenses

'000 GEL	Three-month period ended 30 September 2011	Nine-month period ended 30 September 2011	Three-month period ended 30 September 2010	Nine-month period ended 30 September 2010
Freight car rental	6,311	17,508	1,886	6,722
Taxes other than income tax	4,204	12,233	3,992	11,952
Provision for EBRD loan cancellation fee	2,517	2,517	-	-
Security	1,908	5,748	1,534	5,620
Repairs and maintenance	1,879	10,718	2,438	3,074
Write off of non-current assets	-	4,094	-	4,831
Guarantee provision	-	-	14,950	14,950
Communication services	-	-	-	3,611
Other	2,974	6,654	3,283	7,905
	19,793	**59,472**	**28,083**	**58,665**

The guarantee provision relates to the Group's guarantee of a third party's loan from a Georgian bank. In the three-month period ended 30 September 2010 the Group recognised a provision for the guarantee as indications arose during the period that the third party will not be able to repay the bank loan. The provision is based on the full amount of the guarantee. The Group expects to incur most of the liability over the next 2 years.

9 Foreign currency exchange rate fluctuations

Included in finance income for the nine-month period ended 30 September 2011 is a net foreign exchange gain of GEL 23,343 thousand mainly as a result of the GEL depreciating against the Swiss Franc ("CHF") and GEL appreciation against the U.S. Dollar ("USD") as the Group held a significant part of its bank balances in CHF and the Group's loans and borrowing were denominated in USD during the nine-month period ended 30 September 2011 and the three-month period ended 30 September 2011 (three- and nine-month periods ended 30 September 2010: GEL 29,024 thousand and GEL 28,650 thousand). In the three-month period ended 30 September 2011, the Group incurred a foreign exchange loss of GEL 15,033 thousand due to GEL appreciation against CHF in September 2011.

10 Income tax expense

Income tax is recognised based on management's best estimate of the weighted average annual income tax rate expected for the full financial year applied to the pre-tax income of the interim periods. The Group's consolidated effective tax rate for the three- and nine-month periods ended 30 September 2011 was negative 22 percent and 4 percent (three- and nine-month period ended 30 September 2010: 15 percent and 16 percent). The statutory tax rate is 15 percent. The change in the effective tax rate was caused mainly by the factors set out below.

During 2011 the Group won a case in the Supreme Court of Georgia related to additional tax liabilities assessed by the Georgian Tax Authorities for the years 1998 to 2003, and accrued by the Group before 2007, of approximately GEL 13 million. The case was finalised in September 2011. The Georgian Tax Authorities recognised the decision of the Supreme Court of Georgia and the amount of the assessment, which had been paid by the Group, was recorded as a prepayment on the Group's tax card. The Group reversed the provision for the assessment in the three-month period ended 30 September 2011 and recognised a related current tax asset as at 30 September 2011.

11 Property, plant and equipment and other non-current assets

Acquisitions and disposals of property, plant and equipment

During the three- and nine-month periods ended 30 September 2011 the Group acquired assets with a cost, excluding capitalised borrowing costs, of GEL 119,463 thousand and GEL 195,801 thousand respectively (30 September 2010: GEL 26,347 thousand and GEL 79,990 thousand respectively).

Capitalised borrowing costs related to the Main Line Modernisation project for the three- and nine-month periods ended 30 September 2011 amounted to GEL 6,158 thousand and GEL 18,508 thousand, respectively, (30 September 2010: GEL 1,618 thousand and GEL 1,618 thousand, respectively) and capitalised borrowing costs related to the Tbilisi Bypass project for the three- and nine-month periods ended 30 September 2011 amounted to GEL 4,189 thousand and GEL 12,879 thousand, respectively (30 September 2010: nil).

During the three- and nine-month periods ended 30 September 2011 assets with a carrying amount of GEL 11,846 thousand and GEL 24,004 thousand were transferred to the owner (three- and nine-month periods ended 30 September 2010: nil and GEL 14,722 thousand).

Other non-current assets

Increase in other non-current assets is mainly related to prepayments made and materials and equipment purchased for the Main Line Modernisation and Tbilisi Bypass projects.

Capital commitments and major projects

As at 30 September 2011 the Group had entered into contracts for the construction or purchase of property, plant and equipment of GEL 1,074,243 thousand mainly relating to the Main Line Modernisation (GEL 544,396 thousand) and Tbilisi Bypass projects (GEL 443,643 thousand) (30 September 2010: GEL 739,393 thousand), excluding prepayments made for the contracts. Included in capital commitments are contracts for the construction of a building in the west of Georgia for future sale or lease for USD 22,345 thousand.

In 2010, the Group began a feasibility study and design works for the construction of the Nenskra Hydropower Plant ("HPP") and, in 2011, concluded an agreement with a consultant for assistance in securing an investor and raising project finance for the construction of the HPP. The construction is intended to start in the first half of 2012. The Group intends to establish a new subsidiary to which all agreements in relation to the HPP will be contributed. Subsequently the Group intends to transfer the subsidiary to the Government of Georgia.

12 Equity

Dividends

No dividends were declared or paid by the Company during the nine-month period ended 30 September 2011 (nine-month period ended 30 September 2010: declared GEL 37,496 thousand). No dividends were proposed after 30 September 2011.

13 Loans and borrowings

No significant issues or repayments of loans and borrowings occurred during the nine-month period ended 30 September 2011. Changes in the carrying amounts are attributable to interest accruals and payments and foreign currency translation differences.

In July 2010 the Group issued bonds with a face value of USD 250 million maturing in July 2015. The proceeds are to be used for the implementation of two capital projects: Main Line Modernization and the Tbilisi Bypass.

On 17 March 2010 a loan agreement was signed between the Group and the European Bank for Reconstruction and Development ("EBRD"), by which the EBRD agreed to lend the Group up to CHF 146.2 million partly to finance the Tbilisi Bypass project. No funds had been drawn down under this facility. Following intensive negotiations with EBRD on 4 November 2011 the loan agreement executed between Georgian Railway LLC and EBRD was cancelled. Prepaid finance costs included in trade and other receivables related to this loan agreement of GEL 3,047 thousand were written off in the three-month period ended 30 September 2011. The Group also made a provision for the cancellation fee related to this loan of GEL 2,517 thousand in the three-month period ended 30 September 2011.

Cash and cash equivalents includes restricted cash of GEL 11,912 thousand as of 31 December 2010 (30 September 2011: nil and 30 September 2010: nil).

14 Related parties

(a) Parent and ultimate controlling party

The Company was wholly owned by the State of Georgia represented by the State Enterprise Management Agency of the Ministry of Economy and Sustainable Development of Georgia as at 30 September 2011. On 25 October 2011 24% of the Company's charter capital was transferred to "Partnership Fund" JSC which is wholly owned by the State of Georgia.

(b) Transactions with key management personnel

Key management received the following remuneration during three- and nine-month periods ended 30 September 2011 and 2010, which is included in employee benefits expense:

'000 GEL	Three-month period ended 30 September 2011	Nine-month period ended 30 September 2011	Three-month period ended 30 September 2010	Nine-month period ended 30 September 2010
Salaries and bonuses	349	920	300	803

(c) Other related party transactions

(i) Revenue, purchases and expenses

The Group purchases most of its electricity from a State-owned operator which amounted to GEL 3,107 thousand and GEL 13,200 thousand for the three- and nine-month periods ended 30 September 2011 (three- and nine-month periods ended 30 September 2010: GEL 2,163 thousand and GEL 10,593 thousand). The Group also purchases security services from a state agency which amounted to GEL 1,949 thousand and GEL 5,725 thousand for the three- and nine-month periods ended 30 September 2011 (three- and nine-month periods ended 30 September 2010: GEL 2,030 thousand and GEL 5,826 thousand). The Group usually does not have significant balances for these purchases.

Management estimates that the aggregate amounts of other income and expenses and the related balances with other Government-related entities are not significant.

(ii) Other balances

'000 GEL	30 September 2011	31 December 2010	30 September 2010
Liabilities to the owner	14,968	29,241	29,262

Liabilities to the owner relate to non-core property, plant and equipment that has been withdrawn but not yet transferred formally to the Government of Georgia. These liabilities are recognised at the carrying amount of assets to be transferred to the Government of Georgia.

15 Subsequent events

The Company has made amendments to its corporate governance structure and currently is in the process of changing the legal form of the Company from a limited liability company, whose charter capital is not divided into shares, to a joint stock company.

In October 2011, the Company executed a preliminary sale/purchase agreement with Georgian Railway Construction JSC, its 100% subsidiary, on the sale of 73 hectares of land which will be freed up as part of the Tbilisi Bypass project. The consideration for the land plot is the sum of all the future payments due under the design, construction and consultancy contracts relating to the Tbilisi Bypass project concluded by the Company.

The Group made a decision to transfer Georgian Railway Construction JSC to the Government of Georgia. The transfer is expected to be concluded in the second half of November 2011.