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## Research Update:

# Outlook On Georgian Oil and Gas Corporation Revised To Negative; Ratings Affirmed

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## Research Update:

# Outlook On Georgian Oil and Gas Corporation Revised To Negative; Ratings Affirmed

## Overview

- Georgian Oil and Gas Corporation (GOGC) is considering undertaking two major investment projects.
- This could mean that its deleveraging process takes longer than we had previously expected; leverage could remain at above 4x in 2016-2017.
- We are therefore revising our outlook on the long-term rating on GOGC to negative from stable, and affirming the rating at 'B+'.
- The negative outlook reflects the risk that we could lower the rating on GOGC if its debt/EBITDA were to exceed 4x for a prolonged period.

## Rating Action

On March 3, 2016, Standard & Poor's Ratings Services revised the outlook on Georgian Oil and Gas Corporation to negative from stable. We affirmed the 'B+/B' long- and short-term corporate credit ratings.

## Rationale

The outlook revision primarily reflects the revision of our base-case scenario for GOGC. We understand the company is now contemplating increasing its investments in 2016-2017. Having successfully completed construction of the Gardabani thermal power plant in late 2015, GOGC is currently considering investing into an extension of this project, estimated at \$200 million-\$250 million, and constructing an underground gas storage facility worth another \$250 million. This will require increase in debt financing and means that the company might be able to deleverage only if both projects are successfully launched, which will not happen before 2018.

GOGC's financial risk profile is constrained by relatively high leverage, our assumption of high volatility of cash flows and ratios during stress periods, and sizable investments required to finance its growth projects. The company also issued a loan of Georgian lari (GEL) 47 million to its sister state-controlled entity in 2012 and had GEL17 million of cash deposits pledged as collateral for a loan obtained by another GRE. Although the loan is interest-bearing and we assume it will be repaid to GOGC and that the pledged cash will be released by 2017, these transactions heighten the risk that GOGC's funds might be used to finance the activities of other Georgian GREs.

GOGC's business risk is constrained by the company's reliance on a single counterparty, the State Oil Company of Azerbaijan Republic (SOCAR), for gas

supply, via several long-term trading contracts. The impact on GOGC's earnings and cash flow generation would likely be material if the contract terms were unexpectedly amended during the contract period. The constraining factors also include the company's lack of long-term strategic planning and a history of unexpected changes in the government's strategic decisions for GOGC. For example, the company abandoned plans to construct the Namakhvani hydropower plant in favor of the Gardabani gas-fired CCPP in 2013. Furthermore, on June 12, 2015, the company announced a potential sale of the Gardabani CCPP to the Georgian government; however, we understand that this has now been cancelled.

In our base case for GOGC, we assume:

- Annual growth in revenues of about 40-50% in 2016, on the back of Gardabani CCPP coming on line and moderate currency devaluation.
- Adjusted EBITDA margin of 25%-27% in 2016-2017.
- Capital expenditures (capex) of GEL400 million on average for 2016-2018 for the second phase of Gardabani CCPP, and construction of the underground gas storage.
- Annual dividends of about GEL20 million-GEL30 million in 2016-2017.

Based on these assumptions, we arrive at the following credit measures:

- Debt to EBITDA of about 4.0x-4.5x in 2016-2017, decreasing to about 3.0x afterwards; and
- FFO to debt of about 15% in 2016-2017, improving to above 20% in 2018.

## **Liquidity**

We assess GOGC's liquidity as adequate. As of Dec. 31, 2015, we estimate GOGC's ratio of liquidity sources to uses for the next 12 months comfortably exceeded 1.2x. Our assessment takes into account that the \$250 million bond is due May 2017, and that the company needs to refinance it within the next few months to maintain the adequate assessment.

Principal liquidity sources:

- Around GEL191 million of available cash and liquid instruments.
- Cash generated from operations of about GEL170 million.
- Working capital inflows of around GEL50 million.

Principal liquidity uses:

- Maintenance capital expenditures of about GEL72 million.
- Dividends of GEL15 million.
- GOGC has to comply with maintenance covenants, the strictest of which is net debt to EBITDA of 3.5x. We believe GOGC has adequate covenant headroom due to meaningful cash on the balance sheet.

## **Outlook**

The negative outlook reflects the risk that we could lower the rating if GOGC's leverage exceeds our expectations of debt/EBITDA consistently below 4x. We understand that the company is quite likely to proceed with its two large investment projects--the second phase of Gardabani and an underground gas storage facility--which could increase leverage to above this threshold if

financed solely with debt. However, we also understand that these projects are subject to availability of financing and a certain share could be financed with equity or project-finance at the project level with no recourse to GOGC. Therefore GOGC's leverage in 2016-2018 will ultimately depend on the type of financing chosen.

We assume that GOGC's importance for the Georgian government will not diminish and that the company will retain its status as the national oil company and will not be subject to privatization in the medium term. We could revisit our assessment of the GRE's status if the company were to proceed with both of its investment projects without any government support. We also assume that GOGC will not provide any more loans to other GREs at the expense of its own financial profile.

### **Downside scenario**

We could lower the ratings if GOGC's Standard & Poor's-adjusted debt-to-EBITDA increased to sustainably above 4x as a result of its investments. Temporary deviation from the threshold levels might still be commensurate with the rating if ratios appear to return to target levels in the near term.

We could also lower the rating if GOGC's liquidity weakens, for example if the company were to finance its investments with short-term debt, or if its exposure to refinancing risk were to increase. In particular, if the company were unable to issue new debt by the end of Q2 2016 or obtain a commitment for another type of financing to cover the bond maturing in 2017, this would pressure the rating.

Downward pressure could also stem from increased dividends, an inability to collect receivables from customers, and making substantial loans to other Georgian GREs. Under our GRE criteria, and provided the stand-alone credit profile remains 'b', we would need to revise the likelihood of support to at least moderately high to result in a downgrade. Furthermore, a one-notch downgrade of the sovereign would likely result in a similar rating action on GOGC.

### **Upside scenario**

We could revise the outlook to stable if the company's leeway in ratios levels increased. That might happen if the company refrained from new large investment projects or if it obtained meaningful equity financing for some of them.

Under our criteria, we would need to revise GOGC's SACP at least to 'bb-' to then upgrade the company, provided that the sovereign rating remained 'BB-' and the likelihood of support remains very high. If debt/EBITDA approached close to 2x we could consider an upgrade. A positive rating action on the sovereign would also likely lead to a similar action on GOGC, all else being equal.

## Ratings Score Snapshot

Corporate Credit Rating: B+/Negative/B

Business risk: Weak

- Country risk: High
- Industry risk: Moderately high
- 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: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: b

- Related government rating: BB-
- Likelihood of government support: Very high (+1 notch from SACP)

## Related Criteria And Research

### Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry - March 28, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Midstream Energy Industry - December 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating

- October 01, 2010

## Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Georgian Oil and Gas Corporation JSC		
Corporate Credit Rating	B+/Negative/B	B+/Stable/B
Senior Unsecured	B+	B+

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