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Research Update:

Georgian Oil and Gas Corp. 'B+/B' Ratings Affirmed, Despite Expected Increase In Leverage; Outlook Stable

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Overview

- We forecast that Georgian Oil and Gas Corp.'s (GOGC's) leverage will increase to about 4x in 2018, compared with about 2.9x in 2017, due to profitability pressures from rising costs and flat social gas prices.
- We expect EBITDA to increase in 2019, however, when the group's major development project, Gardabani II power plant, should start generating cash flows.
- We are therefore affirming our 'B+/B' ratings on GOGC.
- The stable outlook reflects our expectation that the 2018 increase in leverage will be temporary and reduce in 2019 after the new power plant begins operating, and that the group's liquidity will remain adequate at all times.

Rating Action

On March 28, 2018, S&P Global Ratings affirmed its 'B+/B' long- and short-term issuer credit ratings on Georgian Oil and Gas Corp. JSC (GOGC). The outlook is stable.

We also affirmed the 'B+' rating on GOGC's $250 million notes due 2021.

Rationale

Our rating already factors in significant volatility of margins and financial metrics, and, after financial measures improved in 2017, we are expecting a temporary increase in GOGC's leverage in 2018. This is because the average purchase price of natural gas is increasing, while we expect the selling price of social gas to stay flat. As a result, we expect GOGC's gross debt-to-EBITDA ratio to increase to 3.9x-4.1x in 2018 compared with about 2.9x in 2017. However, we believe that the higher leverage will be temporary, and that GOGC will achieve stronger results in 2019, when it commissions its Gardabani II combined-cycle power plant, which is currently under construction. We therefore expect leverage to return to about 3.6x-3.8x in 2019.

We continue to view GOGC's financial risk profile as aggressive, which includes our assessment of the group's volatile cash flows during stress periods. GOGC's margins remain exposed to potential mismatches in changes of natural gas average purchasing and selling prices. For example, one of the key reasons we expect EBITDA to decline in 2018 is the Georgian government's decision to maintain social gas prices flat, whereas we had expected a gradual increase in that price. At the same time, the average purchasing price of gas is expected to increase by up to 8% for GOGC in 2018 and 5% in 2019, due to its use of a higher share of more expensive gas. This could significantly compress GOGC's margins in the gas business for the next one to two years, after which a meaningful increase in cheaper gas supplies from the Shah Deniz 2 project is expected, which should improve GOGC's gas business margins.

The up to 33% decline in revenues from the rent of pipelines after the government implemented a new tariff methodology, will additionally hit GOGC's 2018 EBITDA, as will GOGC's potentially increasing operating costs. As a result, we expect GOGC's EBITDA to drop from an estimated Georgian lari (GEL) 228 million in 2017 to about GEL160 million-GEL170 million in 2018. Gardabani II power plant, coming on line in late 2019, should strengthen the group's EBITDA to about GEL185 million-GEL190 million already that year, with further improvements in 2020, since the plant will have been operational for a full year.

Our assessment of GOGC's business risk is constrained by the regulatory framework in Georgia, exposure to Azerbaijan as the main source of gas, and by unexpected shifts in the average purchase gas price as a result of annual renegotiation of the gas mix from various contracts. GOGC could also be exposed if the current link with the U.S. dollar of the domestic gas and electricity prices becomes unsustainable, for example, in case of material future foreign exchange fluctuations or payment issues at GOGC's major customers.

Constraining factors also include the track record of unexpected changes at GOGC, based on the government's strategic decisions for the company. For example, GOGC abandoned its plans to build the Namakhvani hydropower plant in favor of the Gardabani power plant in 2013.

We see the risk that GOGC's funds and assets might be used to finance other Georgian government-related entities (GREs). Historically, GOGC has issued loans to other GREs, to the tune of GEL99 million as of June 30, 2016. We understand that some of the loans were repaid in 2016 and the remainder was offset from equity.

At the same time, GOGC's role as Georgia's national oil company ensures constant demand for its services. GOGC relies on gas supplied by a consortium led by BP and State Oil Company of the Azerbaijan Republic that transports gas from Azerbaijan to Turkey via Georgia. Under supplemental and optional gas agreements, GOGC is able to buy significant volumes of gas flowing from Azerbaijan at a price below the level of the social gas price set in Georgia. Effectively, this forms GOGC's profits from its gas-trading business.

The introduction in 2015 of Gardabani I 230 megawatt combined-cycle thermal power plant, with a stable tariff framework, created a stable source of cash flows for the company and reduced the volatility of its cash flows. GOGC is now adding a similar power plant, Gardabani II, due to begin operating in late 2019. Subject to the final contractual framework, it should further improve the stability of GOGC's cash flows by reducing the share of volatile gas business.

Additionally, we understand that GOGC has decided to build an underground gas storage facility. The active construction phase is set to begin after Gardabani II comes online. This should further increase the group's role in Georgia's economy by helping it ensure stable gas supplies to the country. The nature of regulation and tariff mechanism is unclear to us at this point, however.

Due to its state ownership through Partnership Fund and its important function of supplying gas to the economy of Georgia, we consider GOGC a GRE with a very high likelihood that the government would provide timely and sufficient extraordinary support to the company, should it become necessary.

In our base case for GOGC, we assume:

- Average gas purchase price growth of about 8% for 2018 and 5% in 2019.
- Revenue decline of 3%-4% in 2018, transitioning into growth of 18%-20% in 2019, following Gardabani II's commissioning.
- The Gardabani II expansion continues in 2018, financed with the company's sources. As a result, capital spending (capex) is set to increase to about GEL360 million-GEL380 million in 2018 and up to GEL110 million–GEL120 million in 2019, from less than GEL100 million in 2017.
- Capex on the underground storage facility included in the base case (total amount of up to GEL270 million for 2018-2022 with active investment phase beginning after Gardabani II has been finished).
- No material cost overruns in the major capex projects.
- Neutral working capital.
- Dividends in line with dividend policy of 35% of net income.

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

- Debt to EBITDA ratio of 3.9x-4.1x in 2018 and 3.6x-3.8x in 2019, compared with an estimated 2.9x in 2017.
- EBITDA interest coverage ratio of 3.4x-3.6x in 2018 and 3.9-4.1x in 2019, as compared with an estimated 4.4x in 2017.

Liquidity

We assess GOGC's liquidity as adequate, reflecting the ratio of sources of liquidity to its uses of above 1.2x in the 12 months beginning Jan. 1, 2018. The group's liquidity is supported by its sizable cash balance, which allows GOGC to fund the Gardabani II construction without need for additional borrowing. We also believe that, for the coming 12 months, GOGC will have sufficient headroom of at least 15% under its incurrence covenant of 3.75x ratio of net debt to EBITDA on its bond, which provides the group with additional flexibility in borrowing.

Principal liquidity sources for the 12 months started Jan. 1, 2018, include:

- Around GEL498.6 million of available cash and liquid instruments.
- GEL129 million in cash generated from operations.

Principal liquidity uses for the same period include:

- Capex of about GEL370 million, which includes new projects.
- Dividends of about GEL73.8 million.

Outlook

The stable outlook on GOGC reflects our expectation that GOGC's debt-to-EBITDA ratio will increase to about 4x on a gross basis in 2018, but will return to 3.6x-3.8x in 2019. We expect a temporary increase in leverage due to rising costs and inability to increase domestic selling prices of gas in 2018 to be mitigated partly in 2018 by growing sales and the expected start of operations at Gardabani II toward the end of 2019. We also expect GOGC to fund the Gardabani II construction fully with its own cash reserves and internal cash generation. The stable outlook also assumes there no new sizable development projects, material negative regulatory changes, or disposals of major assets.

Downside scenario

We could lower our ratings on GOGC if we were to revise our assessment of the company's stand-alone credit profile to 'b-' from the current 'b+'. This could occur if debt to EBITDA is sustainably and consistently above 4x, combined with significant deterioration of the group's liquidity. This could happen, for example, in case of further operational setbacks and continued compression of margins in light of higher purchasing costs for gas while domestic selling prices remain stable. At the same time, depletion of cash buffers due to heavy capex and lower cash flows could result in a weaker liquidity assessment. Ratings downside could also stem from a significant unfavorable change in the existing gas purchase and sale framework, changes to the operational framework of the Gardabani I power plant, disposal of key assets, or government pressure to provide significant support to other GREs.

Upside scenario

We could raise our ratings on GOGC if we were to raise our ratings on Georgia. An upgrade could also happen if debt to EBITDA is consistently below 3x, which we don't foresee before the Gardabani II expansion project is completed and starts to generate cash flows for GOGC.

Issue Ratings--Subordination Risk Analysis

Capital structure

GOGC's capital structure consists solely of $250 million senior unsecured debt issued at the parent level.

Analytical conclusions

GOGC's debt is rated 'B+', in line with the issuer credit rating, as no elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating: B+/Stable/B

Business risk: Weak
- Country risk: High
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: b+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable ratings analysis: Neutral (no impact)

Stand-alone credit profile: b+
- Sovereign rating: BB-
- Likelihood of government support: Very high (no uplift)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- 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, Dec. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Georgian Oil and Gas Corp. JSC	
Issuer Credit Rating	B+/Stable/B
Senior Unsecured	B+

Additional Contact:
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