Fitch Ratings

Fitch Affirms Georgian Oil and Gas Corporation at 'BB-'; Outlook Stable

Fitch Ratings-London/Moscow/Warsaw-04 March 2016: Fitch Ratings has affirmed JSC Georgian Oil and Gas Corporation's (GOGC) Long-term foreign currency Issuer Default Rating (IDR) at 'BB-' with a Stable Outlook and senior unsecured rating on its USD250m bond maturing in 2017 at 'BB-'. A complete list of rating actions is available at the end of this commentary.

GOGC is a state company that is involved in gas supply, pipeline rental, electricity generation, oil upstream and transportation activities. The ratings of GOGC are aligned with the sovereign's as the government of Georgia considers the company critical to its national energy policy. Fitch views GOGC's standalone profile as commensurate with a 'B+' rating due to the company's small size and limited operations.

Following the successful completion of Gardabani gas-fired combined cycle power plant (Gardabani CCPP) in 2015, GOGC intends to implement new investment projects, such as a similar gas-fired power station and a gas storage facility, in 2016-2020. We understand from management that the required investments will exceed USD400m for both projects and will be financed with GOGC's cash flow from operations and debt. In our view, GOGC will be able to maintain a gross debt-to-EBITDA at below 4.0x (2015: 4.9x) and net debt-to-EBITDA at below 3.0x (2015:3.3x) through the cycle.

KEY RATING DRIVERS
Ratings Aligned with Sovereign's
GOGC is one of several corporations in Georgia viewed by the government as critical to the national energy policy. GOGC's rating alignment is supported by 100% indirect state ownership via JSC Partnership Fund (PF) and by strong management and governance linkages with the sovereign.

GOGC's operations are supervised by the Ministry of Energy and the company has the status of a national oil company operating within the contractual framework of inter-governmental agreements between Georgia and Azerbaijan. GOGC's main completed investment project, the Gardabani CCPP, benefits from a government-guaranteed internal rate of return (IRR) of 12.5% over the asset's life, further underlining the company's strong ties with its ultimate owner. In its discussions with Fitch in 2015, the Georgian government has also stressed its commitment to continue supporting the financial health of GOGC.

Power Plant Put into Operation
GOGC commissioned a USD220m 239megawatt (MW) capacity gas-fired power plant in Gardabani in September 2015. GOGC fully financed the project through equity contributions and loans to both the power plant SPV and PF, which acquired a stake in the project from GOGC. GOGC's and PF's share ownership of the plant are at 51% and 49%, respectively, although GOGC retains managerial control of the SPV.

PF fully repaid the loan in September 2015 to improve GOGC's liquidity profile. In our forecasts for GOGC, we incorporate 100% of future cash flows from Gardabani CCPP, but exclude interest and principal repayments from the project SPV. Gardabani CCPP will start paying dividends to its shareholders in 2027 after it repays the loan taken from GOGC. The power plant has the status of guaranteed capacity provider and will receive a regulated revenue stream with an IRR of 12.5% over asset life guaranteed by the government. We expect that Gardabani CCPP's annual gross profit will range between USD30m and USD40m in 2016-2019.

'B+' Standalone Profile
We assess GOGC's standalone profile as commensurate with a 'B+' rating, supported by the contractual nature of GOGC's revenues. The company's gross income from pipeline rental, oil transportation and power generation is fairly predictable, and it will amount to 88% of GOGC's total gross income in 2016 (defined as revenue less gas purchase costs), according to Fitch's estimates.

However, GOGC's profit from gas supply operations with SOCAR Gas Export and Import (SGEI), a subsidiary of the State Oil Company of the Azerbaijan Republic (SOCAR, BB+/Negative), has been shrinking in 2012-2015 due to a higher share of more expensive gas purchased by GOGC from SOCAR and the introduction of gas price subsidies to households by the government. Its standalone profile is also constrained by its exposure to SGEI, GOGC's sole natural gas customer, which accounted for 71% of revenue in 2015. The lower profitability of the gas supply business is offset with additional stable EBITDA stemming from the reserve fee of Gardabani CCPP.

As a result of the gas supply margin squeeze, GOGC's gross income from the gas supply segment declined to GEL38m in 2015 from GEL54m in 2012, while gross income from other segments rose to GEL121m from GEL67m over the same period. We assume that the subsidies will be reduced in 2017-2018 but Georgia will import gas at a higher average price in the future due to growing consumption and purchases of more expensive alternative SOCAR gas. This risk is mitigated by a possibility that gas prices in the alternative contract may be lowered in line with the global decline in gas prices. We estimate that GOGC's gas supply absolute margins will grow in 2016-2019 and average at USD10 per thousand cubic metres (mcm).

Leverage Depends on Investments
GOGC is considering implementing two major projects over the medium term. The company may build another 230MW gas-fired power plant that will be located next to Gardabani CCPP and share the same design. GOGC expects the plant to be completed by 2018. In addition, GOGC may construct a gas storage reservoir in a former oil field in Georgia. The final investment decision and financing plan for the new power plant is expected in 2016.

As Georgia currently has no gas storage facilities, we assume this project would be strategic for the government, and would further strengthen GOGC's ties with the sovereign. We expect that the cost before value added tax of the new power plant will amount to USD190m, to be spread over 2016-2017, while the gas storage project will require around USD230m of investments in 2018-2020. Fitch assumes the investments in the gas storage facility will begin in 2018 only after the new power plant is completed as we expect slower growth in GOGC's gas sale price than GOGC management has projected. The government guarantees related to the return on these two projects or other forms of state support have not yet been established, but GOGC expects the new power plant project that will start in 2016 will have a state-guaranteed IRR.

GOGC's gross leverage was broadly equal to 4.0x EBITDA in 2012-2014, in line with Fitch's guidance for a standalone rating in the upper 'B' category, but increased to 4.9x in 2015 due to the benefit of GEL depreciation on GOGC's income not being fully felt (but will only be seen in 2016 assuming a broadly stable average USD/GEL rate) and weaker EBITDA from gas supply operations. We currently forecast that the company's gross leverage will remain close to 5.0x in 2016-2017, before falling to below 4.0x in 2018 after GOGC's second power plant is commissioned. Ultimately, the credit metrics will depend on the size and timing of the company's investment plans. However, we conservatively assume that the increase in gas sale tariffs will be less steep than expected by GOGC, e.g. we assume gas sale prices to be on average USD9/mcm lower than the company's forecast prices in 2018-2019.

Size and Capex Constrain Ratings
The principal rating constraints are the company's small size, high leverage and required funding for new investment projects resulting in negative free cash flow (FCF). We believe the government views GOGC as an investment vehicle for strategically important projects, such as the gas power plant and a potential gas storage facility, which adds to the company's inherent credit risks given the large size of such projects.

Receivables Growth Damages Cashflow
GOGC's cashflow from operations (CFO) slumped to GEL17m in 2015 from GEL80m in 2014, primarily due to higher accounts receivable balance that reached GEL181m at 31 December 2015, up from GEL70m a year earlier. The balance from SGEI accounted for around GEL143m of GOGC's receivables at end-2015. As SGEI pays an annualised interest of LIBOR+16% on the payables to GOGC related to natural gas supply operations, we expect that SGEI will significantly reduce the amount owed to GOGC over 2016. SGEI's obligations arising from natural gas purchases from GOGC are guaranteed by SOCAR.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- Stable dollar-denominated revenues and EBITDA from core pipeline rental, oil transportation and power generation operations.
- Gas supply obligations of GOGC for households and power generation will not exceed the amount of gas available to the company through existing contracts by

more than 100,000mcm per year.
- Average gas sale price equal to USD123/mcm in 2016-2019.
- Investments in the second gas-fired power plant amounting to USD190m in 2016-2017; the plant will start operation in 2018.
- Investment in the gas storage facility of USD230m in 2018-2020; the facility begins generating income after 2020.
- USD/GEL exchange rate equal to 2.37 in 2016 and 2.35 thereafter.
- Total capex averaging GEL250m in 2016-2019.
- Dividend payout ratio equal to 35%.

RATING SENSITIVITIES
Positive: Future developments that may result in positive rating action include:
- A positive rating action for Georgia (due to such factors as smaller current account deficits, strong and sustainable GDP growth accompanied by ongoing fiscal discipline or reduction in the dollarisation ratio, among others)
Negative: Future developments that may result in negative rating action include:
- A negative rating action for Georgia (due to such factors as pressure on foreign exchange reserves or deterioration in either the domestic or regional political climate, among others)
- Weakening state support and/or an aggressive investment programme resulting in a significant deterioration of standalone credit metrics, e.g. net debt/EBITDA above 3.5x on a sustained basis
- Unexpected changes in the contractual frameworks governing GOGC's midstream activities

LIQUIDITY
At end-2015, GOGC's cash and short-term deposits equalled GEL191m, and the company did not have debt repayments due 2016. GOGC also held a non-restricted long-term deposit of GEL37m at end-2015. We assume that GOGC's USD250m bond due 2017 will be refinanced. In addition, GOGC lent on USD28.5m to the State Service Bureau LLC, the state property management agency, in 2013, and the repayment of this loan was extended from 2014 to 2017 in May 2014. We estimate that GOGC has limited exposure to FX risk as its revenues, debt and around 85% of its costs are denominated in US dollars.

At end-2015, GOGC's cash and deposits were held with several local banks, including Bank of Georgia (BB-/Stable), TBC Bank (BB-/Stable) and Bank VTB (Georgia) OJSC. Additionally, GOGC had a USD30m undrawn committed credit line from Bank VTB (Georgia) OJSC as of 31 December 2015.

FULL LIST OF RATING ACTIONS

Long-term foreign and local currency IDRs: affirmed at 'BB-'; Outlook Stable;
Short-term foreign and local currency IDRs: affirmed at 'B';
Foreign currency senior unsecured rating: affirmed at 'BB-'.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?
rpt_id=869362&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTcxNTU5NDAsInNlc3Npb25LZXkiOiIyN05BVVYxOTZJVUtHQ1VMTlM1SlVJT0gxNUY0Wkt
6e_Z2Gji1nuyzd6ue1ISYNiDbDr-jvJSty1U)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?
pr_id=1000467&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTcxNTU5NDAsInNlc3Npb25LZXkiOiIyN05BVVYxOTZJVUtHQ1VMTlM1SlVJT0gxNUY0Wk
6e_Z2Gji1nuyzd6ue1ISYNiDbDr-jvJSty1U)
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Endorsement Policy (https://www.fitchratings.com/jsp/creditdesk/PolicyRegulation.faces?context=2&detail=31)