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RESEARCH

Georgian Oil and Gas Corporation
Gas margin squeeze

Fixed Income Research | Georgia
Georgian Oil and Gas Corporation
June 19, 2020

GOGC released audited FY19 results. Revenue was up 23.2% y/y to US$ 312.4mn. This growth was entirely driven by gas segment, making up 65% of 2019 revenue. Demand for social gas increased in 2019, as consumption from TPPs and households were up. Notably, unusually dry season led to an increased demand from TPPs, as they operated at full capacity for longer period. In addition, the company started commercial gas sales, which lifted average gas sale price to US$ 128.0/mcm in 2019 compared to 115.5/mcm in 2018. On the back of increased demand, it became necessary for GOGC to acquire large portion of expensive 'Additional Gas' from SOCAR which caused hike in weighted average gas purchase price (+24.1% y/y). As a result, gas supply margin almost halved to 12.3% in 2019 from 24.1% a year before. Other segments remained mostly stable in 2019. Due to deterioration in gas segment, adjusted EBITDA margin fell from 33.6% to 21.8% over 2018-19. We expect 2020 EBITDA to remain under pressure, due to lower sales price agreed upon COVID 19 related social pressures. We forecast gradual rebound in profitability from 2021, helped by electricity generation unit and reduction in average gas purchase price (as throughput in SCP is expected to increase substantially). Net-debt-to-adjusted EBITDA ratio jumped to 3.02x in 2019 from 1.5x in 2018, mostly due to lower profitability coupled with significant depreciation of GEL. GOGC intended to refinance the US$ 250mn Eurobond due in April 2021 in 1Q20, however COVID 19 related disruptions in the financial markets prevented the company to secure financing. The company plans to refinance the bond by tapping international debt markets by 1Q21. However, considering current market instability, GOGC is also in active negotiations with IFIs to pre-agree alternative financing option. Fitch revised company's stable outlook to negative in April 2020 in line with that of Sovereign.

Revenue was up 23.2% y/y to US$ 312.4mn in 2019. The growth was entirely driven by gas segment, which made up 65% of 2019 revenue. Social gas demand increased in 2019, helped by increased consumption from both TPPs (+38.8% y/y to 678mmcm) and households (+16.1% y/y to 984mmcm). In addition, the company started sale of commercial gas (imports from Russian Federation), bringing in additional c. US$ 35.0mn in commercial revenue. Launch of gas sales to commercial sector lifted average gas sale price to US$ 128.0/mcm in 2019 compared to 115.9/mcm in 2018.

Gas purchase price surged as the share of expensive 'Additional Gas' increased in 2019. To meet increased demand from social sector, it became necessary for GOGC to acquire larger portion of expensive 'Additional Gas' from SOCAR in 2019. This resulted in hike in gas purchase price (+24.1% y/y), causing deterioration of gas margins. Gas segment gross profit dropped from 24.1% in 2018 to 12.3% in 2019.

Increased gas purchase costs weighed on the company's profitability in 2019. Adjusted EBITDA was down 18.4% to US$ 68.8mn in 2019, translating into an adjusted EBITDA margin of 22.0% vs. 33.3% in 2018. **Net-debt-to-adjusted EBITDA ratio also jumped to 3.02x in 2019 from 1.5x in 2018.** Deteriorated profitability coupled with GEL's depreciation were the main reason behind the hike in the ratio.

We forecast EBITDA to remain under pressure in 2020, due to lower sales price agreed upon COVID-19 pandemic. We expect gradual rebound in profitability from 2021 helped by electricity generation unit (additional c. US$ 25mn EBIDTA) and improvement in gas segment margins. Net-debt-to-EBITDA ratio is forecasted to remain elevated in 2020 (at c. 3.45x), before retreating to below 2.5x from 2021, in our view.

GOGC is facing a US$ 250mn Eurobond refinancing in Apr-21. COVID-19 related deterioration in market sentiments prevented the company to refinance its Eurobond in 1Q20. GOGC plans to tap international debt markets by 1Q21, however the company is in active negotiations with IFIs to pre-agree alternative financing option.

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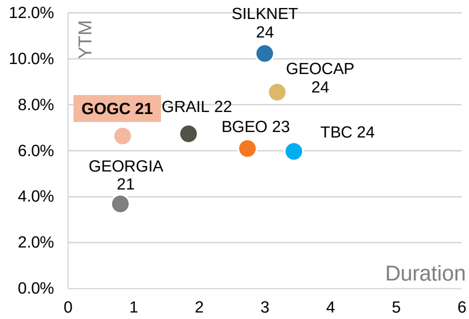
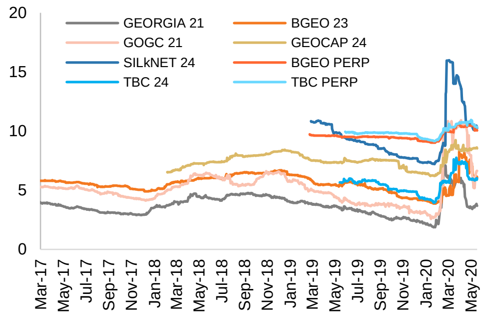
Figure 1: Georgian Eurobond universe



Source: Bloomberg, data as of June 17

Figure 2: Georgian Eurobonds



Source: Bloomberg

Table 1: Key financials (US$ '000) and margins

	FY18	FY19	Change, y/y
Revenue	253,557	312,356	+23.2%
Gross profit	108,571	93,401	-14.0%
Gross profit margin	*42.8%*	*29.9%*	*12.9ppts*
Adjusted EBITDA	84,359	68,825	-18.4%
Adjusted EBITDA margin	*33.3%*	*22.0%*	*-11.2ppts*
EBIT	70,251	57,860	-17.6%
EBIT margin	*27.7%*	*18.5%*	*-9.2ppts*
Net income	62,055	42,149	-32.1%
Net profit margin	*24.5%*	*13.8%*	*-10.7ppts*
Assets	632,530	658,161	+4.1%
Liabilities	263,272	289,687	+10.0%
Equity	369,258	368,473	-0.2%
Net-Debt-to-EBITDA	1.50x	3.02x	+1.52x

Source: Company data

US$-GEL	FY15	FY16	FY17	FY18	FY19
Period-end	2.395	2.647	2.592	2.677	2.868
Average	2.270	2.367	2.509	2.534	2.819

Source: NBG

GOGC credit ratings

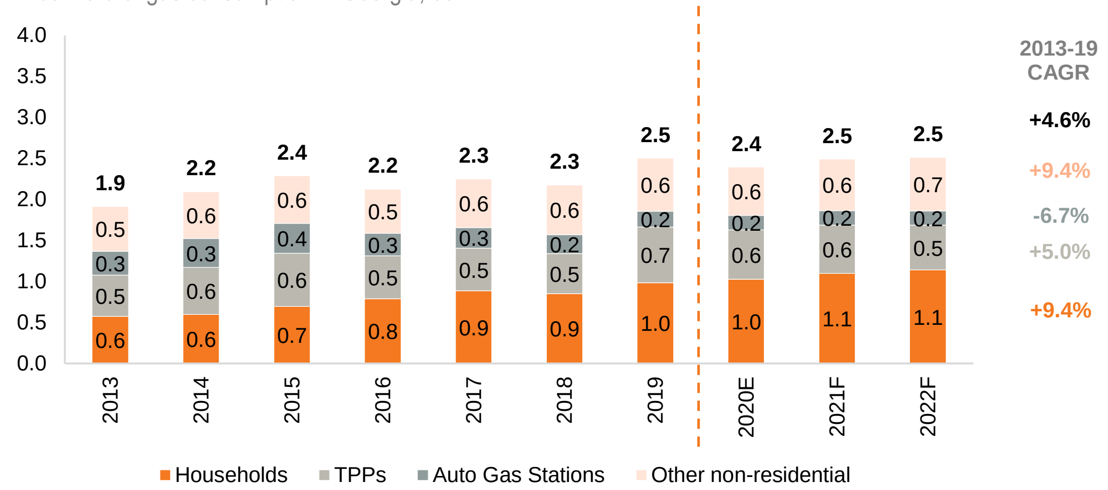
S&P Global Ratings
BB-
Negative
Affirmed Mar-2020

Fitch Ratings
BB
Negative
Affirmed Apr-2020

Gas market overview

Gas consumption in Georgia increased at the highest rate in 5 years in 2019 reaching 2.56bcm (+13.3% y/y). Increased demand from TPPs and households was the main reason behind the growth. Lower hydro generation (due to unfavorable hydrological conditions) was compensated by increased imports (+7.8% y/y) and thermal generation (+34.3% y/y) in 2019. As a result, gas consumed by TPPs was up 38.7% y/y to 678mmcm. At the same time, with growing number of gas consumers throughout Georgia (+69,592 new customers) gas consumption by households also increased by 16.1% y/y to 984mmcm.

Figure 3: Gas consumption in Georgia hiked in 2019
Annual natural gas consumption in Georgia, bcm



Source: GNERC, Galt & Taggart Research

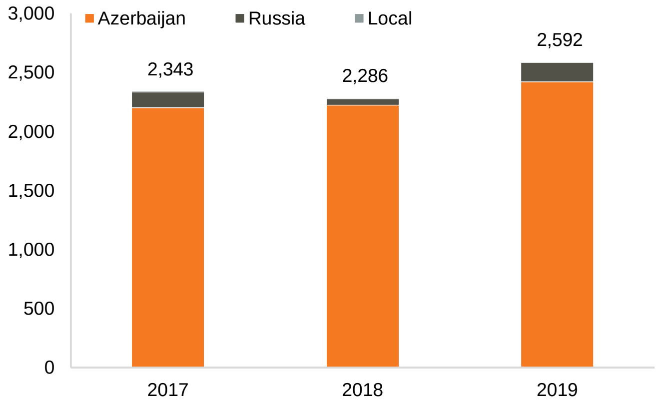
We forecast gas consumption to decline at a single digit in 2020. Corporate segment is expected to shrink due to COVID-19 related disruptions in economic activity, particularly in hospitality and education sectors. Slowdown in other sectors is also expected. Furthermore, auto-gas stations are facing a challenging environment as oil price slump has pressured their competitive advantage. Electricity consumption will likely experience declines as well (read more in our Electricity market Watch from May 7, 2020), putting pressure on demand from TPPs. Although household consumption might see a marginal growth, it won't be enough to compensate the decline in demand in other segments, in our view.

Russia's share in gas import mix has increased to 6.25% of total gas import in 2019, as GOGC started direct sales of gas to commercial sector. GOGC started gas purchase from Russia's Gazprom to meet the demand of commercial sector in 2019. Notably, the gas purchase agreement with Gazprom was further modified in Apr-20 at more favorable terms for GOGC for the period of Feb-Dec 2020.

Georgia's benefits from SCP will increase significantly starting from 2021. Once the two sections of the Southern Gas Corridor, TANAP (100% completed) in Turkey and TAP (90% completed) in Europe are operational (expected from 1Q21) the demand on Azeri gas is expected to increase significantly. As transit volumes grow, Georgia will be able to purchase more gas at cheaper prices, reducing average gas purchase price for GOGC.

Figure 4: Azerbaijan remains the top source of gas for Georgia, however Russia's share is growing

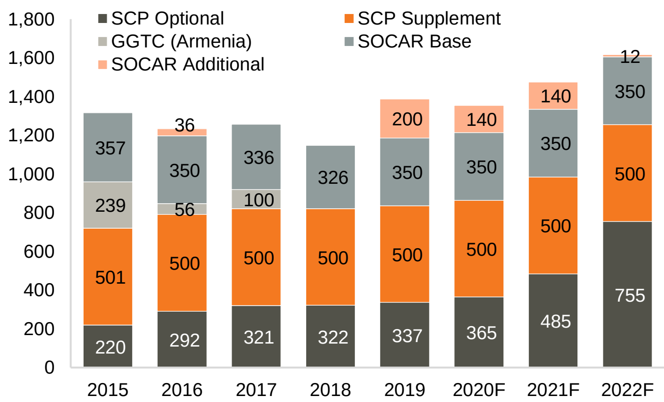
Gas import by sources, mmcm



Source: GNERC, Galt & Taggart Research

Figure 5: GOGC purchased 'expensive' gas in 2019 to meet increased demand of the social sector

GOGC gas purchase volumes by source, mmcm



Source: Company data, Galt & Taggart Research

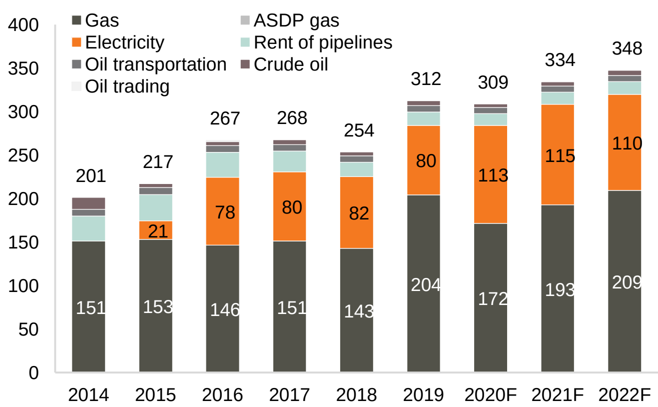
Gas margins under pressure

GOGC's revenue posted a solid 23.2% y/y growth in 2019 reaching US$ 312.4mn. The uplift in the top line was mostly due to increased gas supply revenue, which was up 43.2% y/y to US$ 204.4mn or 65.4% of total. Increase in gas demand from social sector on the one hand and new streams of revenue from commercial sector (c. 18% of gas revenue) on the other, lifted gas segment revenue in 2019.

Gas sector margins deteriorated in 2019. Average gas sale price increased 12.5% y/y to US$ 128.0/mcm in 2019, lifted by higher prices charged on commercial gas. However, gas purchase prices increased at a higher pace (24.1% y/y), resulting in lower margins for the company. Notably, higher margins earned on commercial gas were not enough to compensate the increase in social gas purchase price. Overall, gas segment gross profit margin halved from 24.1% to 12.3% over 2018-19.

Figure 6: Gas revenues increased in 2019

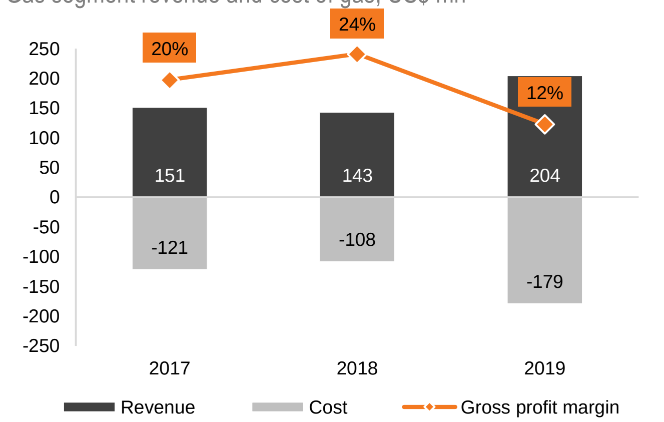
Revenue composition, US$ mn



Source: Company data, Galt & Taggart Research

Figure 7: Gas segment gross profit margin halved over 2018-19

Gas segment revenue and cost of gas, US$ mn



Source: Company data, Galt & Taggart Research

To meet increased social gas demand, it became necessary for GOGC to buy expensive 'SOCAR Additional' gas in 2019. Cost of gas, the largest expense category for the company accounting for 85% of the total operating expenses, was up 51.0% y/y to US$ 219.0mn in 2019. The growth in volume coupled with hike in average gas purchase price contributed to the overall increase in gas costs. Average gas purchase price increased 24.1% y/y in 2019 as increased demand from social sector was met by higher volume of expensive 'Additional gas' from SOCAR.

To support the household sector (during the pandemic), GOGC will likely reduce gas sale price thus avoiding tariff increase in 2020. Average social gas sale price is expected to decline further to c. US$ 100/mcm in 2020 from US$ 115.5/mcm in 2019. Notably, residential social gas tariffs take into consideration capital expenditures made by the distribution companies during the year. SOCAR is expected to have a new tariff set from the regulator before 1st of July 2020 and it is expected that instead of increasing SOCAR's tariff to compensate the capital expenditures made, GOGC will lower sale price to SOCAR Export-Import (who sells gas to SOCAR for residential customers).

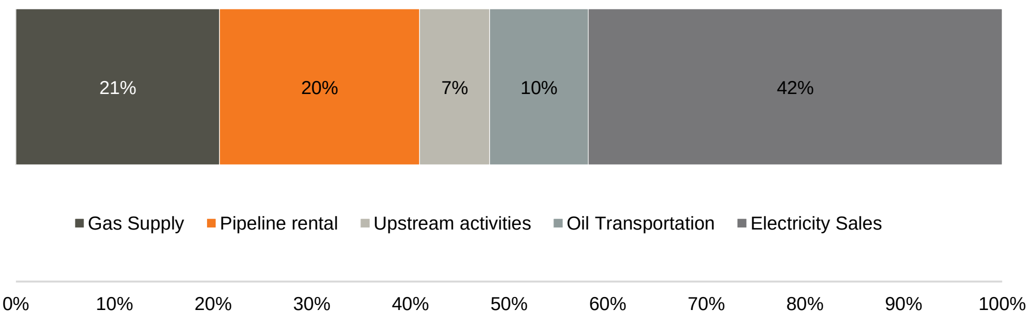
We expect social gas segment to operate at a break-even or a slight negative margin in 2020. Average gas purchase price is expected to gradually decline in 2020 as the share of cheap SCP gas increases and there will be no need to buy expensive gas from SOCAR. However, decline in average gas purchase price will not be enough to support high margins in the gas sector in 2020, in our view. We expect, social gas segment to operate at a slight negative margin in 2020.

Overall gas segment margin is expected to remain positive in 2020 helped by a profitable commercial segment. Margins in commercial segment are expected to grow further in 2020 as GOGC managed to amend the agreement with Gazprom in April 2020 at more favorable terms for GOGC.

Electricity segment will make up 70% of 2020 EBIDTA

Gardabani 2, launched in 1Q20, will help GOGC's profitability going forward. Electricity unit accounted for 42% of 2019 EBITDA while generating only 25.6% or US$ 79.9mn in revenue. Despite the expected decline in thermal generation in 2020 (c. 11% y/y decline to 600mmcmc) GOGC's electricity revenues are expected to increase by 40.9% y/y as new revenue streams will flow from Gardabani 2. **More than 70% of 2020 EBITDA is expected to stem from electricity unit.**

Figure 8: Electricity segment accounted for 42% of 2019 EBITDA while generating only 25.6% of revenue
EBITDA composition by segment, 2019 ('000 US$)



Source: Company data, Galt & Taggart Research

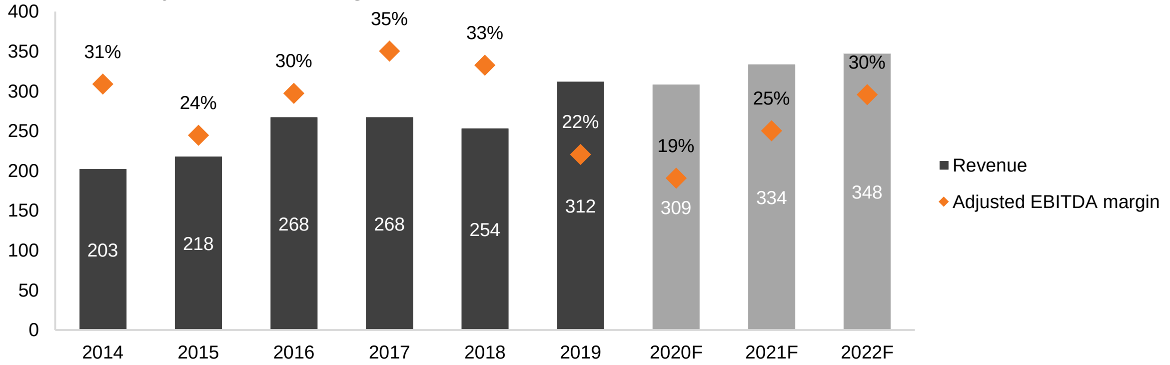
Other revenue sources remained mostly stable during 2019. Income from rent of pipelines was down 7.9% y/y to US$ 15.3mn due to GEL's depreciation over 2018-19 as the contract is fixed in GEL. Oil transportation and crude oil sale revenues were up 3.6% y/y to US$ 7.5mn and 18.2% y/y to US$ 5.4mn, respectively. **Apart from higher gas costs other operating expenses remained mostly stable in 2019.**

EBITDA margin is expected to deteriorate further in 2020

2020 adjusted EBITDA is expected to be dragged down by lower profitability in gas segment. 2019 adjusted EBITDA came in at US$ 68.8mn (-18.4% y/y) due to lower margins earned in gas business. Adjusted EBITDA margin also slid down by 11.2ppts to 22.0% in 2019.

We forecast further decrease in adjusted EBITDA margin in 2020. As gas segment margins are expected to remain squeezed in 2020, we forecast adjusted EBITDA margin to decline further to 19.0% in 2020 before rebounding to above 25% from 2021, helped by lower gas purchase prices.

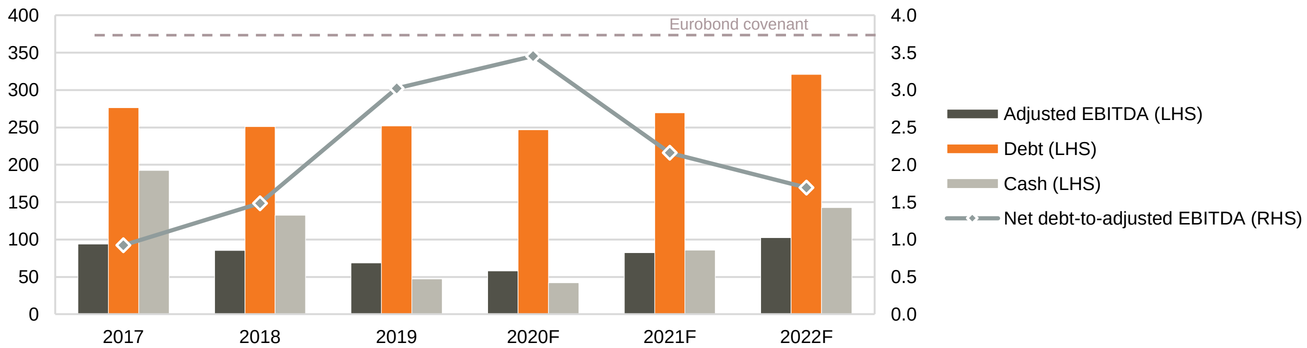
Figure 9: Adjusted EBITDA margin under pressure as gas segment margins are squeezed
Revenue and adjusted EBITDA margin, US$ mn



Source: Company data, Galt & Taggart Research

Net debt-to-adjusted EBITDA ratio jumped to 3.02x in 2019, from 1.5x in 2018. Deteriorated profitability, coupled with GEL's significant depreciation against USD were the main reasons behind the hike in the ratio in 2019. We expect further deterioration in ratio in 2020 to c. 3.45x mostly due to lower profitability, however the ratio is expected to remain below the Eurobond covenant of 3.75x. With improved performance from 2021 the leverage ratio should decline to below 2.5x over 2021-22, in our view.

Figure 10: Net debt to adjusted EBITDA jumped to 3.02x in 2019
Adjusted EBITDA, Net debt and Net debt to adjusted EBITDA ratio



Source: Company data, Galt & Taggart Research

Bottom line dragged down by non-cash FX expenses in 2019. The depreciation of the GEL against the USD during 2019 (11.2%) led to a non-cash FX loss of US$ 13.3mn in the reporting period compared to a US$ 8.6mn last year. All of the above contributed to the 30.6% y/y decline in net profit for the company in 2019, which stood at US$ 43.1mn.

GOGC declared US$ 20.0mn in dividends in 2019, which represented 32.3% of 2018 net income. Notably, the Parent company (Partnership Fund) made a decision that GOGC could distribute up to 35% of 2018 net income in July 2019. In addition, the company paid US$ 1.3mn to the parent, which was recognized as a prepaid dividend for 2019 net profit.

US$ 250mn refinancing need

GOGC is facing a US$ 250mn Eurobond refinancing in Apr-21. The company intended to refinance the US$ 250mn Eurobond in 1Q20, however COVID 19 related disruptions in the financial markets prevented the company to secure the financing. GOGC plans to tap international debt markets by 1Q21 to refinance the Eurobond. However, considering current market instability, GOGC is also in active negotiations with IFIs to pre-agree a backup standing facility for refinancing. We view the likelihood of securing financing from IFIs as high, due to strong financial prospects of the company as well as vital importance for the country. Furthermore, considering the improved sentiments in the global equity markets in April/May we think that GOGC will be able to refinance the Eurobonds in the fall 2020 or latest in 2021 before maturity.

The company intended to issue EUR 300mn Eurobond to refinance the US$ 250 Eurobond and rest to be used for the construction of Gardabani 3 HPP. In addition to Gardabani 3 construction the company plans to start investing in underground gas storage (UGS) development project from 2020. EUR 150mn loan facility has been approved by KfW in 2018, the first tranche of which will be used in 2020 for feasibility studies of the project.

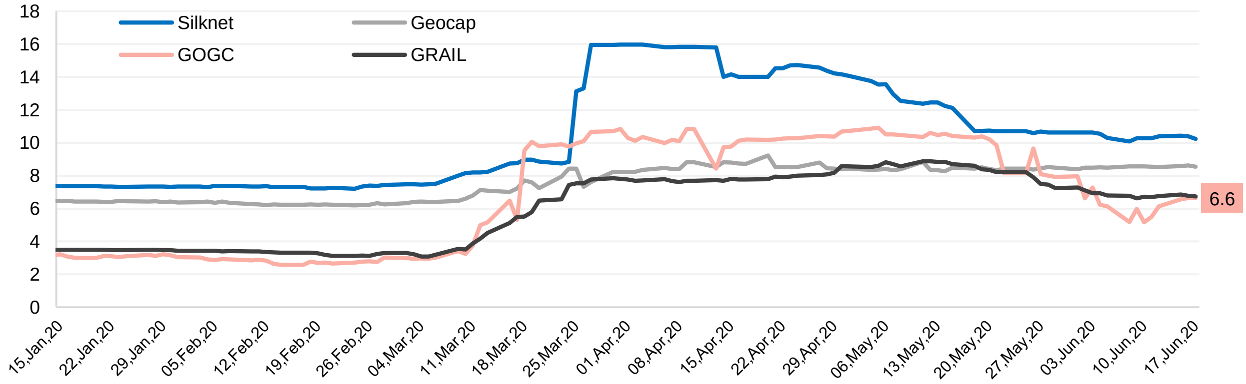
GOGC is the only company from Georgia whose credit ratings from Fitch matches the sovereign rating. Along with the revision of outlook on Georgia's sovereign rating from stable to negative in Apr 2020, Fitch Ratings lowered GOGC's outlook to negative as well. The decision was backed by the strong government support. Notably, Fitch Ratings has also revised outlook on Georgian Railway and on 5 Georgian banks to negative in Apr-2020.

Eurobond performance

Throughput 2018-19 yield on Georgian Eurobonds have been on the downward trajectory. By end -9, the yield on sovereign GEORGIA 21 bond dropped to a historical minimum of 2.4%. Yield on quasi-government GOGC and GRAIL also followed the trend, with the yields for the two companies dropping to 3.1% and 3.6%, respectively by December-19. The declines continued in the first two months of 2020, with the yields further decreasing to 1.9% for GEORGIA 21, 2.7% for GOGC and 3.1% for GRAIL by end Feb 20. However, since the COVID 19 outbreak the yields started to hike and GOGC turned out to be the worst performer among the selected placements, with the yield hiking by 818bps to 10.8% by end March 2020. In the meantime, yields on sovereign and GRAIL Eurobonds increased by 436bps and 468bps, respectively. Notably, spread vs. GRAIL reached historical maximum in March-April 2020. In the last week of May, the yields started to slightly decline, dropping to 5.2% by 10 June, 2020, before rebounding to 6.6% as of 17 June 2020, translating into a 100.1% price per par.

Figure 11: GOGC trimmed recent losses and is trading at par for the first time since early March 2020

YTM on selected Georgian Eurobonds



Source: Bloomberg, data as of 17 June, 2020

Financial statements

FX rates used in the forecast: GEL 3.18/US$ in 2020, GEL 3.05/US$ in 2021, GEL 2.95/US$ in 2022

Income statement

US$, '000	2017	2018	2019	2020F	2021F	2022F
Revenue	**267,710**	**253,557**	**312,356**	**308,719**	**334,248**	**347,520**
Sale of gas	151,301	142,690	204,360	171,582	192,723	209,354
Sale of electricity	79,609	82,496	79,856	112,506	115,491	110,429
Rent of pipelines	23,856	16,592	15,274	13,522	14,098	14,576
Oil transportation	7,301	7,247	7,509	6,961	7,100	7,242
Sale of crude oil	5,642	4,532	5,358	4,148	4,836	5,919
Operating expenses	**(188,864)**	**(182,506)**	**(218,982)**	**(265,584)**	**(261,800)**	**(261,800)**
Cost of gas and oil	(156,519)	(144,986)	(218,955)	(225,921)	(224,650)	(217,402)
Personnel costs	(7,057)	(7,921)	(8,160)	(9,334)	(10,359)	(11,169)
Taxes, other than on income	(3,847)	(4,308)	(5,584)	(4,940)	(5,348)	(5,560)
Other	(6,565)	(11,983)	(10,831)	(9,720)	(10,311)	(10,668)
Other income	3,200	806	3,582	483	550	627
Operating expenses excluding depr. and amort.	(173,987)	(169,198)	(244,477)	(251,804)	(252,926)	(245,745)
Adjusted EBITDA	**93,761**	**84,359**	**68,825**	**58,805**	**83,581**	**102,721**
Depreciation and amortization	(14,877)	(14,913)	(13,601)	(18,647)	(20,258)	(21,431)
Results from operating activities	82,045	70,251	57,860	40,640	63,873	81,917
Finance income	27,279	16,725	7,193	(14,922)	14,946	13,770
Finance costs	(21,480)	(25,448)	(23,518)	(16,549)	(16,549)	(16,549)
Net finance income	5,798	(8,723)	(16,325)	(31,472)	(1,604)	(2,779)
Share of loss of equity accounted investees	837	527	615	-	-	-
Profit before income tax	88,681	62,055	42,149	9,168	61,477	79,921
Income tax expense	(821)	-	-	-	-	-
Profit from continuing operations	87,860	62,055	42,149	9,168	61,477	79,921
Profit and total comprehensive income for the	**87,859**	**62,055**	**42,149**	**9,168**	**61,477**	**79,921**
Profit and total comprehensive income attributable						
Owners of the Company	76,349	53,179	36,374	7,912	53,053	68,969
Non-controlling interests	11,511	8,876	5,776	1,256	8,424	10,952

Statement of financial position

US$, '000	2017	2018	2019	2020F	2021F	2022F
Assets						
Property, plant and equipment	300,293	358,067	409,905	410,118	444,799	502,344
Prepayments for non-current assets	22,967	23,418	33,884	18,334	11,469	7,115
Intangible assets	438	419	496	447	466	482
Finance lease receivable	24,255	25,351	25,503	24,475	27,159	29,885
Loans given	4,645	5,586	5,633	2,970	1,688	-
Trade and other receivables non-current	8,166	7,083	5,481	4,448	4,174	3,884
Equity accounted investees	5,972	6,419	705	-	-	-
Non-current assets	366,736	426,343	480,251	460,793	489,755	543,710
Inventories	4,788	6,660	7,140	7,871	8,147	8,665
Current tax assets	-	811	152	-	-	-
Prepayments for current assets and expenses	19,594	18,793	23,084	20,817	21,704	22,440
Trade and other receivables	56,719	47,590	98,207	68,755	77,217	83,874
Cash and cash equivalents	192,485	132,333	47,360	43,595	89,032	146,566
Current assets	273,586	206,187	176,554	141,038	196,100	261,545
Total assets	**640,321**	**632,530**	**658,161**	**601,831**	**685,855**	**805,255**
Loans and borrowings	245,884	245,884	245,884	241,845	264,617	315,781
Deferred tax liabilities	-	-	-	-		
Non-current liabilities	245,884	245,884	245,884	241,845	264,617	315,781
Loans and borrowings current	30,290	5,038	5,894	4,904	4,904	4,904
Trade and other payables	11,285	11,577	33,294	15,748	19,629	18,635
Current tax liabilities	44	-	2,284	-	-	-
Provisions	797	772	720	649	677	700
Current liabilities	42,416	17,387	42,192	21,301	25,209	24,239
Total liabilities	**288,300**	**263,272**	**289,687**	**263,146**	**289,826**	**340,019**
Equity and liabilities						
Share capital	241,076	234,101	224,188	202,171	210,789	217,934
Fair value adjustment reserve for non-cash	(108,858)	(105,425)	(98,400)	(88,736)	(92,518)	(95,655)
Additional paid-in-capital	27,667	26,794	20,852	18,804	19,606	20,270
Retained earnings	165,494	179,580	185,313	172,256	214,083	266,170
Equity attributable to owners of the Company	325,379	335,051	331,953	304,495	351,958	408,719
Non-controlling interests	26,643	34,208	36,520	34,190	44,071	56,517
Total equity	**352,021**	**369,258**	**368,473**	**338,685**	**396,029**	**465,236**
Total equity and liabilities	**640,322**	**632,530**	**658,161**	**600,512**	**682,856**	**801,386**

Financial ratios

	2017	2018	2019	2020F	2021F	2022F
Profitability						
Gross profit margin	41.5%	42.8%	29.9%	26.8%	32.8%	37.4%
EBITDA margin	36.2%	33.6%	22.9%	19.2%	25.2%	29.7%
Adjusted EBITDA margin	35.0%	33.3%	22.0%	19.0%	25.0%	29.6%
EBIT margin	30.6%	27.7%	18.5%	13.2%	19.1%	23.6%
EBT margin	33.1%	24.5%	13.8%	3.0%	18.4%	23.0%
Net profit margin	32.8%	24.5%	13.8%	3.0%	18.4%	23.0%
Return on Investment						
Return on average assets (ROAA)	13.6%	9.4%	6.8%	1.5%	9.4%	10.6%
Return on average equity (ROAE)	27.3%	16.5%	11.9%	2.7%	16.4%	18.3%
Solvency						
Liabilities to assets	45.0%	41.6%	44.0%	2.7%	16.4%	18.3%
Liabilities to equity	81.9%	71.3%	78.6%	77.7%	73.2%	73.1%
Liabilities to EBITDA	3.07x	3.26x	4.12x	4.44x	3.44x	3.29x
Debt-to-assets	43.1%	39.7%	38.3%	41.0%	39.3%	39.8%
Debt-to-equity	78.5%	68.0%	68.3%	72.9%	68.1%	68.9%
Debt-to-EBITDA	2.94x	3.11x	3.58x	4.16x	3.20x	3.10x
Net debt-to-assets	13.1%	18.7%	31.1%	33.8%	26.3%	21.6%
Net debt-to-equity	23.8%	32.1%	55.5%	60.0%	45.6%	37.4%
Net debt-to-EBITDA	0.89x	1.47x	2.91x	3.43x	2.15x	1.68x
Net debt-to-adjusted EBITDA	**0.92x**	**1.48x**	**3.02x**	**3.45x**	**2.16x**	**1.70x**
Financial leverage (equity multiplier)	1.82x	1.71x	1.79x	1.78x	1.73x	1.73x
Liquidity						
Current ratio	6.45x	11.86x	4.18x	6.62x	7.78x	10.79x
Quick ratio (acid test)	6.34x	11.61x	4.09x	6.43x	7.60x	10.57x
Cash ratio	4.54x	7.61x	1.12x	2.05x	3.53x	6.05x

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