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Research Update:

Georgian Oil and Gas Corporation JSC Upgraded To 'B+' On Sound Operating Performance; Outlook Stable

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Research Update:

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Overview

- Georgian Oil and Gas Corporation JSC (GOGC) has a track record of favorable earnings and operating cash flow generation, underpinned by its existing contract structure in gas trading activities, which we assume will continue over the next two years.
- We continue to assess the likelihood of sufficient and timely extraordinary financial support for GOGC from the Government of Georgia as very high.
- We are raising our long-term rating on GOGC to 'B+' from 'B'.
- The outlook is stable, as we assume that the financial risks associated with GOGC's negative free operating cash flow, sizable investment program, and potential cost overruns, will be mitigated by government support, above-industry-average profitability, and an adequate maturity profile.

Rating Action

On Aug. 29, 2014, Standard & Poor's Ratings Services raised its long-term corporate credit rating on Georgian Oil and Gas Corporation JSC (GOGC) to 'B+' from 'B'. The outlook is stable.

At the same time, we affirmed our 'B' short-term corporate credit rating on the company.

Rationale

The upgrade reflects our revision of the company's stand-alone credit profile (SACP) to 'b' from 'b-'. This incorporates GOGC's track record of generating favorable operating cash flows and relatively high margins, based on its existing gas trading long-term contract structure, as well as our expectations that GOGC will continue posting positive results over 2014-2015 on the back of the existing contract mix and terms.

Our assessment of GOGC's SACP at 'b' is derived from its anchor of 'b', based on our assessment of a "weak" business risk profile and a "highly leveraged" financial risk profile, and a neutral impact from our analytical modifiers.

GOGC's SACP 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 SACP is also constrained by 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 combined cycle power station in 2013. In addition, the company issued a $28.5 million loan to another state-controlled entity in 2012, which was not repaid when due in 2013 and, as we understand, has been restructured.

We assume that the company's free operating cash flow (FOCF) will be significantly negative in the coming two years, owing to planned investments for the $220 million Gardabani project. At the same time, we note that GOGC secured financing for the project via a Eurobond issue in 2012, and, in our base-case scenario, we don't envisage additional debt over the next two years.

Factors supporting the SACP include GOGC's strategic importance to the government as the main gas supplier to the domestic market, and the government's strong track record of providing financial assistance to GOGC. In addition, GOGC has take-or-pay conditions in its contract with SOCAR, achieves higher profitability than its peers, and owns two strategic pipelines, which generate about 17% of total revenues and provide relatively stable earnings and cash flows from regulated activities.

The long-term rating includes one notch of uplift to reflect our assessment that there is a very high likelihood of extraordinary government support for GOGC if needed from the Government of Georgia (BB-/Stable/B), based on our criteria for government-related entities (GREs). This assessment stems from our view of GOGC's:

- Very important role for the government, given its mandate to ensure gas supply to the domestic market through ownership of strategic pipelines, its active role in strategic government development plans, and its status as a national oil company; and
- Very strong link with the government, given that it is 100% government-owned (via the fully government-owned State Partnership Fund), our expectation that the government will maintain majority ownership over the medium term, the government's involvement in the company's strategic decision-making, and the risk to the sovereign's reputation if GOGC were to default. This view is supported by previous strong financial support for the company from the government in the form of grants, concessional loans, direct equity contributions, and tax benefits.

Liquidity

We assess GOGC's liquidity as "adequate," as defined by our criteria. As of June 30, 2014, we estimate GOGC's ratio of liquidity sources to uses for the next 12 months to comfortably exceed 1.2x.

Principal liquidity sources as of that date include:

- Georgian lari (GEL) 222 million (about $131 million) of available cash and deposits; and
- Cash from operations of about GEL89 million in the next 12 months.

Principal liquidity uses at the same date include:

- Capital expenditures of about GEL176 million (about $104 million);
- Dividends of GEL35 million (about $21 million); and

- Repayment of GEL6 million in short-term debt.

The Eurobond documentation stipulates that GOGC must maintain a net-debt-to-EBITDA ratio lower than 3.5x. We anticipate that the company will have tight headroom in 2014, but stay compliant with the covenants. Our assessment of liquidity is capped at "adequate" because we believe GOGC lacks several characteristics that would support a higher assessment, such as sufficient covenant headroom for the forecast 30% EBITDA decline, without breaching coverage tests or affecting GOGC's generally high standing in the credit markets.

Outlook

The stable outlook reflects our view that the financial risks associated with GOGC's negative FOCF generation, sizable investment program, and potential cost overruns, will be mitigated by government support, above-industry-average profitability, and an adequate debt maturity profile. We view a debt-to-EBITDA ratio (including our adjustments) of less than 4x as commensurate with the current rating. We assume that there will be no materially adverse changes in the terms and contract mix that would impair GOGC's margins and cash flow generation. We also 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 also assume that GOGC will not provide any more loans to other GREs at the expense of its own financial profile.

Upside scenario

Rating upside is limited in the next 12 months, as we anticipate heavily negative FOCF on the back of the Gardabani investments, and debt leverage remaining relatively high (about 4.0x). In accordance with our criteria for GREs, GOGC's SACP would need to be revised at least to 'bb-' in order to result in an upgrade, provided that the sovereign rating remains 'BB-' and the likelihood of support remains very high. A one-notch upgrade of the sovereign would not lead to a similar action on GOGC, all else being equal.

Downside scenario

We could lower the ratings if the company's liquidity and maturity profile were not commensurate with the ratings, or if the debt-to-EBITDA ratio exceeded 4.0x or FFO to debt fell below 20%. This could stem from increased investments or substantial negative changes in the current operational structure or contract scheme, leading to impaired earnings and cash flow generation. The latter, depending on the size of the impact, could lead us to reassess downward both the business risk profile and financial risk profile. A one-notch downgrade might be driven by a revision of our assessment of the likelihood of timely and sufficient extraordinary government support to moderately high from the current very high, provided the SACP remains at 'b'. Furthermore, a one-notch downgrade of the sovereign is likely to result in a similar rating action on GOGC.

Ratings Score Snapshot

Corporate Credit Rating: B+/Stable/B

Business risk: Weak

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

Stand-alone credit profile: b

- Sovereign rating (Government of Georgia): BB-/Stable/B
- Likelihood of government support: Very high (+1 notch from SACP)

Related Criteria And Research

Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry - March 28, 2014
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - January 02, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Midstream Energy Industry - December 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 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
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - December 09, 2010

- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008

Ratings List

	Ratings	
	To	From
Georgian Oil and Gas Corporation JSC		
Corporate credit rating		
Foreign and Local Currency	B+/Stable/B	B/Positive/B
Senior Unsecured		
Foreign Currency	B+	B

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