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Research Update:

Georgian Oil and Gas Corporation Outlook Revised To Stable On Improving Performance; 'B+/B' Ratings Affirmed

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Research Update:

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Overview

- Georgian Oil and Gas Corporation's (GOGC's) EBITDA is significantly increasing thanks to commissioning the Gardabani power plant and a relatively favorable gas purchase price.
- We understand that the company's large capital spending projects will likely start in 2017-2018, after long-term financing is secured, rather than in 2016.
- We are revising our outlook on GOGC to stable from negative and affirming the 'B+/B' long- and short-term corporate credit ratings.
- The stable outlook reflects our expectation that debt to EBITDA at GOGC (on a gross basis, as adjusted by S&P Global Ratings) will be below 4x, that there will be no material changes to the current gas purchase and sales structure, and that the company will not start heavily investing in its new projects without long-term financing in place.

Rating Action

On Nov. 16, 2016, S&P Global Ratings revised its outlook on Georgian Oil and Gas Corporation JSC (GOGC) to stable from negative. We affirmed 'B+/B' long- and short-term corporate credit ratings.

Rationale

The outlook revision reflects our expectation that higher EBITDA generation should help GOGC accommodate its capital expenditure (capex) projects without a material increase in leverage. We now expect debt to EBITDA to stay below 4x in 2016-2018 (on a gross basis, as adjusted by S&P Global Ratings).

Thanks to currently favorable gas purchase prices and successful commissioning of the Gardabani thermal power plant in 2015, we expect GOGC's EBITDA to increase to over Georgian lari (GEL) 200 million (about US$80 million) per year, compared with GEL125 million in 2015. Also, we understand that GOGC now plans to start large investments in its two major capex projects only in mid-2017 (expansion of the Gardabani thermal power plant [total cost estimated at US$180 million]) and 2018 (construction of an underground gas storage facility), after it obtains long-term financing for both projects. We understand that the new assets will now be commissioned and start generating cash flow no earlier than in 2019. Still, we think the increased operating

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cash flow should reduce the pressure on free operating cash flow (FOCF) in 2016-first half 2017 and support leverage below 4x during the heavy construction phase.

GOGC's business risk is constrained by the company's reliance on several large long-term contracts for gas supply from Russia and Azerbaijan. 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. Currently and in our base-case scenario, GOGC gets a relatively favorable gas price from Azerbaijani counterparties, following recent contract renegotiation.But GOGC is fundamentally exposed to oil price volatility because the price for some of its gas purchases is linked to oil and oil product prices, while the sale price is fixed in U.S. dollars for the long term.

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 combined-cycle power plant (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.

Our assessment of GOGC's financial risk profile is constrained by high volatility of cash flows and ratios during stress periods; sizable investments in growth projects, which will turn FOCF negative in 2017-2018; and relatively high leverage. Historically, GOGC has issued loans to other government-related entities (GREs) (GEL99 million outstanding as of June 30, 2016), and, although the loans are interest bearing and we understand that part of the loans has been repaid in 2016, we see the risk that GOGC's funds and assets might be used to finance other Georgian GREs.

Our rating on GOGC includes a one-notch uplift, reflecting our expectation of a very high likelihood of extraordinary government support. GOGC has a mandate to ensure gas supply to the domestic market. The company is 100% government owned, so privatization risk is remote in our view, and there is a track record of government financial support to GOGC, for example in the form of grants. We understand that the state is closely involved in strategic decision making for GOGC, and if GOGC were to default, it might entail risks to the sovereign's reputation. That said, GOGC is primarily an intermediary. In our view, the activities currently undertaken by GOGC could theoretically be performed by a private entity in case of a material change in the government's strategy.

In our base case, we assume:

- No material changes to the current gas purchase and sales arrangements, and no changes in the key asset structure, for example, no transfer of the power station to the state.
- Gas purchase prices to remain relatively favorable, reflecting our oil price assumptions of Brent at US$45 per barrel in 2017 and US$50 per barrel in 2018.

- The Gardabani expansion starts in 2017 and the underground storage facility construction starts 2018, financed with long-term debt. As a result, capex is set to increase from below GEL100 million in 2016 to closer to GEL270 million-GEL300 million in 2017.
- No material cost overruns in the major capex projects.
- Neutral working capital.
- Dividends of about GEL20 million-GEL40 million in 2016-2017.

Based on these assumptions, we arrive at the following credit measures:
- EBITDA increasing to above GEL200 million in 2016-2018, thanks to the contribution from the new power station.
- Strongly negative FOCF in 2017-2019.
- Debt to EBITDA of about 3.5x in 2016-2018.

Liquidity

We assess GOGC's liquidity as adequate, supported by its refinancing earlier in 2016. In April 2016, GOGC has issued a new US$250 million eurobond due in 2022 and refinanced most of its first US$250 million eurobond issue due in 2017.

Principal liquidity sources include:
- Around GEL260 million of available cash and liquid instruments.
- Cash generated from operations of about GEL150 million.
- GEL35 million inflow from the repayment of a related-party loan.

Principal liquidity uses include:
- Short-term debt, which includes the remaining US$53 million (about GEL130 million) portion of the 2017 bond.
- Capex of about GEL200 million, which includes new projects.
- Dividends of about GEL30 million.

Although GOGC managed to refinance in 2016, we believe that, like many other emerging-market issuers, access to financial markets can be volatile.

The covenant on the new eurobond limits GOGC's ratio of net debt to EBITDA at 3.75x. We believe GOGC has adequate covenant headroom, due to meaningful cash on the balance sheet and because the covenant language allows for carve outs for project finance debt on new construction.

Outlook

The stable outlook reflects our view that GOGC's ratio of debt to EBITDA will be below 4x (on a gross basis, as adjusted by S&P Global Ratings), that the existing contract framework for gas purchase and sale will remain in place without any material changes, and that the company will not start new capex projects without long-term financing in place. It also assumes no major cost overruns or operational issues on the new projects. It also corresponds to the stable outlook on Georgia.

Upside scenario

Rating upside could stem from a positive rating action on the sovereign, all else being equal. Rating upside based on GOGC's stand-alone performance is currently limited, because for an upgrade, we would need to revise GOGC's stand-alone credit profile to at least 'bb-', provided that the sovereign rating remained 'BB-' and the likelihood of support remained very high. This could happen if debt to EBITDA approaches 2x, but it is quite far from our base-case scenario.

Downside scenario

We could downgrade GOGC if debt to EBITDA is sustainably above 4x, due to significantly lower profits or material capex overruns. This could happen, for example, in case of operational setbacks, or if the company's margins are squeezed by higher gas purchase prices.

Rating downside could also stem from a significant unfavorable change in the existing gas purchase and sale framework, or disposal of key assets, or government pressure to provide sizable support to other weaker GREs, or a material weakening of GOGC's role for and link with the government in case the government's strategy in the sector materially changes.

We could also lower the rating in case of a sovereign downgrade.

Ratings Score Snapshot

Corporate Credit Rating: B+/Stable/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)
- 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: BB-

- Likelihood of government support: Very high (+1 notch)

Related Criteria And Research

Related Criteria

- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- 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
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- 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; Outlook Action

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

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