FITCH REVISES MOL'S OUTLOOK TO STABLE; AFFIRMS AT 'BBB-'

Fitch Ratings-Warsaw/London-24 March 2016: Fitch Ratings has revised MOL Hungarian Oil and Gas Company Plc's (MOL) Outlook to Stable from Negative, while affirming its Long-term Issuer Default Rating (IDR) at 'BBB-'. A full list of MOL's ratings is at the end of this commentary.

The Outlook change reflects our view that MOL should be able to maintain a conservative financial profile with leverage within our guidelines, despite lower projected oil prices in 2016 and moderating refining margins. Under our conservative assumptions MOL's net debt may increase in 2016, but its free cash flow (FCF) deficit is likely to be moderate and manageable, unlike that of many other integrated oil players. This is due to expected strong downstream performance, a fairly low share of higher-cost upstream assets in its portfolio and considerable capex reduction. We expect MOL to generate positive post-dividend FCF in 2017-19.

The outcome of the dispute between MOL and Croatia over the management rights in INA remains difficult to predict, with two arbitrations currently in progress. A negative outcome for MOL, including the loss of control over INA, cannot be excluded and would likely be credit-negative but manageable for MOL. We treat this possibility as an event risk.

MOL is a vertically integrated oil and gas producer with operations in upstream, refining, fuel retail and petrochemicals. In 2015 MOL generated USD2.5bn current cost of supplies EBITDA. It operates four refineries (one in Hungary, one in Slovakia and two in Croatia) with a total refinery capacity of 417 thousand barrels of oil equivalent per day (mboepd). MOL's 2015 upstream production amounted to 104mboepd, mainly from mature assets in Hungary and Croatia, but also from greenfields in the North Sea, Kurdistan and other regions.

KEY RATING DRIVERS

Strong Downstream Performance

MOL's normalised downstream EBITDA almost doubled to USD1,650m in 2015 on strong refining and petrochemical margins and MOL's progress with the Next Downstream Development programme announced in 2014. This fully offset MOL's weaker upstream earnings, and resulted in the company's total normalised EBITDA rising 13%yoy.

We expect MOL's downstream EBITDA to fall in 2016 by 15%-20% due to less favourable refining margins; however, it should be supported by less volatile retail margins and further progress with the Next Downstream Development programme. MOL expects the programme should bring USD500m of incremental EBITDA p.a. by 2017, split into growth projects (USD150m, including mainly contribution from already commissioned butadiene and LDPE4 units) and efficiency improvements, such as availability, energy and loss management.

We believe MOL will largely be able to achieve the expected improvements, as demonstrated by the incremental USD210m EBITDA already generated in 2015. However, downstream segment results will continue to rely on the European and global refining margin environment.

Refining Margins to Moderate

European refining margins boomed in 2015 on lower oil prices, and we expect them to moderate in 2016 and beyond as the problem of overcapacity and strong competition from overseas persists. In 2015, the north-west European refining margin averaged USD7.2/bbl, up from USD4.5/bbl in

2014 and USD4/bbl in 2013. We assume margins to average USD5.5/bbl in 2016 and USD5/bbl in 2017-19.

INA Uncertainty Remains

Tensions between the Croatian government and MOL over the corporate governance structure of INA intensified in 2013, but so far with limited consequences for the financial profile and operations of both companies. In 2015, INA accounted for 19% of MOL's consolidated EBITDA and 36% of its hydrocarbon production. It operates two (though less sophisticated and loss-making) of MOL's total four refineries.

The outcome of the dispute remains difficult to predict. There are now two arbitrations in process. Croatia is seeking to cancel the 2009 deal that gave MOL full management rights in INA and in 2014 filed a case with the UN Commission on International Trade Law in Geneva (UNCITRAL). MOL in its turn initiated proceedings against Croatia with the International Centre for Settlement of Investment Disputes (ICSID) in Washington, claiming that the state failed to take over INA's loss-making gas trading business, as stipulated in an agreement entered into in 2009.

Potential outcomes of the dispute with Croatian authorities include a negotiated settlement, disposal of MOL's stake in INA, but also cancellation of the 2009 agreement giving MOL management rights in INA or compensation to be paid by MOL. We treat the latter two possibilities as event risks with potential negative implications for MOL's credit profile. We also believe that the dispute between MOL and Croatia may not be resolved in the near future.

Falling Capex Helps Balance FCF

Unlike many other integrated oil players with a greater focus on upstream operations, MOL should be able to broadly balance its cash inflows and outflows in 2016 under our conservative assumptions. We expect its after-dividend FCF to be negative this year, but not significant, due to strong cash flow from operations and lower capex. Thereafter, MOL's FCF should turn positive, allowing the company to be more active on the M&A market, in line with its 'cautious but opportunistic' acquisition strategy.

MOL's organic capex reduced to USD1.26bn in 2015 after peaking at USD1.7bn in 2014. MOL expects its organic capex to settle at USD1.3bn over the medium term, and we additionally assume that the company will spend around USD200m p.a. on acquisitions. We also assume that MOL will moderately increase its dividends, in line with its announced strategy.

Upstream Decline Reversed; Challenges Remain

MOL managed to arrest its upstream production decline in 3Q14, and its 2015 output returned to the 2013 level of around 104mboepd, up 6.6% yoy. However, this was still 30% below its 2011 production. The previous slump in production was caused by the company's forced withdrawal from Syria and an organic production decline in Hungary and Croatia. We assume MOL's upstream production to increase to around 110mboepd by 2018-19 as its North Sea assets ramp up.

MOL has committed to ensuring that the upstream segment is self-funded at an oil price of USD35/bbl. However, its FCF break-even oil price in the North Sea is likely to remain higher at least in 2016 and 2017, even after assuming the cost deflation. We believe that the company's North Sea development strategy is contingent on the oil price recovery and may not be sustainable if prices remain depressed for longer than we have assumed.

Other challenges the company is facing in the upstream segment are mature assets in Hungary and Croatia, and high political risks in Kurdistan.

Limited Exposure to Hungary

MOL demonstrates only limited exposure to the Hungarian economy as its two main profit drivers - crude oil prices and refining margins - are more affected by global factors. This allows us to rate MOL above the Hungarian sovereign rating (BB+/Positive); however, MOL's foreign currency IDR is potentially capped by the country's current Country Ceiling of 'BBB.'

Fitch revised Hungary's Outlook to Positive from Stable in May 2015 and affirmed the rating in November 2015 (see 'Fitch Affirms Hungary at 'BB+'; Outlook Positive', dated 20 November 2015). A potential upgrade of Hungary would have no direct impact on MOL's ratings. However, we view a stronger sovereign credit profile as positive for MOL as it reduces the risks of non-standard measures being introduced by the government (eg special taxes), while GDP growth could result in higher fuel sales, which may benefit MOL's financial results.

KEY ASSUMPTIONS:
- Fitch oil price deck: USD35/bbl in 2016, USD45/bbl in 2017; USD55/bbl in 2018 and USD65/bbl in 2019;
- Refining margins moderating to USD5.5/bbl in 2016 and USD5/bbl thereafter from USD7.2/bbl in 2015;
- Upstream production gradually rising to around 110mboepd by 2019 from 105mboepd in 2016;
- Capex at USD1.3bn in 2016-17; rising to USD1.4bn in 2018 and USD1.5bn in 2019;
- Small-scale acquisitions of USD200m p.a. in 2016-19;
- Cash dividends rising to HUF70bn in 2019 from HUF50bn in 2015.

RATING SENSITIVITIES
Negative: Future developments that could, individually or collectively, lead to negative rating action include:
- FFO-adjusted net leverage above 2.5x on a through-the-cycle basis (2015: 1.2x; 2016-19E: around 1.6x)
- Large acquisition of non-producing assets
- Upstream production falling significantly below 2015 level
- Negative impact on MOL's financial profile from the dispute regarding its management rights in INA

Positive: Positive rating action is currently unlikely given the company's business profile with fairly small upstream operations, only moderate geographical diversification and high exposure to the European refining industry.

LIQUIDITY
At end-2015 MOL had available liquidity of HUF132bn cash (USD456m), HUF47bn of marketable securities (assuming a 25% haircut in line with our methodology) and USD3bn undrawn committed long-term facilities against debt maturing in one year of HUF206bn (USD712m).

MOL redeemed its convertible bond of EUR610m issued by Magnolia Finance Limited on 20 March 2016. The bond was subordinated, and we had previously fully included it into the company's leverage. The repayment of the bond and its potential replacement by other debt will hence not affect our assessment of MOL's debt load.

FULL LIST OF RATING ACTIONS
MOL Hungarian Oil and Gas Company plc:
Long-term foreign and local currency IDRs: affirmed at 'BBB-'; Outlook revised to Stable from Negative
Short-term foreign and local currency IDRs: affirmed at 'F3'
Senior unsecured rating: affirmed at 'BBB-'

MOL Group Finance SA:
Senior unsecured rating: affirmed at 'BBB-'

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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