08 Nov 2019 | Affirmation

Fitch Affirms MOL at 'BBB-'; Outlook Stable

Fitch Ratings-Warsaw-08 November 2019:

Fitch Ratings has affirmed MOL Hungarian Oil and Gas Company Plc's (MOL) Long-Term Issuer Default Rating (IDR) at 'BBB-'. The Outlook is Stable.

The affirmation reflects MOL's diversified and integrated business with assets in downstream, upstream, retail, and gas midstream, conservative leverage and strong competitive position in the company's core markets. The ratings are constrained by MOL's short reserve life compared with direct peers' and uncertainties over the company's stake in Croatia's INA - Industrija Nafte, d.d. (INA).

MOL has recently announced the acquisition of Chevron's stake in the Azeri-Chirag-Gunashli (ACG) oil field and the Baku-Tbilisi-Ceyhan (BTC) pipeline for USD1.57 billion, which is expected to close in 2020. We estimate the transaction will increase MOL's 2P reserves by 120 million-140 million barrels of oil equivalent (mmboe) and production by around 20 thousand barrels of oil equivalent per day (kboe/d), while funds from operations (FFO) adjusted net leverage will remain comfortably below 2.5x, our negative sensitivity threshold.

Key Rating Drivers

ACG Acquisition Rating-Neutral: The acquisition of a 9.57% stake in ACG oil field, and an effective 8.9% stake in the BTC pipeline that transports the crude to the Mediterranean port of Ceyhan increases MOL's upstream segment total 2P reserves by roughly a half and total annual production by a fifth. The transaction alleviates some rating pressure on MOL related to a decreasing reserve base, while the company's financial profile will remain strong with FFO adjusted net leverage forecast to peak at 1.4x in 2020 and gradually decreasing thereafter, leaving ample headroom for additional inorganic growth.

Mature Upstream Asset Base: Nevertheless, MOL's upstream asset base remains mature compared with that of peers such as Compania Espanola de Petroleos, S.A.U (BBB-/Positive) or Aker BP ASA (BBB-/Stable). ACG reached plateau production in 2010 and its output has steadily decreased. MOL's upstream asset base lacks prospective fields that can help raise production in the next three to five years.

Positive Downstream Prospects in 2020: The upcoming IMO 2020 fuel sulphur regulation, which aims to reduce the maximum allowed sulphur content in fuel oil used for marine transportation to 0.5% from 3.5%, starting from 1 January 2020, has started to feed through to fuel crack spreads by increasing margins on middle distillates and deepening losses on sales of heavy sulphur fuel oil. The overall impact for more complex refiners such as MOL is positive. We also expect refining margins in 2020 will reflect the positive effects of higher demand for middle distillates. Growing global net refining capacity, coupled with expected lower refining capacity maintenance, may, however, partially reduce the positive impact on crack spreads.

Diversified Operations: MOL's integrated business model is a key credit strength, as the company operates across the entire oil and gas value chain and generates stable cash flows throughout the business cycle. MOL's small upstream production (99mboe/d in 3Q19, of which 53% were liquids, excluding JVs and affiliates) is concentrated in two countries - Hungary and Croatia - which account for 73% of total output (excluding JVs and affiliates). MOL's more sizable downstream segment, that accounted for an average of 46% of EBITDA in 2016-2018, drives the company's profitability in periods of low oil prices. In addition, gas midstream and consumer services contributed to an average of 23% of total EBITDA over the period, providing stable earnings and supporting MOL's overall creditworthiness.

Further Diversification into Chemicals: MOL plans to improve downstream diversification through further expansion into chemicals with its flagship polyol project. With expected completion by end-2021, the polyol plant is projected to contribute USD170 million of EBITDA under mid-cycle conditions. We see further expansion in petrochemicals as positive for MOL's credit profile, due to lower specialty chemicals margin volatility and superior growth prospects in the segment, compared with fuel products.

Higher Capex Expected: We expect MOL's total capex of around USD2.3 billion-2.5 billion over 2019 and 2020, due to higher spending associated with the polyol project. We project that this will yield temporarily negative free cash flow (FCF) in 2019, before gradually recovering as spending winds down, supplemented by our assumption of improved gas prices. As a result, we expect MOL's leverage to trend below 1.4x up to 2022, well below our 2.5x negative rating threshold.

Uncertainty around INA Remains: The decision of the United Nations Commission on International Trade Law (UNCITRAL) court in December 2016 to dismiss the claims of the Croatian government against MOL was followed by the government's announcement to buy back the 49.1% stake in INA from MOL. Should this scenario unfold, we expect MOL to monetise its stake at market prices and to use proceeds to replace the INA reserves via another acquisition.

Such a development, combined with the company's current need to replenish its declining

reserves, would further increase the uncertainty around the upstream segment's future performance. In our opinion, the alternative option, where MOL keeps and operates INA implies lower execution risk. This would allow MOL to further optimise INA's downstream assets, which currently suffer from low utilisation and are not profitable.

Higher Contribution from Non-Cyclicals: In 2018, MOL's fairly stable consumer services and gas midstream operations contributed 23% of total EBITDA, up from 14% in 2013. This has been driven by strong retail performance, which generated EBITDA of USD423 million, up from USD358 million a year ago. Management plans further progress in the area by expanding non-fuel offerings and new services, such as car-sharing and fleet management, with a goal to deliver USD600 million in EBITDA by 2023. We see higher contribution from more stable, less cyclical activities as positive for MOL's credit profile. Moreover, we view management's focus on the consumer services division as appropriate in light of the global transition to lower carbon economies.

Derivation Summary

MOL's ratings are supported by vertical integration, some geographical diversification and low leverage, but are constrained by a mature upstream asset base and uncertainties over the company's 49.1% stake in Croatia's INA.

MOL's closest EMEA downstream peers are Compania Espanola de Petroleos, S.A.U (CEPSA, BBB-/Positive) and Polski Koncern Naftowy ORLEN S.A. (PKN ORLEN, BBB-/Stable). PKN ORLEN's 689mbbl/d downstream capacity exceeds MOL's (417mbbl/d), and the gap may widen to 500mbbl/d should PKN's planned acquisition of Grupa LOTOS S.A. go ahead. PKN's upstream segment remains small at 18mboepd in 9M19, potentially increasing to 37mboepd after the acquisition of Lotos, and is not a significant source of cash flow. CEPSA has a slightly larger refining capacity (457mbbl/d), and similar oil and gas ouput to MOL of 94kboepd in 1H19, but larger 2P reserves.

Key Assumptions

-Brent crude oil price of USD65/bbl in 2019, USD62.5/bbl in 2020, USD60/bbl in 2021, USD57.5/bbl in 2022, and USD57.5/bbl thereafter.

- Realised refining margin of USD6.7/bbl up to 2022.

- Stable upstream production compared with 2018.

- Stable refining throughput compared with 2018.

- Polyol project EBITDA contribution of USD85 million in 2022 and USD170 million in 2023.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- Improved operational profile in the upstream and/or petrochemical segment;

- Favourable resolution of the dispute with Croatian government regarding MOL's stake in INA; and

- FFO-adjusted net leverage sustainably below 1.5x

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO-adjusted net leverage above 2.5x on a through-the-cycle basis

- Upstream production falling significantly below 100mboe/d or 1P reserve life sustainably below five years

- Negative impact on MOL's financial profile from the dispute regarding the company's stake in INA

Liquidity and Debt Structure

Comfortable Liquidity: As of end-3Q19, cash and cash equivalents of USD652 million and USD3 billion of available liquidity under long-term revolvers covered short-term debt of USD1 billion. MOL's liquidity is further supported by our expectation of positive FCF generation and good capital market access over the next four years.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

MOL Hungarian Oil and Gas Company Plc; Long Term Issuer Default Rating; Affirmed; BBB-; RO:Sta
; Short Term Issuer Default Rating; Affirmed; F3

; Local Currency Long Term Issuer Default Rating; Affirmed; BBB-; RO:Sta
; Local Currency Short Term Issuer Default Rating; Affirmed; F3
----senior unsecured; Long Term Rating; Affirmed; BBB-
MOL Group Finance S.A.
----senior unsecured; Long Term Rating; Affirmed; BBB-

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Applicable Criteria

Corporate Rating Criteria (pub. 19 Feb 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019)
Government-Related Entities Rating Criteria (pub. 25 Oct 2018)
Parent and Subsidiary Rating Linkage (pub. 27 Sep 2019)
Sector Navigators (pub. 23 Mar 2018)
Short-Term Ratings Criteria (pub. 02 May 2019)

Additional Disclosures

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