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Research Update:

MOL Hungarian Oil and Gas PLC Upgraded To 'BBB-' On Stronger Performance Metrics; Outlook Stable

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MOL Hungarian Oil and Gas PLC Upgraded To 'BBB-' On Stronger Performance Metrics; Outlook Stable

Overview

- MOL Hungarian Oil and Gas PLC (MOL) has improved its credit metrics on the back of higher-than-expected free cash flow generation and continued strong performance of its downstream business.
- We now forecast that MOL's funds from operations to debt will remain close to 60% on average and that the company will continue to generate meaningfully positive free operating cash flow.
- We are therefore raising our ratings on MOL to 'BBB-' from 'BB+'.
- The stable outlook reflects our expectations that MOL's integrated business model will support further improvements in credit metrics, mitigating the impact of volatility in oil prices and refining margins.

Rating Action

On Nov. 15, 2017, S&P Global Ratings raised its long-term corporate credit rating on MOL Hungarian Oil and Gas PLC (MOL) to 'BBB-' from 'BB+'. The outlook is stable. We also raised our issue rating on MOL's senior unsecured bonds to 'BBB-' from 'BB+'.

Rationale

The upgrade is primarily based on the improvement in MOL's current and, in turn, forecast credit metrics, thanks to the company's strong performance and supportive industry conditions, notably high refining and petrochemical margins. We now forecast that MOL will maintain a ratio of funds from operations (FFO) to debt of at least 60% on average over the coming three years. This level of FFO to debt sufficiently buffers the company's performance metrics, in our opinion, against declines or volatility in refining margins, which are still at above-average levels in the cycle. In addition, the company now has sufficient leeway to carry out investments and acquisitions in upstream without putting a pronounced dent in its credit metrics. That said, we consider the company's weak ratio of reserves to production and the scale and location of producing assets as key credit constraints, but we believe the company may address these weaknesses over the next few years.

Importantly, MOL demonstrated the benefits of its integrated business model, having generated meaningfully positive free cash flow in 2016, when oil prices

remained weak and refining margins reduced by 30% from 2015. The company also delivered on its cost-optimization program, which we believe brings sustainable benefits for profitability, and increased the share of less volatile retail and petrochemicals segments.

As a result, we believe MOL's EBITDA should rise slightly even if refining margins remain flat. Although the company plans to invest meaningfully in petrochemicals, we project the company will post positive free cash flow generation of at least Hungarian forint (HUF) 100 billion (€320 million) in 2017 and 2018, therefore allowing for positive discretionary cash flow. This distinguishes MOL from the majority of its larger peers, which continue to struggle with covering dividends and capital expenditures (capex) with operating cash flows.

In our base-case scenario for MOL for 2018-2019, we assume:

- A Brent oil price of \$50 per barrel (/bbl) for the rest of 2017 and 2018, and \$55/bbl in 2019 and thereafter;
- Flat or slightly weaker refining and petrochemical margins in 2018 on average compared with 2017;
- Cash capex of HUF400 billion-HUF450 billion (\$1.5 billion-\$1.7 billion);
- Dividends of HUF60 billion-HUF80 billion; and
- No material acquisitions or share repurchases.

Based on these assumptions, we arrive at the following credit metrics for MOL:

- FFO to debt of close to 60% at the end of 2017, sustained at or above that level in the following years; and
- Positive discretionary cash flow (after working capital, capital investment, and dividends).

Our assessment of MOL's business risk profile as fair reflects the company's diversification across upstream activities, refining, petrochemicals and retail operations in Central and Eastern Europe. MOL's two main refineries are strategically located, highly complex, integrated plants. However, MOL is particularly exposed to Hungary and is materially smaller in terms of production than peers, such as Repsols that have a stronger business risk profile, in our view. We also take into account the ongoing dispute with the Croatian authorities over MOL's 49%-owned subsidiary INA, which we view as strategically important for the company.

We regard MOL as a government-related entity (GRE). The Hungarian government owns about 25% of MOL. We think MOL has an important role for and a limited link with the Hungarian government. This leads to our view of a moderate likelihood of timely and sufficient extraordinary support from the Hungarian government to MOL in the event of financial distress. Our assessment is neutral for our view of MOL's credit quality.

Liquidity

We assess MOL's liquidity as strong, based on our projection that liquidity sources will continue to exceed uses by more than 1.5x over the next 12 months and remain above 1x over the subsequent 12 months. We assume that MOL will be able to obtain funding from international or local banks, if needed, and believe it will proactively refinance its committed bank lines well before they mature, as it has done so far.

In our base case for MOL, we consider the following principal liquidity sources for the 12 months from Sept. 30, 2017:

- Cash and liquid investments of more than HUF180 billion;
- More than HUF800 billion available under long-term committed bank lines. All lines are subject to financial covenants of net debt to EBITDA of 3.5x, under which MOL has significant headroom since its debt to EBITDA is close to 1x; and
- FFO of about HUF550 billion-HUF600 billion.

For the same period, we estimate the following principal liquidity uses:

- Short-term debt maturities of about HUF357 billion;
- Capex of HUF400 billion-HUF450 billion; and
- Dividends of HUF60 billion-HUF80 billion.

Outlook

The stable outlook reflects our expectation that MOL will maintain robust credit metrics, supported by positive free operating cash flow generation, while continuing to invest in its chemicals business. We believe MOL's strong performance will mitigate the impact of volatility in oil prices and refining margins. We expect MOL's FFO to debt will stay close to 60% on average through the cycle, reflecting the benefits of the integrated business model. We also anticipate that the company will maintain a conservative financial policy, with dividend payments being covered by the free cash flow. We also note that an improvement in MOL's businesses, particularly if the company were to increase the life of its reserves, could translate into a more flexible leverage target for the current rating.

Downside scenario

We could lower the rating on MOL if its performance weakened due to a significant decline in refining and petrochemical margins, or if the company's debt were to increase materially from the current level due to acquisitions or financial policy decisions. Ratings downside could materialize if FFO to debt were to decline to persistently well below 60%, that is 50% or below. Also, should the resolution of the INA conflict be unfavorable for MOL, such as the asset expropriation, we could consider a negative rating action.

Upside scenario

We could raise the rating if we see a material improvement in MOL's business, notably on the upstream side, while the company maintains a strong balance sheet. This could occur if MOL acquires assets with meaningful upstream reserves that improve the balance between upstream and downstream, which has now shifted toward the latter. Positive resolution of the conflict with Croatian authorities related to INA could also help solidify its exploration and production business, although the terms of the potential agreement would be important.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/--

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Moderate

- Cash flow/Leverage: Moderate

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable ratings analysis: Neutral (no impact)

Likelihood of government support: Moderate (no impact)

Issue Ratings: Subordination Risk Analysis

Capital structure

- MOL's capital structure consists of senior unsecured debt issued at the parent level.

Analytical conclusions

- The issue rating on MOL's senior unsecured debt is 'BBB-', in line with the corporate credit rating, as no significant elements of subordination

risk are present in the capital structure.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Oil Refining And Marketing Industry, March 27, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Oil And Gas Exploration And Production Industry, Dec. 12, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology For Crude Oil And Natural Gas Price Assumptions For Corporates And Sovereigns, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded

	To	From
MOL Hungarian Oil and Gas PLC		
Corporate Credit Rating	BBB-/Stable/--	BB+/Positive/--
Senior Unsecured	BBB-	BB+
MOL GROUP FINANCE S.A.		
Senior Unsecured*	BBB-	BB+

*Guaranteed by MOL Hungarian Oil and Gas PLC.

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Certain terms used in this report, particularly certain adjectives used to

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