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Research Update:

MOL Hungarian Oil and Gas Downgraded To 'BB' On Ongoing Uncertainty Over INA Stake; Off Watch; Outlook Stable

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Overview

- The disagreement between the Croatian government and MOL Hungarian Oil and Gas PLC (MOL) regarding strategic issues at Croatia-based oil company INA is ongoing. We understand that negotiations continue regarding MOL's 49% stake in INA.
- We believe that continued uncertainty regarding the unresolved situation with the Croatian government is negative for MOL's creditworthiness.
- We are therefore lowering our long-term corporate credit ratings on MOL and related entities to 'BB' from 'BB+' and removing them from CreditWatch negative.
- The stable outlook on MOL reflects our view that the group's operating performance will continue to be supported by upstream prices, which will allow the group to maintain adjusted funds from operations to debt of more than 25%.

Rating Action

On Dec. 20, 2013, Standard & Poor's Ratings Services lowered to 'BB' from 'BB+' its long-term corporate credit ratings on MOL Hungarian Oil and Gas PLC (MOL) and related entities. At the same time, we removed the ratings from CreditWatch, where we placed them with negative implications on Oct. 11, 2013. The outlook is stable.

In addition, we lowered our issue ratings on MOL's senior unsecured debt instruments to 'BB' from 'BB+', and our issue ratings on the group's junior subordinated debt to 'B' from 'B+'. We also removed these ratings from CreditWatch, where we placed them with negative implications on Oct. 11, 2013.

Rationale

The downgrade reflects continued uncertainty relating to the ongoing disagreement between the Croatian government and MOL regarding strategic issues at Croatia-based oil company INA, in which MOL has a 49% stake and management control. We understand that negotiations continue regarding MOL's stake. The downgrade reflects our view that the lack of resolution of MOL's disagreement with the Croatian government is negative for MOL's creditworthiness.

INA constitutes roughly 36%-38% of MOL's combined reserves and production and also owns two refineries. We understand that the Hungarian government has asked MOL to consider selling its stake in INA, and that the Croatian authorities have issued an international arrest warrant for MOL's chairman and CEO, which remains outstanding.

Although our 'BB' corporate credit rating on MOL is now in line with our rating on Hungary, we believe that MOL could maintain sufficient liquidity to cover its commitments in the event of extreme stress on the sovereign. MOL's international operations provide a buffer for the group against potential weakness in its domestic operations. However, we would not rate MOL more than two notches above Hungary because we assess MOL's country risk sensitivity as "high," notably due to MOL's direct government ownership, our classification of MOL as a government-related entity, and its exposure to domestic economic cycles.

In our view, a sale of INA would increase MOL's reliance on Hungary, but it would not lead us to revise our assessment of MOL's "fair" business risk profile. In addition, MOL would receive a high cash value for INA, despite increased geographical concentration in Hungary. This is why we believe that in such a scenario, MOL would be able to maintain sufficient liquidity in a Hungarian sovereign stress situation.

We assess MOL's management and governance as "fair." We do not believe that MOL's governance will be materially affected by the Croatian government's issuance of an international arrest warrant for MOL's chairman and CEO, Mr. Zsolt Hernádi, for bribery. A criminal investigation conducted in Hungary concluded that Mr. Hernádi did not commit the crime that the Croatian prosecutor is investigating. We understand that Mr. Hernádi does not risk arrest as long as he does not travel outside Hungary and we assume that he will continue to execute his managerial duties from within the country. Additionally, we believe that MOL's management and governance structure and practices are sufficient to provide continuity of managerial oversight for the group. Nevertheless, we take into account weaknesses in MOL's ownership structure, evident from the Hungarian government's request to consider the divestiture of MOL's stake in INA.

Our assessment of MOL's business risk profile as "fair" reflects the group's diversification across upstream activities, refining, and retail operations in Central and Eastern Europe. MOL's two main refineries are strategically located, highly complex, integrated plants. However, MOL is heavily exposed to Hungary and its reserve profile is weakening.

We assess MOL's financial risk profile as "significant." This reflects the group's strong core credit ratios for the rating, which we consider positive, but weaker debt coverage ratios (specifically discretionary cash flow to debt), in line with most of MOL's peers.

Our base-case operating scenario for MOL assumes:

- A stabilization of declining exploration and production in 2014, on the

back of new projects coming on stream. However, we see risks associated with the depletion of mature fields.

- Oil prices as per Standard & Poor's oil price deck: Brent price of \$105 per barrel for 2013, \$100 for 2014, and \$95 for 2015 and onward;
- A weak operating environment in downstream operations with regard to crack spreads and the Brent-Ural price differential. We anticipate that this will be somewhat offset by benefits from MOL's efficiency improvement program.

Based on these assumptions, we arrive at the following credit measures, which we believe will remain strong for the rating:

- Adjusted funds from operations (FFO) to debt significantly above 25%;
- Adjusted debt to EBITDA of between 2.0x-2.5x; and
- Positive free operating cash flow (FOCF) of between Hungarian forint (HUF) 60 billion and HUF95 billion in 2014.

Liquidity

We assess MOL's liquidity as "adequate" under our criteria. We anticipate that liquidity sources will continue to exceed liquidity uses by comfortably more than 1.2x over the next 12 months. We assess MOL's liquidity as "adequate" rather than "strong" to reflect our view that the Hungarian sovereign situation could tighten liquidity in the domestic market. 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. In this respect, we note that the group signed new facilities in 2013.

MOL held cash of about HUF225 billion (about €753 million), as of Sept. 30, 2013, as well as short-term investments of HUF218 billion. Of this amount, we understand 86% is held in other currencies, mainly euros and U.S. dollars.

We estimate principal liquidity sources as follows:

- Cash of about HUF225 billion on Sept. 30, 2013.
- About HUF522 billion (about €1.75 billion) available under long-term committed bank lines. All lines are subject to financial covenants.
- FFO of about HUF430 billion-HUF480 billion in each full year 2013 and 2014.
- Asset disposal proceeds for the Hungarian government's purchase of a stake in MOL's natural gas safety storage facility MMBF.

Principal liquidity uses, according to our assumptions, will be:

- Capital expenditure (capex) of HUF340 billion-HUF380 billion, including maintenance capex of about HUF135 billion.
- MOL's recently announced acquisition of Wintershall's U.K. North Sea assets of HUF84 billion (a transaction value of about \$375 million).
- Dividends of HUF45 billion-HUF50 billion.
- Short-term debt of about HUF330 billion.
- Moderate working capital outflows.

MOL has ample covenant leeway in our opinion. Key tests are a group-reported net financial debt-to-EBITDA limit of 3x (the tightest test level) and a minimum tangible net worth of HUF600 billion. In the case of acquisitions, leverage can increase to 3.5x for up to one year. Covenant headroom was significant on Sept. 30, 2013.

Outlook

The stable outlook on MOL reflects our view that over our rating horizon of the next 18 months, the group's operating performance will continue to be supported by upstream prices, which will allow the group to maintain adjusted FFO to debt of more than 25%. The outlook further reflects our forecast that the group will maintain an "adequate" liquidity position, and prudent financial policies, including cash flow-funded capex.

Downside scenario

Rating pressure could arise if MOL were unable to maintain "adequate" liquidity or if we considered MOL unlikely to be able to repay its financial obligations under our sovereign default scenario stress test. In addition, a downgrade could result if discretionary cash flow (FOCF minus dividends) turned sharply negative, and we forecast FFO to debt of less than 25% for a sustained period.

We would consider a downgrade if MOL's access to banks or capital markets were to decline. Major acquisitions above our base-case forecasts or significant dividends would also put pressure on the ratings.

If we downgraded Hungary by one or two notches, this may not necessarily directly affect our ratings on MOL, because our criteria allow for a rating differential of up to two notches between MOL and the sovereign. In the event of a downgrade of Hungary, we would look at the effect of domestic economic developments on MOL's profits and liquidity.

A downgrade of Hungary by more than two notches, or a downgrade of our transfer and convertibility assessment on Hungary to below 'BB' from 'BBB-' currently, would likely result in a downgrade of MOL.

Upside scenario

We believe there are certain scenarios that could result in us upgrading MOL. For example, an upgrade could occur if MOL were to sell INA and invest the cash from the disposal in new producing assets--potentially in areas with lower country risk than Hungary. Likewise, if MOL retains its stake in INA but continues to diversify its assets to improve its competitive position, an upgrade could be warranted in the medium term.

Ratings Score Snapshot

Corporate credit rating: BB/Stable/--

Business risk: Fair

- Country risk: Moderate
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb

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)
- Sovereign rating: Hungary BB/Negative/B
- Likelihood of government support: Moderate (no impact)

We acknowledge the contribution of Edouard Okasmaa in the preparation of this report.

Related Criteria And Research

- Corporate Methodology, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology And Assumptions: Liquidity Descriptors for Global Corporate Issuers, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology For Crude Oil And Natural Gas Price Assumptions For Corporates And Sovereigns, Nov. 19, 2013

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
MOL Hungarian Oil and Gas PLC Magnolia Finance Ltd. Corporate Credit Rating	BB/Stable/--	BB+/Watch Neg/--

MOL Hungarian Oil and Gas PLC

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Senior Unsecured	BB	BB+/Watch Neg
MOL GROUP FINANCE S.A. Senior Unsecured*	BB	BB+/Watch Neg
Magnolia Finance Ltd. Junior Subordinated	B	B+/Watch Neg

*Guaranteed by MOL Hungarian Oil and Gas PLC.

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