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Research Update:

MOL Hungarian Oil and Gas PLC On Watch Negative Pending Negotiations On Cooperation With The Croatian State

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Research Update:

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Overview

- The disagreement between the Croatian government and MOL Hungarian Oil and Gas PLC regarding strategic issues at Croatia-based oil company INA has intensified and we understand negotiation is ongoing regarding MOL's 49% stake in INA.
- If MOL reduced or fully disposed of its stake in INA, or if the operating environment in Croatia changed, MOL's exposure to the weak Hungarian economy would likely significantly increase.
- We are placing our 'BB+' long-term rating on MOL on CreditWatch with negative implications.
- If we viewed that MOL's diversification outside Hungary had reduced, or that the benefits of this diversification had reduced, we could lower the rating on MOL by one notch to equalize it with our 'BB' long-term rating on Hungary.

Rating Action

On Oct. 11, 2013, Standard & Poor's Ratings Services placed its 'BB+' long-term corporate credit rating on MOL Hungarian Oil and Gas PLC and all related issue ratings on CreditWatch with negative implications.

Rationale

We understand that MOL is in negotiation with the Croatian government regarding cooperation on strategic issues relating to the Croatian oil company, INA, in which MOL has a 49% stake. The CreditWatch placement reflects the impact on MOL of a potential partial or full disposal of INA. It also reflects the impact of a possible worsening operating environment in Croatia for MOL.

We note that the Hungarian government has asked MOL to consider divesting its stake and also that the Croatian authorities have issued an international arrest warrant for MOL's chairman CEO.

Were MOL to sell its stake, its exposure to the weak Hungarian economy would significantly increase, in our opinion. Under these circumstances, we would probably not continue to rate MOL one notch above our 'BB' sovereign long-term rating on Hungary.

Equally, we might reassess the one-notch rating difference between MOL and Hungary if the operating environment in Croatia worsened for MOL, therefore reducing the benefits of geographic diversification. This might include increased taxes in various forms, changes to operating conditions because of the introduction of new requirements or permits, or regulatory changes that constrain MOL's cash-generating capacity in Croatia.

MOL currently has a 49% stake in INA and management control; it also consolidates INA in its accounts. A reduction of MOL's stake in INA would represent a significant reduction of the group's geographic diversification and would be contrary to its previous expansion strategy. INA constitutes roughly 36%-38% of the group's combined reserves and production and also controls two of the group's refineries.

It's unclear at this stage whether MOL would receive appropriate compensation for this deconsolidation.

The existing one-notch rating differential between MOL and the sovereign reflects MOL's diversification into the profitable exploration and production segment (70% of EBITDA in 2012) and its healthy liquidity. In addition, three of MOL's four refineries are located outside Hungary, providing important diversification in the economies of Slovakia and Croatia. We believe MOL derives more than 50% of its EBITDA outside Hungary, and about 70% of the group's assets are located abroad. A sale of INA would materially weaken this diversification in our view, and would reduce MOL's potential to survive a Hungarian sovereign stress situation.

We assess MOL's management and governance as "fair." We don't expect MOL's governance to be materially affected by the Croatian government's issuance of an international arrest warrant for MOL's chairman 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 MOL's management and governance structure and practices are sufficient to provide managerial and oversight continuity for the company. Nevertheless, we take into account weaknesses in the company's ownership structure, as evidenced by the Hungarian government's divestiture request regarding INA.

MOL's credit ratios are strong for the rating, which we consider positive. We forecast the ratio of funds from operations (FFO) to debt to remain in the 30%-35% range in 2013, and annual free operating cash flow to be $400 million-$600 million, under our long-term oil price assumption of $80 per barrel of oil equivalent.

Liquidity

We assess MOL's liquidity as adequate. Liquidity sources cover needs by more than 1.2x over the next 12 to 18 months, in our view, even under the stressed scenario. However, we still assess its liquidity as adequate, rather than strong to reflect our view that the Hungarian sovereign situation could result in tighter liquidity in the domestic market. We assume MOL will be able to obtain funding from international or local banks, if needed, and expect it to proactively refinance its committed bank lines well ahead of their maturities. In this respect, we note that the company has signed new facilities during 2013.

MOL held cash of about Hungarian forint (HUF) 318 billion (€1 billion), at year-end 2012. Of this amount, we understand about 70% is held in other currencies, mainly euros and U.S. dollars.

We estimate principal liquidity sources as follows:

- Cash of about HUF391 billion on June 30, 2013, of which we view HUF40 billion as tied to operations and not immediately available for debt reduction.
- About €1.4 billion available under long-term committed bank lines. The key facilities include a €0.6 billion line maturing in June 2017 (with a one-year extension possible), and a €500 million line maturing in September 2014. All lines are subject to financial covenants.
- FFO of about HUF430 billion-HUF480 billion during 2013.

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

- Capital expenditure of HUF300 billion-HUF337 billion.
- Dividends of HUF45 billion-HUF50 billion.
- Short-term debt of HUF467 billion.
- Moderate working capital outflows.

MOL has ample covenant leeway in our opinion. Key tests are a company-reported net financial debt-to-EBITDA limit of 3x and minimum tangible net worth of HUF600 billion. In case of acquisitions, leverage could increase to 3.5x for up to one year. Covenant headroom was high on June 30, 2013.

CreditWatch

We aim to resolve the CreditWatch placement after seeking more information regarding the potential outcome of the ownership situation at INA. If we came to understand that there was a high likelihood that MOL would reduce its ownership, we could equalize our rating on MOL with that on Hungary, implying a one-notch downgrade for MOL. This would be based on a reduction of MOL's geographic diversification, and regardless of whether MOL received appropriate compensation for its 49% stake.

Even if MOL were to keep its existing stake in INA, we might still equalize the rating with that on Hungary if we assessed that the operating environment in Croatia had significantly worsened, reducing the benefits of diversification. This could occur if a tightening fiscal environment, deteriorating operating conditions, or regulatory changes constrained cash-generating capacity in Croatia, or if MOL's access to banks or capital markets were to decline.

We could affirm the ratings if MOL was able to demonstrate a satisfactory plan to maintain the group's diversification, assuming credit ratios remain in line with the rating--for example FFO to debt comfortably above 25% and at least breakeven discretionary cash flow.

Related Criteria And Research

- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Key Credit Factors: Global Criteria For Rating The Oil And Gas Exploration And Production Industry, Jan. 20, 2012
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Corporate Criteria--Parent/Subsidiary Links, Oct. 28, 2004

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
MOL Hungarian Oil and Gas PLC		
Magnolia Finance Ltd.		
Corporate Credit Rating	BB+/Watch Neg/--	BB+/Negative/--
MOL Hungarian Oil and Gas PLC		
Senior Unsecured	BB+/Watch Neg	BB+
MOL GROUP FINANCE S.A.		
Senior Unsecured*	BB+/Watch Neg	BB+
Magnolia Finance Ltd.		
Junior Subordinated	B+/Watch Neg	B+

*Guaranteed by MOL Hungarian Oil and Gas PLC.

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