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Research Update:

MOL Hungarian Oil and Gas Outlook Revised To Negative After Similar Rating Action On The Sovereign

Primary Credit Analyst:
Per Karlsson, Stockholm (46) 8-440-5927; per_karlsson@standardandpoors.com

Secondary Contact:
Simon Redmond, London (44) 20-7176-3683; simon_redmond@standardandpoors.com

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Overview

- On March 21, we revised our outlook on our 'BB' rating on Hungary to negative from stable.
- This has led to increasing pressure on our rating on MOL Hungarian Oil and Gas because a significant share of MOL's income streams and assets stem from Hungary.
- We are therefore revising our outlook on MOL to negative from stable and affirming our 'BB+' ratings.
- The negative outlook on MOL reflects that a further downgrade of Hungary would likely result in a downgrade of MOL, given our view of a maximum one-notch rating differential between MOL and the sovereign and the risks to MOL's cash-generating capacity from weakening operating conditions.

Rating Action

On March 27, 2013, Standard & Poor's Ratings Services revised its outlook on MOL Hungarian Oil and Gas PLC to negative from stable. At the same time, the 'BB+' long-term corporate credit ratings were affirmed.

Rationale

The rating actions follow the revision of our outlook on Hungary (see "Outlook On Hungary Revised To Negative; 'BB'/B' Ratings Affirmed," published March 21, 2013, on RatingsDirect on the Global Credit Portal).

We revised our outlook on MOL to reflect our view of increased risks that a tightening fiscal environment, deteriorating operating conditions, and other regulatory changes could constrain MOL's cash-generating capacity. A downgrade of Hungary would therefore likely result in a downgrade of MOL.

Nevertheless, we continue to rate MOL one notch higher than Hungary. This 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, four of MOL's five refineries are located outside Hungary, providing important diversification into 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. This geographic diversity should enable MOL to keep generating healthy results. It also allows for cash flow from outside Hungary that can go toward repaying MOL's foreign currency debt, which is another supporting factor.

Worsening operating conditions in Hungary could hurt MOL's profit and cash flow generation ability, but we believe even in a stressed scenario MOL should still be able to meet its financial obligations. Our stress tests assume, among other things, a collapse in demand that affects demand for refined products and gas, and further adverse tax measures.

Another mitigating factor is Hungary's membership of the EU. EU-wide regulations would make it difficult for Hungary to introduce export or import barriers that would hamper MOL's operations. This differentiates MOL from peers operating in non-EU countries.

In our view, MOL's overall risk from operating in Hungary has increased, given the lower-rated sovereign. We expect the tough operating conditions, uncertainty about the government's future actions, and weakening demand for refined oil products to continue.

The Hungarian government owns 24% of MOL, which in our view is run independently from the state. We assess MOL's link with the Hungarian government as limited and therefore have not included a rating uplift. MOL's oil and gas operations support our view of its important role for the Hungarian government. We factor in, among other things, that the government spent nearly €1.9 billion to buy 21.2% of MOL in 2011 and is unlikely to dispose of this stake; it recently even raised it to 24.6%.

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 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 sovereign concerns 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 recently signed new facilities.

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.

Principal liquidity sources:

- Cash of about HUF318 billion as of Dec. 31, 2012, of which we view HUF40 billion as tied to operations and not immediately available for debt reduction.
- About €1.5 billion available under long-term committed bank lines. The key facilities include a €0.6 billion line maturing in June 2017 (with the possibility of extending for one year), a €500 million line maturing in September 2014, and a recently granted $450 million facility due 2016.
- We note, however, that the €0.6 billion facility is contracted to increase to €1 billion when the €825 million facility falls due in July 2013. All lines are subject to financial covenants.

Principal liquidity uses:

- Our assumption of capital expenditure of HUF300 billion-HUF337 billion. We note that MOL has spent less than its guidance in recent years.
- Dividends of HUF45 billion-HUF50 billion.
- Short-term debt of HUF406 billion.
- Some 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. The leverage limit for the €1 billion line is 3.5x. Covenant headroom was very high on Dec. 31, 2012, since leverage was below 1.5x and the tangible net worth almost HUF2 billion. Under our stress scenario, covenant headroom would tighten, but we anticipate that management would tackle such a risk proactively should it arise.

Outlook

The negative outlook on MOL reflects that a further downgrade of Hungary would likely result in a downgrade of MOL, given our view of a maximum one-notch rating differential between MOL and the sovereign. It also reflects the risks that a tightening fiscal environment, deteriorating operating conditions, and other regulatory changes could constrain MOL's cash-generating capacity.

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

We would also consider a rating action if MOL's access to banks or capital markets were to decline. Major acquisitions or significant dividends would also put pressure on the ratings. We view these as unlikely, however, given MOL's financial policies and the uncertain macroeconomic environment.

The main condition for a revision of our outlook on MOL to stable would be a similar outlook revision for the sovereign rating, supported by FFO to debt comfortably above 25% and at least breakeven discretionary cash flow. An upgrade is currently unlikely.

Related Criteria And Research

- 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
- Key Credit Factors: Criteria For Rating The Global Oil Refining Industry, Nov. 28, 2011
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

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

Ratings Affirmed

MOL Hungarian Oil and Gas PLC	
Senior Unsecured	BB+
MOL GROUP FINANCE S.A.	
Senior Unsecured*	BB+
Magnolia Finance Ltd.	
Junior Subordinated	B+

*Guaranteed by MOL Hungarian Oil and Gas PLC.

Additional Contact:
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers:

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