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MOL Hungarian Oil and Gas PLC

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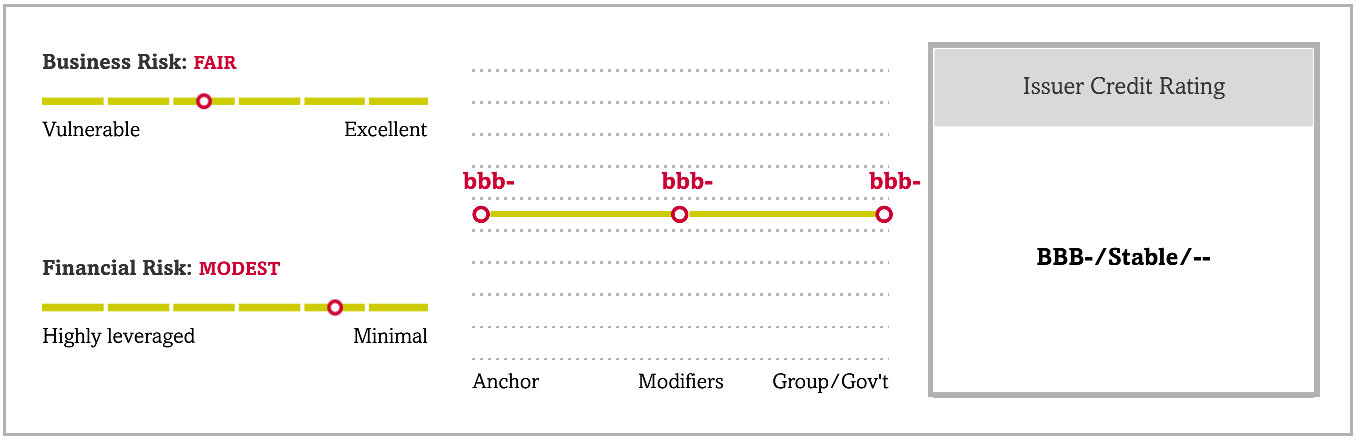
MOL Hungarian Oil and Gas PLC



Rationale

Business Risk: Fair	Financial Risk: Modest
• An integrated business model, supporting lower volatility in cash flows compared with many peers. • Declining reserve life in upstream, which represents a major challenge for the company due to limited opportunities in the core region of Eastern Europe. • Moderately high country risk exposure, especially in terms of exploration and production (E&P), mitigated by investments such as in the U.K. • Solid position in the downstream segment of MOL's core geographical markets, with a combination of high-complexity assets, growing chemicals operations, and a large fuel retail network. • Unsettled dispute and litigation with the Croatian government regarding MOL's 49% stake in Croatia-based oil company INA.	• Low leverage, with funds from operations (FFO) to debt comfortably above 60%. • Meaningful flexibility around capital investments, as about 20%-30% of capital expenditure (capex) is growth-driven. • Higher flexibility in dividend distribution than larger integrated players.

Outlook: Stable

The stable outlook on MOL Hungarian Oil and Gas PLC reflects our expectation that the company will continue with its investments in chemicals, while its credit metrics will remain robust, supported by positive free operating cash flow. We expect MOL's FFO to debt to stay close to 60% on average through the cycle, reflecting the benefits of the integrated business model. We also expect the company to maintain a conservative financial policy, including no major increase in dividend distribution. If we see an improvement in MOL's businesses, notably if the company were to improve its weak oil reserve life, or achieve higher integration into chemicals, higher leverage could be accommodated at the 'BBB-' rating level.

Downside scenario

We could lower the rating on MOL if debt were to increase more materially than we currently expect due to acquisitions or higher investments in chemicals. Ratings downside could materialize if FFO to debt were to decline to persistently to a level of 50% or below. Also, should the resolution to the INA conflict be unfavorable to MOL, such as the asset expropriation, this could also lead to 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 maintaining a strong balance sheet. This could be achieved if MOL acquires assets with meaningful oil and gas reserves that would improve the balance between upstream and downstream, which is now significantly weighted toward downstream. Positive resolution of the conflict with Croatian authorities related to INA could also support achievement of this goal, although the terms of the potential agreement would be important.

Our Base-Case Scenario

Our base-case scenario for MOL reflects our expectation that the company will continue generating positive free cash flow despite heavy investments in chemicals, supporting maintenance of an FFO-to-debt ratio comfortably above 60%.

From the operating standpoint, we assume MOL will benefit from the currently inflated oil prices of above $70 and still-supportive refining margins, which should allow the company to build some headroom for increased capex and possible acquisitions.

Assumptions

- Brent oil price of $65 per barrel for the rest of 2018, $60 in 2019, and $55 in 2020 and thereafter.
- Flat or slightly weaker refining and petrochemical margins in 2018 on average compared with 2017.
- Stable oil and gas production of about 110,000 barrels of oil equivalent (boe) per day in 2018 and 2019.
- Cash capex in 2018-2019 of Hungarian forint (HUF) 450 bilion-HUF600 billion due to investments in chemicals, which is almost 2x 2016-2017 capex, which was below HUF300 billion.
- Dividend payments moderately increasing compared with historical levels in line with growth in EBITDA, to about HUF60 billion-HUF75 billion.
- No material acquisitions or share repurchases.

Key Metrics

	2017A	2018P	2019E
Unadjusted FFO (bil. HUF)	624.9	600-650	580-600
Unadjusted capex (bil. HUF)	285.5	450-500	550-600
Unadjusted FOCF (bil. HUF)	255.2	110-150	110-150
Dividends (bil. HUF)	56.4	60-75	60-75
FFO/debt (%)	65.2	60-70	55-65
Debt/EBITDA (x)	1.3	1.2-1.3	1.3-1.5

A--Actual. P--Projected. E—Estimate. FOCF--Free operating cash flow. We have made our normal adjustments to all figures.

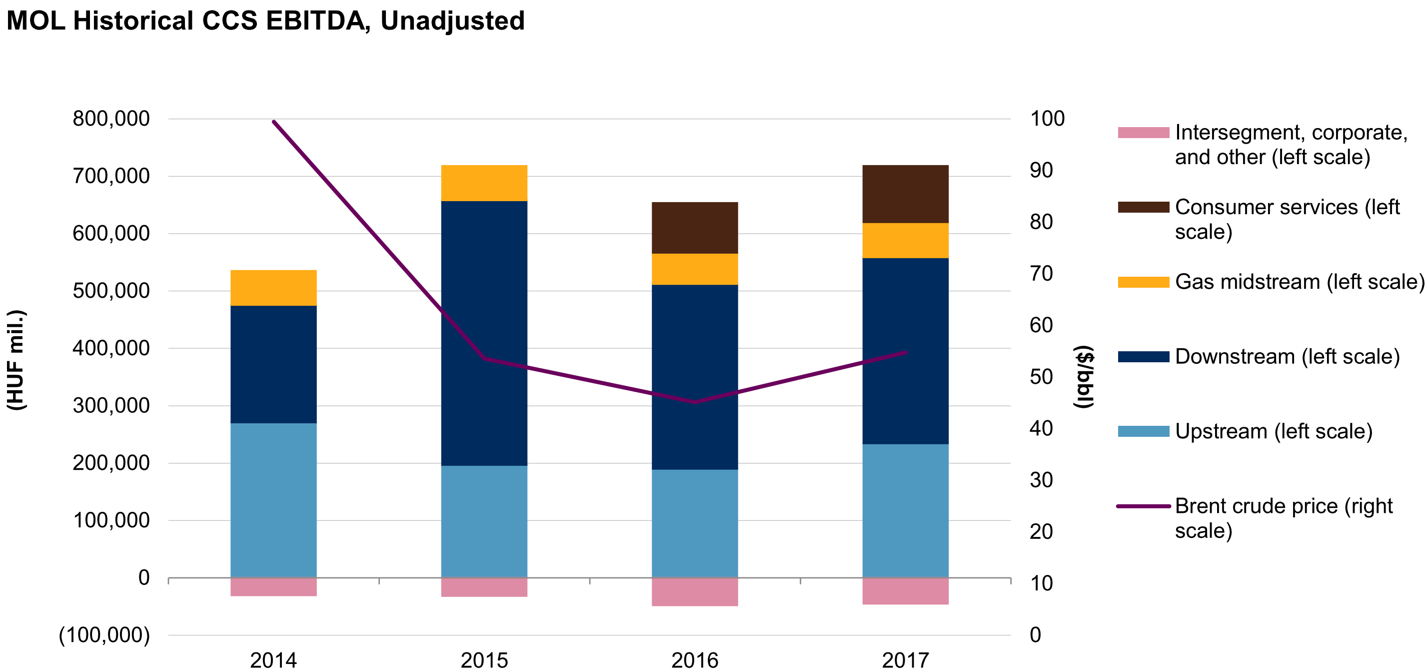
Company Description

MOL is a midsize integrated oil and gas company operating in Central and Eastern Europe (CEE), headquartered in Budapest, Hungary. The company has annual oil and gas production of 105,000-110,000 barrels of oil equivalent per day and has refining capacity of 417,000 barrels per day. The majority of oil and gas production still comes from Croatia and Hungary, complemented by the Middle East and Africa and the North Sea. Three out of four MOL refineries are regionally very competitive with high complexity characteristics. The company also has a large fuel retail network all over CEE and is also investing heavily in petrochemicals. The company's market capitalization is currently close to $8 billion.

Business Risk: Fair

Our assessment of MOL's business recognizes the strengths of its integrated business model and lower cash flow volatility compared with many of its larger integrated peers. This reflects the higher proportion and complexity of the downstream business and sizable more stable retail operation, which should account for about 15% of consolidated EBITDA in 2018.

Chart 1



CCS--Current cost of supplies. e--Estimate. Source: S&P Global Ratings.

The key weaknesses of MOL include the relatively small scale of its upstream business, especially when looking at reserves. To support production at the current level, MOL will need to add more reserves, likely through acquisitions. This could support improvement of our assessment over time.

MOL's downstream operations support the business assessment. Three of its four refineries are among the most complex in the region. In addition, several years ago MOL started investing in petrochemicals, where margins are somewhat less volatile than in traditional refining. The company's $1 billion investment in polyol production should add even more cash flow stability and ultimately support the business risk profile.

MOL's country risk exposure is relatively high, with core operations in the CEE region and presence in riskier emerging markets, such as Pakistan or the Kurdistan region of Iraq. This is partly mitigated by operations in the North Sea for example.

We continue to closely monitor the ongoing dispute 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. INA constitutes approximately 36%-38% of MOL's combined reserves and production and also owns two of the four refineries. We understand that the ongoing arbitration is so far in MOL's favor, but, given the uncertainty, the company cannot fully manage the asset--for example, investing in the upgrade of Rijeka refinery. We also note the Sisak refinery could be a candidate for closure. In our analysis, we assume a status quo when it comes to INA. However, any negative development would likely pressure the rating.

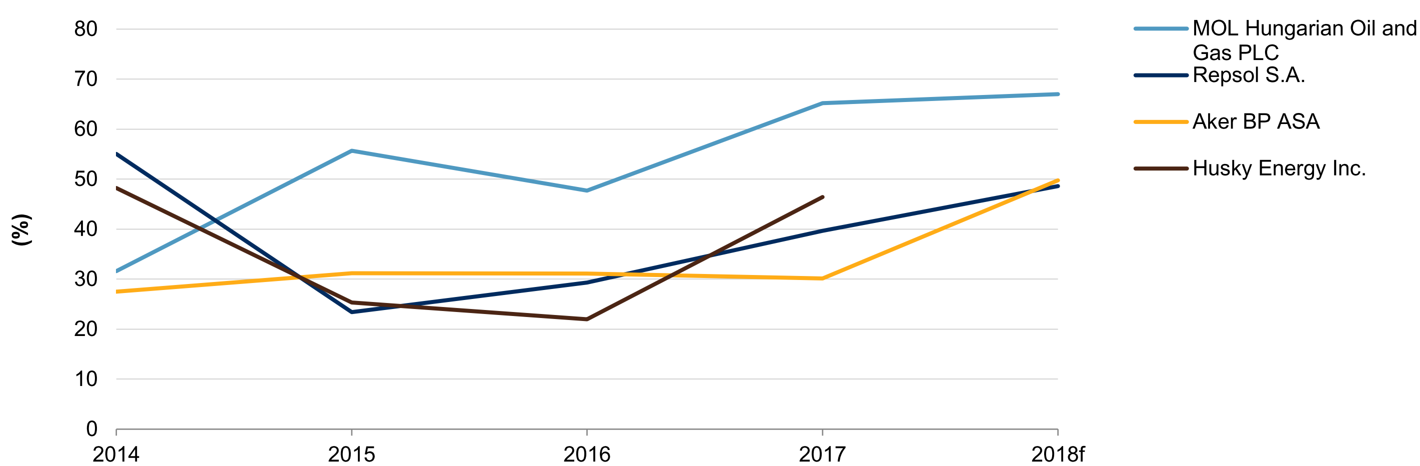
Peer comparison

We view MOL's business risk profile as weaker than that of larger integrated peers, such as Repsol or Husky, mostly due to smaller E&P reserves and higher country risk exposure. MOL also has lower production and reserves than pure E&P players such as Aker BP.

From a financial standpoint, MOL has the most conservative ratios among the peers, supported by solid cash flow generation and relatively modest dividends.

Chart 2

Peers' FFO-To-Debt Profiles



FFO--Funds from operations. F--Forecast.

Table 1

MOL Hungarian Oil and Gas PLC -- Peer Comparison

Industry Sector: Integrated Oil & Gas

	MOL Hungarian Oil and Gas PLC	Repsol S.A.	Aker BP ASA	Husky Energy Inc.
Rating as of Sept. 7, 2018	BBB-/Stable/--	BBB/Stable/A-2	BB+/Positive/--	BBB+/Stable/--
(Mil. $)	--Fiscal year ended Dec. 31, 2017--			
Revenues	4,153,181.0	13,202,300.4	663,698.4	3,830,825.5
EBITDA	709,444.0	1,979,186.9	571,676.6	821,183.2
Funds from operations (FFO)	618,341.8	1,601,008.9	345,262.3	685,527.2
Net income from cont. oper.	306,952.0	657,912.7	70,978.7	162,031.4
Cash flow from operations	524,007.8	1,405,922.7	569,795.7	789,219.1
Capital expenditures	285,099.0	723,983.1	258,100.1	457,645.8
Free operating cash flow	238,908.8	681,939.6	311,695.7	331,573.2
Discretionary cash flow	182,461.8	578,956.6	247,119.6	328,068.7
Cash and short-term investments	228,084.0	1,493,253.9	59,798.0	518,046.8

Table 1

MOL Hungarian Oil and Gas PLC -- Peer Comparison (cont.)

Industry Sector: Integrated Oil & Gas

	MOL Hungarian Oil and Gas PLC	Repsol S.A.	Aker BP ASA	Husky Energy Inc.
Debt	947,742.4	4,035,334.0	1,136,274.3	1,474,802.2
Equity	2,055,771.0	9,341,522.4	771,967.4	3,613,753.0
Adjusted ratios				
EBITDA margin (%)	17.1	15.0	85.7	21.4
Return on capital (%)	12.6	8.9	14.3	3.1
EBITDA interest coverage (x)	11.0	7.8	6.1	7.1
FFO cash int. cov. (X)	13.4	9.1	7.2	13.7
Debt/EBITDA (x)	1.3	2.0	2.0	1.8
FFO/debt (%)	65.2	39.7	30.2	46.4
Cash flow from operations/debt (%)	55.3	34.8	49.9	53.4
Free operating cash flow/debt (%)	25.2	16.9	27.2	22.4
Discretionary cash flow/debt (%)	19.3	14.4	21.5	22.2

Financial Risk: Modest

Our assessment of MOL's financial risk profile recognizes the company's modest leverage and strong cash flow generation. We expect that FFO to debt will remain at above 60% on average through the cycle.

We anticipate higher capex in 2018-2020, as the company undertakes a large investment in chemicals. Given the large scale and flexibility over this investment, we could tolerate slightly weaker credit metrics, assuming they improve to the rating commensurate level within one year.

The company has historically been very conservative with regard to merger and acquisition (M&A) opportunities, walking away from overpriced transactions. However, the company will now likely have to look for external growth opportunities to replenish its declining reserve base. From this perspective, it is important that the company builds sufficient headroom in its credits metrics over 2018, enjoying favorable market conditions, to be able to absorb any potential M&A. We also note that if such acquisitions support growth in reserves and production, a more relaxed rating threshold could become commensurate with the current rating.

The company's dividend distribution has been historically modest and more flexible compared with fully privately-owned peers. We expect the company to adjust its dividends in case leverage increases toward the higher end of its financial policy of net debt to EBITDA of 2x due to weaker market conditions or higher investments and acquisitions.

Financial summary

Table 2

MOL Hungarian-- Financial Summary

Industry Sector: Integrated Oil & Gas

	--Fiscal year ended Dec. 31--				
(Mil. HUF)	**2017**	**2016**	**2015**	**2014**	**2013**
Revenues	4,153,181.0	3,574,934.0	4,186,127.0	4,879,132.0	5,420,685.0
EBITDA	709,444.0	611,200.5	738,813.0	523,848.0	502,051.0
Funds from operations (FFO)	618,341.8	524,825.5	641,124.4	417,938.9	399,483.2
Net income from continuing operations	306,952.0	263,497.0	(256,554)	4,078.0	21,442.0
Cash flow from operations	524,007.8	466,550.5	569,008.4	380,261.9	586,231.2
Capital expenditures	285,099.0	289,438.0	378,426.0	478,334.0	252,389.0
Free operating cash flow	238,908.8	177,112.5	190,582.4	(98,072.1)	333,842.2
Discretionary cash flow	182,461.8	126,760.5	139,088.4	(152,413.1)	283,122.2
Cash and short-term investments	228,084.0	270,838.0	132,214.0	203,743.0	564,170.0
Debt	947,742.4	1,099,942.8	1,150,394.0	1,323,125.4	964,169.0
Equity	2,055,771.0	1,801,626.0	1,699,954.0	2,074,574.0	2,040,092.0
Adjusted ratios					
EBITDA margin (%)	17.1	17.1	17.6	10.7	9.3
Return on capital (%)	12.6	10.5	(3.8)	5.0	0.9
EBITDA interest coverage (x)	11.0	13.3	10.2	6.9	6.3
FFO cash int. cov. (x)	13.4	9.3	18.8	6.5	7.2
Debt/EBITDA (x)	1.3	1.8	1.6	2.5	1.9
FFO/debt (%)	65.2	47.7	55.7	31.6	41.4
Cash flow from operations/debt (%)	55.3	42.4	49.5	28.7	60.8
Free operating cash flow/debt (%)	25.2	16.1	16.6	(7.4)	34.6
Discretionary cash flow/debt (%)	19.3	11.5	12.1	(11.5)	29.4

Liquidity: Strong

We assess MOL's liquidity as strong, reflecting the company's solid cash cushion and our anticipation of positive free operating cash flow. We anticipate that liquidity sources will exceed uses by more than 2x over the next 12 months and remain above 1x over the subsequent 12-month period. We also favorably assess MOL's solid banking relationship given the company's status as Hungary's largest corporate entity, and a track record of MOL proactively refinancing its committed bank lines well before they mature.

Our base-case liquidity assessment includes the following liquidity uses and sources as of June 30, 2018:

Principal Liquidity Sources	Principal Liquidity Uses
• Cash and liquid investments of about HUF 290 billion. • More than HUF1,000 billion available under long-term committed bank lines. Most lines are subject to financial covenants of net debt to EBITDA of 3.5x, under which MOL has strong headroom as its debt to EBITDA is close to 1x. • FFO of about HUF580 billion-HUF600 billion.	• Short-term debt maturities of about HUF 131 billion. • Capex of HUF450 billion-HUF500 billion. • Dividends of HUF60 billion-HUF75 billion.

Debt maturities

Table 3

MOL Hungarian -- Debt Maturities	
As of Dec. 31, 2017	
(Bil. HUF)	
2018	174
2019	151
2020	20
2021	20
2022	32
Beyond next five years	266

Government Influence

MOL is about 25% owned by the Hungarian state. Under our criteria, we regard MOL as a government-related entity, but this does not affect the rating. We assess MOL's role for the Hungarian government as important and its link as limited, which leads to our assessment of a moderate likelihood of extraordinary government support.

Rating Above The Sovereign

Our rating on MOL is not higher than our sovereign rating on Hungary. However, we believe that theoretically MOL could successfully pass the test for rating above the sovereign. Going forward, potentially we don't see the sovereign rating as a constraint for MOL's rating.

Ratings Score Snapshot

Issuer Credit Rating

BBB-/Stable/--

Business risk: Fair

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

Financial risk: Modest

- **Cash flow/Leverage:** Modest

Anchor: bbb-

Modifiers

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

Stand-alone credit profile : bbb-

- **Related government rating:** BBB-
- **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 issuer credit rating, as no significant elements of subordination risk are present in the capital structure.

Reconciliation

We adjust the debt for operating leases (HUF25 billion), asset-retirement obligations (HUF247 billion), and a company specific line--the transfer of A shares with put and call options (HUF201 billion). The total debt adjustment is HUF284 billion, which includes surplus cash of HUF202 billion.

Table 4

Reconciliation Of MOL Hungarian Oil and Gas PLC Reported Amounts With S&P Global Ratings Adjusted Amounts (Mil. HUF)

	--Fiscal year ended Dec. 31, 2017--								
MOL Hungarian Oil and Gas PLC reported amounts									
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**	**Capital expenditures**
Reported	663,262	1,740,954	4,155,863	672,583	354,367	24,629	672,583	559,696	285,532
S&P Global Ratings adjustments									
Interest expense (reported)	--	--	--	--	--	--	(24,629)	--	--
Interest income (reported)	--	--	--	--	--	--	10,756	--	--
Current tax expense (reported)	--	--	--	--	--	--	(41,555)	--	--
Operating leases	24,874	--	--	8,611	3,408	3,408	5,203	5,203	--
Postretirement benefit obligations/deferred compensation	16,652	--	--	506	506	432	416	(1,286)	--
Surplus cash	(205,276)	--	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	--	433	(433)	(433)	(433)
Share-based compensation expense	--	--	--	6,858	--	--	6,858	--	--
Dividends received from equity investments	--	--	--	25,784	--	--	25,784	--	--
Asset retirement obligations	246,973	--	--	--	--	35,444	(27,059)	(26,944)	--
Exploration costs	--	--	--	4,684	--	--	--	--	--
Non-operating income (expense)	--	--	--	--	28,700	--	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	--	(12,228)	--
Non-controlling Interest/Minority interest	--	314,817	--	--	--	--	--	--	--
Transferred A shares with put and call options	201,257	--	--	--	--	--	--	--	--
Revenues - Profit on disposals	--	--	(2,682)	(2,682)	(2,682)	--	(2,682)	--	--
COGS- LIFO Liquidation gains	--	--	--	(6,900)	(6,900)	--	(6,900)	--	--
Total adjustments	284,480	314,817	(2,682)	36,861	23,032	39,717	(54,241)	(35,688)	(433)

Table 4

Reconciliation Of MOL Hungarian Oil and Gas PLC Reported Amounts With S&P Global Ratings Adjusted Amounts (Mil. HUF) (cont.)

S&P Global Ratings adjusted amounts

	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations	Capital expenditures
Adjusted	947,742	2,055,771	4,153,181	709,444	377,399	64,346	618,342	524,008	285,099

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	**Modest**	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	**bbb-**	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of September 21, 2018)

MOL Hungarian Oil and Gas PLC	
Issuer Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-
Issuer Credit Ratings History	
15-Nov-2017	BBB-/Stable/--
20-Jul-2017	BB+/Positive/--
19-Jul-2016	BB+/Stable/--
17-Jul-2015	BB/Positive/--
20-Dec-2013	BB/Stable/--
11-Oct-2013	BB+/Watch Neg/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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