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Research Update:

MOL Hungarian Oil and Gas Outlook Revised To Positive On Purchase Of Assets In Azerbaijan; Affirmed At 'BBB-'

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Rating Action Overview

- MOL Hungarian Oil and Gas PLC intends to fund its acquisition of certain Chevron assets in Azerbaijan from available liquidity sources.
- We believe the acquisition, expected to close in second-quarter 2020 subject to government and regulatory approvals, will strengthen MOL's business profile despite increasing leverage.
- We are therefore revising our outlook on MOL to positive from stable and affirming our 'BBB-' ratings on MOL and its senior unsecured debt.
- The positive outlook indicates that we could raise the ratings in the next 24 months if MOL's business resilience and diversity strengthen, and it restores its credit metrics.

Rating Action Rationale

Increasing upstream production and reserves in low-cost fields in new geographies should strengthen MOL's business. Decreasing reserves and relatively limited prospects for organic growth in the upstream segment have been key weaknesses of MOL's business risk profile in previous years. As such, we see MOL's announcement that it will acquire Chevron's 9.57% stake in the Azeri-Chirag-Gunashli oilfield in Azerbaijan, and an effective 8.9% stake in the Baku-Tbilisi-Ceyhan pipeline, as an important step in replacing and increasing its hydrocarbon reserves. We also consider that the acquisition will significantly boost MOL's daily oil and gas production by 15%-20%.

The transaction provides a more visible path to strengthening MOL's reserves to 500 mmboe by 2023 or earlier. However, it will not increase proven and probable (2P) reserves to the 2009 peak of 665 million barrels of oil equivalent (mmboe). 2P reserves are projected to reach 360 mmboe-380 mmboe by the end of 2020 with the acquisition, compared with 324 mmboe at year-end 2018. The weakening of reserve life would therefore slow, but additional growth initiatives would be required to reach the set target of 500 mmboe. Furthermore, we note the high visibility of cash flows from the BP-operated giant mature field with a long reserve life. The production-sharing agreement between the State Oil Company of Azerbaijan Republic (SOCAR) and contractors limits sensitivity to oil price variations due to the oil cost compensation and 75%/25% split of profit oil. In other words, less upside and downside but, overall, more stability.

We believe the transaction strengthens MOL's scale and diversification. The addition of the new assets will increase MOL's resilience to business cycles, in our view, since its business mix will become more balanced. The share of upstream activities will rise to about 50% (nine months EBITDA 2019 pro forma) from 43%, making the company less sensitive to volatile European refining margins. We therefore expect to reassess MOL's business risk profile to satisfactory after the transaction closes.

Positive free cash flow from the acquired assets will cushion the impact on leverage. MOL will fund the total consideration of $1.57 billion from available liquidity, which includes $650 million of cash and $3.4 billion from committed credit facilities. Although the transaction is relatively large, we expect only a moderate impact on MOL's credit metrics, with funds from operations (FFO) to debt in the 50%-60% range over the next two years since the assets will continue to generate positive FOCF, even at materially lower oil prices.

Outlook

The positive outlook indicates that MOL's stronger business resilience and diversity, provided by the acquisition, alongside gradual deleveraging could lead to a higher rating in the next 24 months. At this point, we see at least a one-in-three chance that, over that period, the ratio of FFO to debt may improve beyond our base-case expectation, due to the favorable market environment, the impact of IMO 2020, and the company's financial policy decisions regarding capex and dividends.

Downside scenario

We could revise the outlook to stable if large capex and dividends or lower oil prices lead to significant negative discretionary cash flow (DCF), and FFO to debt declines toward 50% on average. We would consider this level to be commensurate with the 'BBB-' rating if MOL's business risk profile strengthens. If the transaction does not close, leaving continued uncertainties regarding the reserve replacement or if the lawsuit with the Croatian government over jointly owned INA is unfavorable for MOL, we would likely revise the outlook to stable.

Upside scenario

We could raise the rating if the acquisition goes through as planned, supporting the diversity and resilience of MOL's business, and MOL deleverages, with FFO to debt at about 60% through the cycle. This would also require cash flows after capex and dividends to be at least neutral.

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 (boepd) and 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 of MOL's refineries are regionally very competitive, with high complexity characteristics. The company also has a large fuel retail network across CEE and is investing heavily in petrochemicals. The company's market capitalization is currently close to $7.8 billion.

Our Base-Case Scenario

Excluding the acquired assets, we anticipate a gradual decrease of the contribution from upstream business, due to a natural production decline and slightly lower price assumptions for 2021. Combined with MOL's sizable investment in petrochemicals and continued dividends, this leads to slightly negative free operating cash flow (FOCF). We forecast FFO to debt remaining above 60% on average, however due to MOL's current financial headroom.

The acquisition will likely increase our adjusted debt figure for MOL by $1.5 billion-$2 billion, depending on nonfinancial debt adjustments related to the assets. However, the assets are already producing and generating positive FOCF, thereby mitigating the impact on MOL's credit metrics. FFO to debt will therefore only decline slightly, to about 55% in 2020 and 50% in 2021.

Assumptions

- Oil prices of $60 per barrel (/bbl) for the remainder of 2019 and in 2020, and $55/bbl from 2021, according to our latest price deck. The current Brent price is about $60/bbl. We expect MOL's realized oil price to remain at about a 8% discount to Brent due to its production mix.
- Gradually decreasing production from existing assets throughout 2020-2021 to 105,000 boepd because of a natural decline. Pro forma the acquisition, production would be closer to 125,000-130,000 boepd on an entitlement basis.
- Cash capex in 2020-2021 of Hungarian forint (HUF) 650 billion-HUF700 billion ($2.2 billion-$2.3 billion) due to investments in chemicals, almost 2x 2018 capex, which was below HUF400 billion.
- Dividend payments moderately increasing compared with historical levels, in line with growth in EBITDA, to about HUF75 billion per annum.
- No further material acquisitions or share repurchases.

Based on these assumptions, we arrive at the following credit measures:

- Reported EBITDA of HUF700 billion-HUF720 billion in 2019, HUF700 billion-HUF750 billion in 2020, and HUF675 billion-HUF725 billion in 2021. Accounting for the agreed transaction, we estimate EBITDA at about 15% higher
- Adjusted FFO to debt of about 70% in 2019, decreasing toward 55%-60% in 2021. Pro forma the acquisition, we anticipate FFO to debt of about 55% in 2020 and 50%-55% in 2021.
- We estimate DCF will be negative by HUF70 billion-HUF80 billion on average per annum in 2019-2021, as growth capex and dividends payout outpace cash FFO. We note most of the benefits from the investments will come after 2021

Liquidity

We now regard MOL's liquidity as adequate rather than strong in view of the cash outlay for the transaction. Liquidity remains adequate however, since most using accessible cash and committed bank lines allows MOL to pay for the assets without raising new debt. We anticipate that liquidity sources will exceed uses by more than 1.2x over the next 24 months. Moreover, MOL has solid banking relationships, given its status as Hungary's largest corporate entity and a track record of proactively refinancing its committed bank lines well before they mature.

Principal liquidity sources as of Sept. 30, 2019

- Cash and liquid investments of about HUF171 billion.
- More than HUF900 billion available under long-term committed bank lines maturing mostly in 2023-2024. Most lines are subject to financial covenants of net debt to EBITDA of 3.5x, under which MOL has strong headroom with its net debt to EBITDA being close to 1x on a pro forma basis.
- FFO of HUF750 billion-HUF800 billion

Principal liquidity uses

- Short-term debt maturities of about HUF310 billion.
- Capex of HUF700 billion-HUF750 billion.
- Working capital outflow of HUF20 billion-HUF25 billion.
- Dividends of HUF70 billion-HUF75 billion.
- Acquisition consideration of about HUF420 billion, cash-flow adjusted for the effective date of Jan. 1, 2019.

Issue Ratings - Subordination Risk Analysis

Capital structure

MOL's capital structure consists of senior unsecured debt issued at the parent level that we rate in line with the issuer credit rating.

Analytical conclusions

The issue rating on MOL's senior unsecured debt is 'BBB-', in line with the issuer credit rating, since no significant elements of subordination risk are present in the capital structure

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Positive/--

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: Adequate (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)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- 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, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed;Outlook Action

	To	From
MOL Hungarian Oil and Gas PLC		
Issuer Credit Rating	BBB-/Positive/--	BBB-/Stable/--
Senior Unsecured	BBB-	