

RATING ACTION COMMENTARY

Fitch Downgrades Russia's Russneft to 'CCC+'

Fri 06 Mar, 2020 - 13:04 ET

Fitch Ratings - London - 06 Mar 2020: Fitch Ratings has downgraded Russia-focused PJSC Russneft (Russneft) to 'CCC+' from 'B/Positive'.

The downgrade of Russneft reflects its worsened liquidity position and recent transactions with companies affiliated with Russneft's main shareholder that have increased its Fitch-adjusted leverage. The latter has cast doubt on Russneft's corporate governance practices. We project Russneft to generate moderately positive FCF, which however will be insufficient to cover maturities under the current repayment schedule. Its ability to attract external funding is constrained by its loan agreement with its major creditor, VTB.

Russneft's business profile, however, remains good. The company's production (around 140 thousand barrels per day (kb/d), excluding non-consolidated assets in Azerbaijan) and reserves are commensurate with the 'BB' rating category.

KEY RATING DRIVERS

Weakened Liquidity: Russneft's liquidity position has deteriorated due to lower oil prices and higher projected dividends on preferred shares. While we expect Russneft to generate positive FCF over 2020-2022, it is likely to be insufficient to meet repayments under Russneft's loan with VTB (around USD90 million p.a.) and its long-term prepayment deal with Glencore (around USD50 million p.a.). For 2020 we project liquidity score of a low 0.4x, which is reflected in the rating downgrade. Potential liquidity sources (excluded from our liquidity analysis) include capex reduction, short-term prepayment deals, additional funding from VTB and funds provided by the shareholder.

High Dependence on a Single Creditor: The ability of Russneft to attract funding elsewhere, except for prepayment deals, is limited by its loan agreement with VTB. Absent such restriction, we believe it could be able to attract additional funding from Russian banks, though this is untested. Our base case is for VTB to continue cooperating with Russneft, including by providing additional funding or extending maturities, when required, given their relationship record and Russneft's good business profile. However, Russneft's high dependence on a single major creditor makes the company more vulnerable to liquidity risk.

High Adjusted Leverage: We project Russneft's funds from operations (FFO) net leverage (adjusted for operating leases, long-term prepayments and guarantees) to average 4.5x over 2020-2022. This is higher than our previous base case (around 3x over the same period), primarily because of certain transactions with affiliated companies. Russneft's leverage excluding Fitch's adjustments for the prepayment deals, preferred stock and guarantees is significantly lower at 2.8x over 2020-2022.

Prepayments Deals: Glencore, Russneft's second-largest shareholder (31% of the common stock), has been supporting Russneft through long-term prepayments for future oil supplies. In 2019, it also attracted a long-term prepayment from VTB (used to fund a transaction with an affiliated company) and a short-term prepayment from a private trader (used for general corporate purposes). We estimate Russneft's total prepayment balance at end-2019 amounted to around RUB42 billion, up from RUB28 billion at end-2018. We view prepayments as effectively a debt-like instrument.

Concentrated Ownership: Russneft's shareholding structure is concentrated, with Mikhail Gutseriev and his family controlling 47% of ordinary shares. Russneft and other businesses controlled by Mr Gutseriev are consolidated under the umbrella of the Safmar group, which does not prepare public accounts. Moreover, most of Mr Gutseriev investments are not public companies and it is not possible to assess the financial position of the group.

Transactions with Affiliated Parties: In 2019, Russneft entered into several transactions with affiliated companies, including a guarantee for a EUR267 million loan to fund Mr Gutseriev's stake purchase in PJSC Kuzbass Fuel Company, and a short-term loan granted to an affiliated company for around EUR200 million (funded by the long-term prepayment from VTB). Russneft expects the latter loan will be repaid in 2020, which is not taken into account in our rating case. These recent transactions signal weak corporate governance practices and high exposure to key man risk, which is reflected in the 'CCC+' rating.

Preferred Shares: In 2019, VTB purchased one-third of Russneft's preferred shares previously owned by Mr. Gutseriev's family and subsequently transferred to Rost Bank. The bank became part of the rescued and nationalised B&N Bank, now owned by the Central Bank of Russia (CBR). CBR later transferred the shares to Trust bank. In 2019, VTB purchased a third of the shares from Trust, while Russneft guaranteed to purchase back the shares from VTB for RUB21 billion in 2026, which we add to Russneft's adjusted debt. Russneft has also committed to increase its preferred dividend payments from USD16 million-USD40 million to a minimum USD60 million, and has provided a guarantee to VTB with regard to the minimum dividends payable to the bank.

Preferred Shares Treated as Debt: We continue to allocate the preferred stock as 100% debt according to Fitch's Corporate Hybrids Treatment and Notching Criteria. Even though the shares are non-cumulative, a decision not to pay preferred dividends would trigger the guarantee issued in favour of VTB and could, in our view, result in adverse reputational consequences for the company's main shareholder.

Tax Incentives Support Earnings: Russneft benefits from tax incentives enacted by the government to stimulate production from depleted and hard-to-recover reserves, where production costs are higher. Its strategy is to ramp up production at such fields, eg, Tagrinskoye and Verkhne-Shapshinskoye in western Siberia, through the application of enhanced oil recovery techniques, such as horizontal drilling and multi-stage fracking. In 2019, Russneft continued to increase the share of produced oil subject to tax incentives, which enabled it to generate broadly flat EBITDA year-on-year despite lower oil prices.

Stable Production and Reserves: We assume Russneft's production to marginally fall in 2020 and remain broadly stable over 2020-2023. Russneft's oil production and reserves are commensurate with the 'BB' rating category; however, the company has higher production costs than Russian peers' and higher susceptibility to potential changes in taxation (eg, reduction in tax incentives).

ESG Influence: Russneft has an ESG Relevance Score of 5 for Group Structure factor (eg Complexity, Transparency and Related-Party Transactions) due to material transactions with affiliated companies, including a loan and guarantees, which have been provided despite the company's already limited liquidity and have resulted in materially higher adjusted leverage. This has a negative impact on the credit profile, and is highly relevant to the rating, contributing to the downgrade.

Russneft has an ESG Relevance Score of 4 for Governance Structure (eg Board

Independence and Effectiveness; Ownership Concentration). We believe that the recent affiliated company transactions point to weak corporate governance practices and exposure to the key man risk, which has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

DERIVATION SUMMARY

Russneft's downgrade reflects the company's weak liquidity position, high adjusted net leverage on the back of recent transactions with affiliated parties and corporate governance risks. The company's production (around 140kb/d in 2018) and proved reserves (around 1 billion barrels) are in line with the 'BB' rating category and its business profile and cash-flow generation are better than those of Seplat Petroleum Development Company (B-/Positive) and Lonestar Resources US, Inc. (B-/Stable), though Russneft has higher refinancing risks and weaker liquidity.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Exchange rate: USD/RUB 65.1 in 2020, 66.5 in 2021 and 66.5 thereafter;
- Upstream production falling 3% in 2020 and stagnant up to 2022;
- Improving per-barrel profitability due to higher share of production from greenfields with a favourable tax treatment;
- Capex averaging RUB20 billion in 2020-2022;
- Annual preferred dividends of USD60 million;
- No dividends paid to ordinary shareholders.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- Structural improvement in liquidity (liquidity score above 1.0x) and/or

demonstrated ability to attract external funding.

- Improved corporate governance practices, including fewer transactions with affiliated parties and efficient and independent corporate governance structure in place.

Developments That May, Individually or Collectively, Lead to Negative Rating Action

-Deteriorating liquidity position.

-FFO-adjusted net leverage (including preferred stock and prepayments) sustainably above 7x.

LIQUIDITY AND DEBT STRUCTURE

Weak Liquidity: We assess Russneft's liquidity as weak with a projected one-year liquidity score at 0.4x. Alternative liquidity sources could include capex reduction, short-term prepayment deals, additional funding from VTB and funds provided by the shareholder. The company's liquidity position over the next three-to-five years is likely to remain weak based on the current debt maturity profile.

SUMMARY OF FINANCIAL ADJUSTMENTS

- Russneft's operating lease expenses are capitalised at 6x and added to adjusted debt.

- Fitch treats preferred shares of Russneft as debt. The value of shares was RUB27 billion at end-2018.

- Fitch treats prepayments for oil deliveries from Glencore and other traders as debt (RUB28 billion at end-2018).

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being

managed by the entity.

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For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT ⚡	RATING ⚡	PRIOR ⚡
PJSC RussNeft	LT IDR CCC+	Downgrade
		B Rating Outlook Positive

[VIEW ADDITIONAL RATING DETAILS](#)

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PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

[Corporate Rating Criteria - Effective from 19 February 2019 to 27 March 2020 \(pub. 19 Feb 2019\)](#)

[Corporate Hybrids Treatment and Notching Criteria - Effective from 11 November 2019 to 12 November 2020 \(pub. 11 Nov 2019\)](#)

ADDITIONAL DISCLOSURES

[Dodd-Frank Rating Information Disclosure Form](#)

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