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Research Update:

Russian Oil Transporter Transneft 'BB+' FC And 'BBB-' LC Ratings Affirmed; Outlook Stable

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Overview

- Despite Transneft's large capital expenditures and exposure to foreign exchange risk, our assessment of the company's 'bbb' stand-alone credit profile remains unchanged thanks to the company's monopoly position in oil pipeline transportation and solid credit metrics.
- We regard Transneft as a critically important entity for the Russian economy, with very strong links with the government; and we cap our view of Transneft's creditworthiness at the level of the sovereign rating.
- We are therefore affirming our 'BB+' foreign currency and 'BBB-' local currency long-term ratings on Transneft.
- The stable outlook mirrors that on Russia.

Rating Action

On Feb. 15, 2017, S&P Global Ratings affirmed its 'BB+' foreign currency and 'BBB-' local currency long-term corporate credit ratings on Russia-based OAO AK Transneft, monopoly operator of oil pipeline networks. The outlook is stable.

We also affirmed our 'BB+' issue rating on the company's \$1.05 billion senior unsecured notes due 2018.

Rationale

The affirmation reflects that, although we assess Transneft's stand-alone credit profile (SACP) at 'bbb', we continue to cap the rating on the company at the level of our sovereign credit rating on the Russian Federation. This is based on our view of Transneft's very strong links with the Russian government.

We believe there is an extremely high likelihood of extraordinary support for Transneft from the government. Transneft plays a critical role in the functioning of the Russian oil industry, which is the major source of the government's tax revenues and national income. We continue to see a very strong link between the company and its shareholder, the Russian government, which holds 100% of voting shares. The state appoints the company's board members, and fully controls the company's strategy, tariffs, and key investment projects. We understand, however, that Transneft autonomously manages its day-to-day operations and financing activities.

In our view, in the event of sovereign stress, the company would not be sufficiently insulated from negative government interventions, such as pressures to support other government-related, strategic, or socially important entities, or pay higher dividends. Also, Transneft's business primarily focuses on domestic operations. Although the company resells oil to China to repay its loan to the China Development Bank, Transneft does not produce this oil, and we understand that the margin on these operations is minimal.

Given our current assessment of Transneft's SACP, we do not apply to the rating any uplift for government support. However, we believe that government support potentially protects the rating from downside risk if Transneft's SACP were to deteriorate.

Transneft benefits from its natural monopoly status in transporting about 90% of Russia's oil production. Russia is one of the world's largest crude oil producers and exporters. We view transportation volume risk as low at least in the next three to five years, because Russia's oil production has proven resilient to oil price fluctuations. We do not expect Russia's current commitments to cut oil production to affect Transneft's operations because the implementation is uncertain. Even if volumes decline somewhat, average transportation distances could increase as oil companies would be interested in increasing the share of further-away fields subject to material tax cuts.

We view Transneft's tariff regulation system as adequate, as it enables the company to fully cover its costs and most capital expenditures (capex), and supports fairly stable robust profitability, with expected EBITDA margin above 40%. The government's decision to adjust tariffs by 90%-100% of expected inflation provides some visibility on tariffs overall, although we acknowledge that tariff adjustments are currently well below historical double-digit levels. Nevertheless, the decision-making process regarding Transneft's capex and the tariffs for certain new routes (notably Zapoliarie-Purpe and Kuyumba-Taishet) could still be opaque and politicized, in our view. Furthermore, we think that Transneft's exposure to country risk in Russia is high.

We expect Transneft's core credit metrics to remain solid, with debt to EBITDA of 1.0x-1.5x and funds from operations (FFO) to debt of above 60% on average in the next three years. We expect negative free operating cash flow (FOCF) in 2017, due to heavy capex on a number of key projects, notably the ESPO expansion and oil product pipelines. Due to heavy and largely committed capex, we now view Transneft's liquidity as adequate, versus strong previously. The company faces some foreign exchange risk, as about 70% of debt is denominated in U.S. dollars, while revenues are mostly in rubles. Still, Transneft's manageable debt and solid foreign currency-denominated liquid assets partially mitigate this risk.

Because of heavy capex and potential ruble weakening under our base-case scenario for the sovereign in 2017, we do not rule out that Transneft's adjusted debt could increase and FFO to debt in 2017 could be slightly below

60%. Still, we expect a rebound in 2018, as the company completes some of its top projects and repays some foreign currency-denominated debt.

Our assessment of Transneft's SACP factors in uncertainties related to the company's financial policy. We see a risk that the company's currently low debt could increase because of higher capex or larger dividends, if so directed by the government.

In our base-case scenario, we assume:

- Oil transportation tariff adjustment of 90%-100% of government-projected consumer price index in 2017-2020.
- Relatively stable transportation volumes.
- Potential ruble weakening, in line with our base case for Russia, to weigh on 2017 credit metrics.
- The company to gradually prepay its foreign currency-denominated debt and continue to keep a large part of its cash in foreign currency, to hedge associated risk.
- Capex in 2017 of more than RUB300 million, broadly in line with 2016 levels, including the ESPO expansion, the North and South oil product pipelines, and material investments in supporting the existing vast network.
- Capex to moderate to RUB230 billion-RUB250 billion from 2018, when the key projects are completed.
- Higher dividends in 2017.
- Achievement of 25% of consolidated net income, in line with the company's policy.

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

- FFO to debt of above 60% on average, with a low slightly below 60% in 2017 followed by a strong rebound to comfortably above 60% in 2018 once key projects are completed, and positive FOCF starts to reduce adjusted debt.
- Negative FOCF in 2017.
- FOCF returning to positive, between RUB50 billion and RUB100 billion, in 2018 and beyond.

Liquidity

We now view liquidity as adequate, with the ratio of liquidity sources to liquidity uses above 1.3x. We believe that Transneft's status as a government-related entity supports its stable relationships with local banks and its standing on the local credit market, even if access to international capital markets has been uncertain for Russian issuers for geopolitical reasons. We believe that the company has generally prudent risk management. Furthermore, although Transneft reported losses of RUB19 billion in defaulted banks in 2015 and net RUB75.3 billion on derivatives in 2014, these losses were manageable given the company's solid cash balances and sound credit metrics.

At year-end 2016, we estimate that Transneft's principal liquidity sources included:

- Sizable cash and short-term financial assets exceeding RUB300 million. We understand that most cash is held with first-tier Russian banks and short-term financial assets are liquid.
- FFO of RUB300 million-RUB350 million.

We do not include in liquidity sources proceeds from the pending sale of its stake in Novorossiysk Commercial Sea Port PJSC (BB-/Stable/--; ruAA/--/--) because the details and timing of this sale are uncertain at this stage.

At the same time, we calculate that Transneft's principal liquidity uses included:

- Large capex program of more than RUB300 million, including new projects and maintenance capex. We believe that most key projects are committed.
- Short-term maturities of about RUB87 billion.
- Dividends, which we expect to increase from the 2016 level, in line with the company's policy to pay out 15%-25% of net income.
- Potential working capital outflows.

Outlook

The stable outlook on Transneft mirrors our outlook on the sovereign.

Our current assessment of Transneft's SACP factors in our assumption that the company will achieve FFO to debt above 60% on average for the next three years. Even if the ratio is slightly below this target, we expect it will rebound in 2018, when moderating capex should facilitate positive FOCF.

Downside scenario

We would lower the rating on Transneft if we were to lower the ratings on the sovereign. We do not expect to rate Transneft above the sovereign because of our view of very strong links between the company and the government, which could leave room for potential negative government interference. Also, we view Transneft as a domestically-focused company exposed to country risks in Russia.

We may revise our assessment of Transneft's SACP if FFO to debt were consistently below 60% and FOCF remained negative. This could happen if capex doesn't decline after 2018, if foreign exchange fluctuations constrain credit metrics beyond our current expectations, if costs increase well above tariffs, or if dividends are markedly higher than our current expectations, which we currently do not expect.

Given our expectation of an extremely high likelihood of extraordinary state support, downside risk to the local currency rating could stem from a deterioration of the company's SACP by three notches (or a full category) to our 'bb' category. For us to consider a negative action on the foreign currency rating, the SACP would have to decline even further to 'b+'. This is far from our base-case scenario.

Upside scenario

Upside potential hinges on the sovereign rating on Russia. We would raise our rating on Transneft in the event of a sovereign upgrade.

Ratings Score Snapshot

Corporate Credit Rating:

- Foreign currency: BB+/Stable/--
- Local currency: BBB-/Stable/--

Business risk: Satisfactory

- Country risk: High
- Industry risk: Very low
- Competitive position: Satisfactory

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial Policy: Negative (-1 notch)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

- Sovereign rating: BBB- local currency, BB+ foreign currency
- Likelihood of government support: Extremely high

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 01, 2016
- 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
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013

- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

OAO AK Transneft

Corporate Credit Rating

Foreign Currency

BB+/Stable/--

Local Currency

BBB-/Stable/--

Senior Unsecured

BB+

TransCapitalInvest Ltd.

Senior Unsecured

BB+

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