Research Update:

# Russian Oil Pipeline Operator Transneft PJSC Ratings Affirmed; Outlooks Stable

**February 27, 2020**

## Rating Action Overview

- We expect Transneft's strengthening financials to provide a sufficient cushion against potential dividend increase, contingent liabilities related to the Druzhba pipeline accident, or any new large capital expenditure (capex) plans.
- We are affirming our 'BBB' local currency and 'BBB-' foreign currency ratings on Transneft.
- The stable outlook on both ratings mirrors that on the sovereign.

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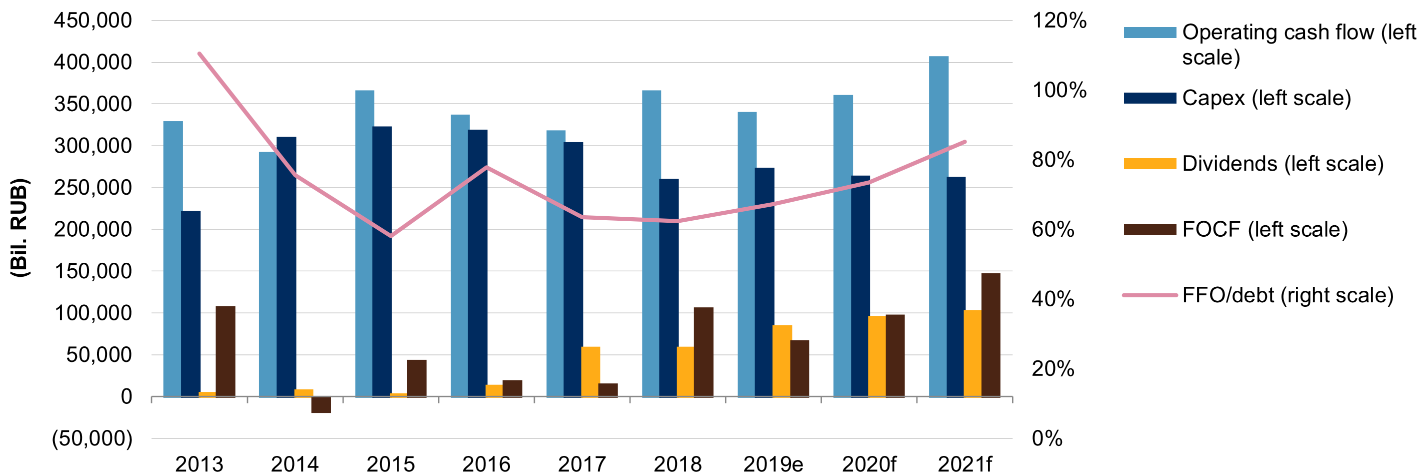
## Rating Action Rationale

**We expect Transneft to demonstrate low debt leverage, with funds from operations (FFO) to debt comfortably above 60%, and positive free operating cash flow (FOCF) after large capex projects have been completed.** Despite the acquisition of Novorossiysk Commercial Sea Port (NCSP) in late 2018 and large capex on new pipeline routes, Transneft managed to maintain FFO to debt above 60% and debt to EBITDA below 1.5x. Since Transneft completed the East Siberia-Pacific Ocean pipeline expansion in 2019, we expect capex to stabilize at Russian ruble (RUB)260 billion-RUB270 billion. With EBITDA set to increase to RUB450 billion-RUB480 billion in 2019-2021, thanks to the consolidation of NCSP, capex stabilization will lead to positive FOCF of RUB50 billion-RUB150 billion annually.

**We understand that the new Russian government that was appointed in January 2020 is focusing on boosting GDP via higher investments and social spending, and therefore we do not rule out additional pressure on Transneft to increase capex and dividends.** Still, thanks to generally stable oil production volumes in Russia and continuing underutilization of certain new routes (notably the Zapoliarie-Purpe and Kuyumba-Taishet pipelines constructed in 2017), we don't see a clear rationale for large additional oil pipeline projects. We believe that Transneft's solid financials help create a solid cushion for dividends of 50% of net income, for additional projects, and for potential contingent liabilities from the Druzhba accident at the current rating level and the 'bbb-' stand-alone credit profile (SACP).

### Transneft's Cash Flows




RUB--Russian ruble. Capex--Capital expenditure. FOCF--Free operating cash flow. FFO--Funds from operations. e--Estimate. f--Forecast.



**We expect contingent liabilities related to the Druzhba accident to be manageable, thanks to government support and solid financials.** In second-quarter 2019, over 3 million tons of customers' oil were contaminated with organic chlorides. We believe that the government's active participation in the negotiations after the accident helped restore exports relatively quickly, strengthened Transneft's bargaining power vis-à-vis its shippers as to compensation, and kept contingent liabilities broadly in line with the Russian ruble (RUB) 23 billion contingency reserve created in the company's first-nine-months 2019 report prepared under International Financial Reporting Standards. This corresponded to the $15 per barrel (/bbl) maximum discount approved by Transneft's board in July 2019. We cannot rule out additional litigation if some customers disagree with the company's proposal or ask for additional compensation for the damage to their equipment. We view Druzhba's contingent liabilities as debt-like. We will continue to monitor the company's progress in tightening its management practices and operating controls to prevent similar accidents in the future.

**We continue to see very strong links between the government and Transneft.** We don't expect the Druzhba accident to impair Transneft's very strong links with the government, and we continue to view the company as a provider of essential oil pipeline infrastructure in Russia's oil-focused economy. As a result, we expect the ratings on Transneft to move in tandem with the ratings on the sovereign.

## Outlook

The stable outlook Transneft mirrors the outlook on the sovereign. We continue to assess the company's SACP at 'bbb' and in our base-case scenario we expect FFO to debt at over 60% on average for the next three years, along with declining capex after major projects have been completed, potentially increasing dividends, and adequate liquidity.

### Downside scenario

We could lower the foreign currency rating if we downgrade the sovereign. We could also lower the local currency rating on Transneft to 'BBB-' if the likelihood of extraordinary state support to the company wanes, for instance, due to changes in government policy. However, if Transneft's role for and link with the government do not change, our expectation of extraordinary government support creates a cushion for our ratings on the company.

We might revise the SACP to 'bbb-' if FFO to debt falls below 45%, or is in the 45%-60% band, as might be the case if Transneft significantly increases capex, preferred share repurchases, or dividends; or faces very large litigations, but discretionary cash flow (DCF) after capex and dividends is heavily negative. However, this would not affect the foreign or local currency ratings.

We would lower the local currency rating only if the SACP deteriorates to 'bb+', which could happen in the case of a very substantial debt increase or unexpected liquidity pressures. To trigger a foreign currency rating downgrade to 'BB+', the SACP would have to deteriorate to 'b+', which we consider very unlikely.

However, none of these are in our base-case scenarios.

### Upside scenario

We will raise our ratings on Transneft if we raise our ratings on Russia and the company's SACP remains unchanged. We do not expect to rate Transneft above the sovereign because of the very strong links between the company and the government, which could leave room for potential negative government intervention. Furthermore, we view Transneft as a domestically focused company exposed to country risks in Russia.

## Company Description

Transneft is a Russian state-controlled monopoly operator of oil pipeline networks. It transports about 83% of the country's crude oil production and about 29% of its light oil products to domestic and international destinations (as of Sept. 30, 2019). The company operates about 51,800 km of oil pipelines and about 16,700 km of oil product pipelines, making it the largest pipeline operator in the world. The Russian government owns 78% of Transneft's shares and 100% of voting rights, and we understand it currently has no plan to decrease its stake.

The company operates a number of routes that bring oil from almost all of Russia's key oil provinces to domestic refineries and export destinations via the onshore Druzhba pipeline, as well as to Baltic and Black Sea ports, mainland China, and the Pacific sea port of Kozmino.

## Our Base-Case Scenario

- Oil transportation tariff to increase by about 3.4%-3.6%, at about 90% of expected consumer price index of 4%, in line with Government Resolution 377.
- Generally stable oil and product transportation volumes, reflecting Russia's stable oil production, only gradual increase in utilization of newly constructed routes, and our view that Russia's oil product export transportation is heavily exposed to tax changes and demand fluctuations.

- Costs to grow below inflation.
- EBITDA to increase to RUB460 billion-RUB490 billion in 2020-2021, from RUB424 billion in 2018 and expected about RUB440-460 billion in 2019, thanks to consolidation of the profitable NCSP operations. We expect NCSP to add about RUB30 billion to consolidated annual EBITDA after the grain terminal disposal.
- Contingent liabilities related to the Druzhba accident to not materially exceed the company's provision of RUB23 billion. We treat such liabilities as debt-like. We do not assume any material change in operating leases or other debt-like liabilities.
- Significant working capital outlays in 2020 (as in the 2019 accounts as of Sept. 30).
- Capex to stabilize in 2020-2021 at about RUB260 billion annually (including about RUB190 billion-RUB200 billion maintenance capex and about RUB10 billion for NCSP), because most strategic projects for the pipeline business are complete.
- Dividends at about 50% of adjusted consolidated net income, in line with the government's policy. We do not expect the RUB20 billion preferred share repurchase to materialize because the Russian government did not approve it.
- No large acquisitions or asset sales.
- All cash available to service Transneft's debt. This includes RUB12.8 billion restricted cash from the sale of NCPS's grain terminal, which should have become available to Transneft by Jan 1, 2020. We do not assume any cash losses with weaker Russian banks.

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

- FFO to debt of above 60% through 2021: potentially 60%-70% in 2019 and 70%-80% in 2020-2021.
- Positive FOCF of about RUB50 billion-RUB150 billion annually, depending on the working capital dynamics.
- No material negative DCF and gradual reduction in net debt, given that positive FOCF should be sufficient to cover a potential dividend increase.

## Liquidity

We view Transneft's liquidity as adequate, with liquidity sources to liquidity needs at well above 1.2x over the next 12 months and comfortably above 1x in the following year. We take into account the company's sound relationships with local banks, supported by Transneft's status as a government-related entity and generally satisfactory standing on local credit markets. We believe that the company has prudent risk management overall. We also take into account that Transneft's access to international capital markets is constrained for geopolitical reasons and international sanctions, which limit its ability to raise long-term debt.

As with other Russian companies, Transneft keeps essentially all of its solid cash balances in large Russian government-related banks, but faces the risks of Russia's relatively weak banking system. Furthermore, the company reported losses of RUB19 billion in defaulted banks in 2015 and net RUB75.3 billion on derivatives in 2014. Transneft sued Sberbank, claiming that the company's management could not sufficiently understand the derivative. Although the losses were manageable, and although we understand that Transneft and Sberbank came to an amicable agreement, we believe that the company's financial management practices support an adequate, rather than strong, liquidity assessment.

As of Sept. 30, 2019, key liquidity sources included:

- RUB66.5 billion in cash, RUB184.2 billion in short-term financial assets (including bank deposits and marketable securities but excluding loans to related parties), and RUB16.8 billion in long-term bank deposits; and
- Expected cash FFO of RUB360 billion-RUB390 billion.

Key liquidity needs as of the same date include:

- Short-term debt totaling RUB36.0 billion, plus short-term operating leases of RUB3.5 billion;
- Capex of about RUB260 billion; and
- Dividends to core shareholders and to minority interest potentially above RUB83 billion paid in 2018.

## Environmental, Social, And Governance

The key governance risk for Transneft stems from the Druzhba accident, which points to necessary improvements in Transneft's operational controls, in our view. We understand that transportation via Transneft's system was been restored by July 2019, a criminal investigation is under way, and Transneft's board approved compensation of up to $15/bbl, but the shippers have yet to agree to it or to present a documented confirmation of damages. We assume the financial impact on Transneft will be manageable, reflecting RUB23 billion reserve created in the 2019 accounts as of Sept. 30.

The key environmental risks in Transneft's oil transport operations are related to oil spills or negative environmental impacts during pipeline construction or maintenance. The company focuses on limiting the frequency of pipeline accidents to below 0.086 per 1,000 km per year (which is low by global standards), consistently reducing polluting emissions, and compliance with ISO standard 14001.

Transneft is a large employer in Russia, with a solid health and safety track-record and participation in a number of community and charity projects. Still, its social importance mostly stems from its core business-to-business services to large Russian oil companies, which are in turn the key drivers for the country's economy. Transneft's governance is typical for a Russian state-controlled entity, with independent professional management but close oversight by various government bodies. We understand that after cash losses with weak banks and through derivative transactions, Transneft has streamlined its liquidity management.

## Ratings Score Snapshot

| **Issuer Credit Rating:** | |
|---|---|
| Foreign currency: | BBB-/Stable/-- |
| Local currency: | BBB/Stable/-- |
| Business risk: | Satisfactory |
| Country risk: | High risk |
| Industry risk: | Very low risk |

| | |
|---|---|
| Competitive position: | Satisfactory |
| Financial risk: | Minimal |
| Cash flow/Leverage: | Minimal |
| Anchor: | a- |
| Modifiers: | |
| Diversification/Portfolio effect: | Neutral (no impact) |
| Capital structure: | Neutral (no impact) |
| Financial policy: | Negative (-1 notch) |
| Liquidity: | Adequate (no impact) |
| Management and governance: | Fair (no impact) |
| Comparable rating analysis: | Negative (-1 notch) |
| Stand-alone credit profile: | bbb |
| **Related government rating:** | |
| Foreign currency: | BBB-/Stable/A-3 |
| Local currency: | BBB/Stable/A-2 |

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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 | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

| Ratings Affirmed | |
|---|---|
| **Transneft PJSC** | |
| Issuer Credit Rating | |
| Foreign Currency | BBB-/Stable/-- |
| Local Currency | BBB/Stable/-- |