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## Research Update:

# Russian Oil And Gas Independent RUSPETRO PLC Rated B-(Prelim)/Stable/--; $350 Mil. Notes Rated 'B-(Prelim)'

**Primary Credit Analyst:**
Per Karlsson, Stockholm (46) 8-440-5927; per_karlsson@standardandpoors.com

**Secondary Contact:**
Elena Anankina, CFA, Moscow (7) 495-783-4130; elena_anankina@standardandpoors.com

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Research Update:

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## Overview

- RUSPETRO, a small independent oil and gas exploration company in Russia, plans to increase average production to 10,000 barrels per day in 2013.
- We consider RUSPETRO's business risk profile to be "vulnerable" and its financial risk profile to be "highly leveraged".
- We are assigning a 'B-' preliminary long term-corporate credit rating to RUSPETRO, and a preliminary 'B-' issue rating to RUSPETRO's pending $350 million notes issue.
- The stable outlook reflects our expectations that RUSPETRO will improve production in 2013 and start to generate meaningful EBITDA and cash flows.

## Rating Action

On Jan. 25, 2013, Standard & Poor's Ratings Services assigned its preliminary 'B-' long-term corporate credit rating to London-based independent oil and gas exploration and production company RUSPETRO Plc. The outlook is stable.

At the same time, we assigned a 'B-' preliminary issue rating to RUSPETRO's pending $350 million notes issue.

The preliminary ratings are subject to the successful issuance of the notes and our review of final documentation. Any change in the amount or terms of the issue would trigger a review by Standard & Poor's and could affect the current corporate credit and issue ratings.

## Rationale

The corporate credit rating reflects RUSPETRO's business risk profile, which we qualify as "vulnerable", and its financial risk profile, which we assess as "highly leveraged".

Key weaknesses for the "vulnerable" business risk profile include the company's current small hydrocarbon production base nearly 6,500 barrels per day, a limited production track record, and only modest proven and developed oil and gas reserves. We think there is still significant execution risk to the planned production increase, both in 2013 and 2014.

The company had 183 million barrels of proven reserves on June 30, 2012, of which only 11 million barrels were developed, however. Reserves are concentrated in three fields in Western Siberia in Russia. Consequently, in our view, the company is also exposed to single-country risk, particularly in relation to potential changes to its taxation regime. Generally we view the exploration and production business as highly volatile.

These weaknesses are somewhat mitigated by RUSPETRO's expectations of strong near-term production growth, large proven and probable reserves of more than 1.5 billion barrels, which provides significant upside potential, and anticipation that a large share of production will be condensate. The high share of condensate is positive, as it is taxed lower in Russia and therefore it is positive for profitability and cash flow. Generally we view management's experience in the industry as positive.

We anticipate a meaningful EBITDA contribution in 2013, given RUSPETRO's expectations of ramped up production over the year. RUSPETRO expects average production to improve significantly in 2013-2014, to just above 10,000 barrels per day in 2013 and to 18,000 in 2014. In our credit scenario, we therefore assume a near-term improvement of EBITDA to about $70 million in 2013 and $140 million-$150 million in 2014 under our oil price assumptions of $90 and $80 per barrel, respectively, in 2013 and 2014. We think there is significant execution risk in those figures. Although there could be some delays ahead, as often happens in the industry, we do not forecast any major deviations from the company's production targets. Performance will also largely depend on management's ability to decrease operating costs, which should, on a unit basis, be affected by economy of scale, however.

While we forecast funds from operations (FFO) to be negative in 2012, we expected material improvement in 2013 following the ramp-up of production. We therefore expect improved credit measures from 2013-2014. Adjusted ratios of FFO to debt could reach up to 10%-15% in 2013 under our oil price assumption, pending on the ramp-up, and debt to EBITDA about 4x-5x. Although we expect free operating cash flow to be negative both in 2012 and 2013, we expect FFO to broadly cover capital spending in 2014. We note RUSPETRO's initial public offering in 2012, in which the company raised $218 million of fresh equity. We expect year-end 2012 adjusted debt, which we assume will be around $370 million-$380 million, will mainly be reduced by a $61.5 million shareholder loan being converted into equity in 2013. We expect year-end 2013 adjusted debt to be about $350 million (we assume the company will need $20 million in hand for its operations, and hence we do not net this figure. We also adjust for a $14 million put option).

Our rating assessment also includes the assumption that a shareholder loan of $62 million will be converted into equity.

## Liquidity

We view RUSPETRO's liquidity as "less than adequate" under our criteria.

This predominantly reflects our ratio of cash resources to cash needs, which we estimate will be below 1.2x after the proposed debt issue. The revolving credit facility (RCF) can be used only for interest payments until the end of 2014; therefore we have not included it, or the interest payments, in our calculations. In our calculation we have included a $20 million debt amortization to a related party. We acknowledge, however, that this loan is not qualitatively the same as a third-party loan. We incorporate the following expectations and assumptions into our assessment of RUSPETRO's liquidity profile:

As cash sources:
- $60 million cash after the debt issue, of which we exclude $20 million that we treat as tied to operations.
- Our expectation of FFO of about $40 million in 2013, under our base-case scenario.
- $50 million undrawn under a committed RCF, due 2018. However, until 2014 the RCF can be used only to pay interest on the preliminary bond. After 2014 the RCF can be used for general corporate purposes.

As cash needs we include:
- Limited short-term debt. Besides the shareholder debt from the shareholder Limolines, which will be converted to equity, there is about $20 million of other shareholder debt due in 2013.
- Capital spending for 2013 of about $95 million, which we expect will increase to $120 million in 2014.
- We expect no dividend payments.

We understand that, after the refinancing, RUSPETRO will be subject to the following key financial covenants:
- According to the proposed bond, fixed-charge coverage must remain above 2.25x for the company to be able to incur additional debt.
- To be able to use the RCF for general corporate purposes post 2014, net debt to EBITDA must not exceed 4x and EBITDA must exceed $100 million in 2014.

## Recovery analysis

The proposed $350 million senior secured notes due 2018 to be issued by RUSPETRO PLC are rated 'B-'(prelim), in line with the corporate credit rating. The notes have been assigned a preliminary recovery rating of '4', indicating our expectation of average (30%-50%) recovery in the event of a payment default. The issue and recovery ratings are subject to satisfactory review of the final documentation.

The recovery and issue ratings are primarily supported by our valuation of the company's reserves under the PV-10 methodology based on Standard & Poor's assumptions (see "Revised Assumptions For Assigning Recovery Ratings To The Debt Of Oil And Gas Exploration And Production Companies", published Sept. 14, 2012, on RatingsDirect on the Global Credit Portal) and the pari passu status of the notes and the proposed $50 million RCF vis-a-vis the security they both benefit from.

The recovery ratings are constrained by the operational risks typical of the development and production of oil and condensate reserves, the existence of some debt baskets under the notes' documentation, and a jurisdiction (Russia) that we view as relatively creditor unfriendly and entailing some country risk.

The net proceeds of the proposed $350 million notes due 2018 will be devoted primarily to repay an existing $290 million Sberbank credit facility and for general corporate purposes. After the transaction, the company's capital structure will consist of the proposed notes, a $50 million RCF also maturing in 2018, a $62 million Limolines facility, and a $18.5 million Makayla facility. We understand that management expects the Limolines loan to be exchanged for shares in February 2012, according to a conversion agreement between the parties, and this expectation is embedded in our recovery ratings. The Makayla facility matures on Aug. 5, 2013, and is expected to be repaid then.

The proposed notes will benefit from a surety from operating companies representing virtually all of the company's consolidated EBITDA and assets and owning the three existing exploration and production licenses. The notes will also benefit from first-priority liens on all the shares of RUSPETRO Holding Ltd. and any loan of the net proceeds of the notes from RUSPETRO PLC to any of its subsidiaries.

The notes' documentation includes a limitation on indebtedness subject to a fixed-charge coverage ratio of 2.25x and a limitation on secured indebtedness subject to a covenant of 4x. We believe that the company's projected ratios will allow it to raise new debt from 2014, if the business plan is successful. In addition, these covenants include some carve-outs permitting some general debt baskets and a securitization facility for an undetermined amount. The documentation also contains a relatively tight restricted payments basket. The issuer of the notes, RUSPETRO PLC, is incorporated in England and Wales, while all the company's oil reserves are located in Russia.

The proposed $50 million RCF will share the same guarantee and surety as the notes on a pari passu basis in both right and order of payment, according to an intercreditor agreement. The RCF's documentation will not contain maintenance financial covenants but will be subject to a covenant and a minimum level of EBITDA which, if not compliant, will limit the company's ability to use the RCF before 2014 for anything other than the payment of interest on the notes.

In line with Standard & Poor's criteria, in order to determine recoveries, we simulated a default scenario. In our hypothetical scenario of default, we have assumed that the Limolines and Makayla facilities will have been exchanged for stock and repaid, respectively, at the point of default. These facilities are unsecured and unguaranteed, and their documentation does not contain maintenance financial covenants.

In our most likely scenario of default, default would occur as a result of a delay in a substantial decrease of oil prices combined with a delay in the ramp up of production, while interest payments and capital expenditure would exhaust cash balances. Our hypothetical scenario simulates a default in 2014.

We believe that if RUSPETRO experiences a payment default, its enterprise value would be a function of its oil reserves, which is why we have used PV-10 methodology, based on our assumptions for evaluating the company's stressed enterprise value. Our assumptions include, among others, a price per barrel of crude oil of $55. We cap the value of proved undeveloped reserves at 25% of the company's total enterprise value.

On this basis, we estimate the company's stressed enterprise value at the point of default would be approximately $155 million. After deducting enforcement costs of 10%, we arrive at a net enterprise value of about $140 million. We then compare the net enterprise value with the amount of debt expected to be outstanding at default, comprising the RCF, the notes, and prepetition interest. This results in average recovery prospects in the low end of the average (30%-50%) range for bondholders, which translates into a recovery rating of '4'.

## Outlook

The outlook is stable and reflects our expectation that RUSPETRO in the short term will improve production and in 2013 start to generate meaningful EBITDA and cash flows. In the short term, downside risk could be created if management is unable to ramp up production as planned. We expect production to average 10,000 barrels per day in 2013. Pressure could also emerge if there are any major unforeseen production implications.

In the medium term, there could be potential for a one-notch upgrade, but such upward rating pressure would likely require sustainable FFO to debt of more than 20%.

## Ratings List

New Rating

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| RusPetro | |
| Corporate Credit Rating | B-(Prelim)/Stable/-- |
| Senior Secured | B-(Prelim) |
| Recovery Rating | 4(Prelim) |

**Additional Contact:**
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

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