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Research Update:

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

Primary Credit Analyst:

Sergei Gorin, Moscow (7) 495-783-4132; sergei.gorin@standardandpoors.com

Secondary Contact:

Alexander Griaznov, Moscow (7) 495-783-4109; alexander.griaznov@standardandpoors.com

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Overview

- We continue to see an extremely high likelihood that the Russian government would provide full and timely extraordinary financial support to OAO AK Transneft, given the company's critical role for and very strong links with the Russian government.
- We continue to assess Transneft's stand-alone credit profile at 'bbb', based on its satisfactory business risk and modest financial risk profiles.
- We are affirming our 'BB+' foreign currency and 'BBB-' local currency long-term ratings on Transneft.
- The negative outlook reflects that on the sovereign.

Rating Action

On Feb. 25, 2016, Standard & Poor's Ratings Services 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 negative.

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

Rationale

The affirmation reflects our view that there continues to be an extremely high likelihood that Transneft would receive timely and sufficient extraordinary support from the Russian government if needed. We regard Transneft as a government-related entity (GRE). We base our assessment of government support on Transneft's:

- Critical role for the functioning of the Russian oil industry, which is a major source of tax revenues and national income; and
- Very strong link with the Russian government, which has 100% of the voting rights, appoints board members, and fully controls the company's strategy, tariffs, and major investment projects. We understand, however, that Transneft makes operating decisions independently from the government.

We currently do not apply uplift for government support to the rating because our assessment of Transneft's 'bbb' stand-alone credit profile (SACP) is

higher than our long-term rating on Russia. However, government support potentially protects the rating from downside risk if Transneft's SACP were to deteriorate.

Our assessment of Transneft's business risk profile as satisfactory incorporates the company's monopoly status in the Russian oil transportation market and its low transportation volume risk, taking into account Russia's position as one of the world's largest crude oil producers and exporters. Transneft continues to enjoy fairly stable, robust profitability, supported by its unique natural monopoly position in transporting about 90% of Russia's oil production to domestic destinations and abroad.

We view Transneft's regulation as adequate. We expect regulated tariffs to continue to support high profitability, with an EBITDA margin exceeding 40%. Nevertheless, the decision-making process regarding Transneft's tariffs and capital expenditures is opaque and politicized, in our view. Another key constraint is Transneft's exposure to country risk in Russia, which we view as high.

We assess Transneft's financial risk profile as modest. We expect the company's core credit metrics to remain steady, with debt to EBITDA of 1.0x-1.5x and funds from operations (FFO) to debt above 60% in 2016-2017. Our assessment is also based on our expectation of negative free operating cash flow in the next two years due to increased investments. The company faces some foreign exchange risk, as 70% of debt is denominated in U.S. dollars, while revenues are mostly in rubles. Still, Transneft's very manageable debt and foreign currency-denominated liquid assets partially mitigate this risk.

We apply a one-notch negative adjustment, reflecting our financial policy modifier assessment. We see a risk that the company's currently low debt might increase over the long term because of higher capital expenditures or larger dividends.

In our base case for 2016-2017, we assume:

- Annual tariff adjustments of 5%-8% per year;
- EBITDA margins of about 44%-46%;
- Annual capital expenditures of Russian ruble (RUB) 320 billion-RUB350 billion (\$4.2 billion-\$4.7 billion); and
- Some increase in dividends in 2017 from moderate levels of 2016.

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

- A Standard & Poor's-adjusted debt to EBITDA of below 1.5x; and
- A ratio of FFO to debt of above 60%.

Liquidity

We view Transneft's liquidity as strong, with a ratio of liquidity sources to liquidity uses that exceeds 1.5x for full year 2016. Given Transneft's GRE status, in our opinion, the company has solid access to financing from state-owned banks.

Principal liquidity sources:

- Considerable cash and short-term investments (which we view as liquid) of about RUB509 billion. We understand that most cash is kept with Russian first-tier banks.
- FFO, which we estimate at about RUB280 billion-RUB300 billion.

Principal liquidity uses:

- A very large capital expenditure program, which we estimate will exceed RUB300 billion.
- Short-term maturities of about RUB75 billion.
- Moderate dividends.

Outlook

The negative outlook on Transneft reflects our outlook on the sovereign. A one-notch downgrade of Russia would lead us to take a similar rating action on Transneft, all else being equal.

Downside scenario

We would likely lower the ratings on Transneft if we were to lower the sovereign ratings. This is because we currently cap the ratings on Transneft at the level of our ratings on Russia (foreign currency BB+/Negative/B; local currency BBB-/Negative/A-3), given its GRE status with a very strong link to and critical role for the government. We also incorporate our view of the risk of negative government intervention if the government is under stress. Therefore, we do not expect to rate Transneft above the sovereign.

If the company's SACP were revised down to 'bb', provided that the sovereign ratings and the level of support remain unchanged, we would lower the local currency rating on to 'BB+'. We could lower the foreign currency rating to 'BB' if the SACP fell below 'bb-'. This could occur if the company took on debt-financed investments or dividends markedly larger than our current base-case assumptions.

Upside scenario

We would likely revise our outlook on Transneft to stable if we revised the outlook on Russia to stable.

Ratings Score Snapshot

Corporate Credit Rating:

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

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: FC BB+/Negative/--; LC BBB-/Negative/--
- Likelihood of government support: Extremely high

Related Criteria And Research

- Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

OA0 AK Transneft

Corporate Credit Rating

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Foreign Currency	BB+/Negative/--
Local Currency	BBB-/Negative/--
Senior Unsecured	BB+

TransCapitalInvest Ltd.	
Senior Unsecured	BB+

Additional Contact:

Industrial Ratings Europe; Corporate_Admin_London@standardandpoors.com

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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