JSC Investgeoservis (/gws/en/esp/issr/96583020)

FitchRatings

Fitch Rates Russia's Investgeoservis 'B+'; Outlook Stable

Fitch Ratings-Moscow/London-18 January 2018: Fitch Ratings has assigned Russia-based oil drilling company JSC Investgeoservis (IGS) 'B+' Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) with Stable Outlook.

The 'B+' IDR reflects IGS's small scale and limited customer and geographical diversification. The company is a privately-owned oilfield services provider operating predominantly in the Yamal region and specialising in natural gas-rich wells. IGS performs primarily horizontal drilling services and its main customer, PAO Novatek (BBB/Stable), and its JVs accounted for 63% of metres drilled in 2016.

The ratings also reflect our expectation that the company's financial profile will remain conservative in 2017-2021, with funds from operations (FFO) fixed charge coverage maintained at above 3.5x and FFO adjusted net leverage below 2.5x under our base rating case.

KEY RATING DRIVERS

Limited Scale and Geographical Diversification: IGS's small scale and geographical concentration are key constraints for the ratings. The group has a fleet of 22 drilling rigs and we estimate its shares of the Russian onshore and horizontal drilling markets at around 1% and 2% respectively. This is partly mitigated, in our view, by IGS's stronger position in the Yamal region where its market share by volume was an estimated 15% in 2015 and where 16 of its 22 rigs were located as of mid-2017.

Our rating case assumes limited competitive pressures in the region as the dominant player, Gazprom Burenie, mainly caters to PJSC Gazprom (BBB-/Positive). The company's strategy is to gradually increase the number of rigs it operates and to enhance geographical diversification.

Reliance on Novatek: Although IGS has diversified away from Novatek, its only customer prior to 2014, its exposure to the group remains high with 63% of total metres drilled in 2016. IGS's customer base also includes companies owned by Rosneft Oil Company, PJSC Gazprom Neft (BBB-/Positive) and other upstream players.

Our base case assumes that the revenue stream from Novatek will remain around 70% in 2017-2021. This is partly mitigated by the long-standing relationship between both companies, IGS's specialisation in complex gas wells and strong track record on Novatek's drilling programmes, including the recently completed Yamal LNG project. We estimate that IGS's share of Novatek's metres drilled (incl. JVs) increased to 66% in 2016 from 38% in 2014.

FCF Drives Deleveraging: Our base case forecasts positive free cash flow (FCF) generation in 2017-2021 on the back of low single-digit revenue growth, EBITDA margins at around 19% and annual capex at around RUB1 billion. IGS's capacity to generate positive FCF through the cycle is supported by the nature of the company's capital investments, which provides IGS with the flexibility to reduce capex if it does not see opportunities of new drilling projects. Our base case assumes dividend distributions of at least RUB300 million p.a. from 2018 onwards, and we expect IGS to partially utilise available cash flows to repay its debt as some of its loan covenants will tighten in 2018.

Limited Revenue Visibility: Although IGS benefits from long-term turnkey contracts with Novatek and its JVs, its revenue is still subject to volatility. IGS's order book provides limited visibility in terms of future drilling volumes and days because its customers normally have sufficient latitude to optimise their drilling programmes, which is common in the Russian oilfield services market.

Contracts agreed for 2018 cover more than 70% of the revenue forecast under our base case, but upstream companies can cut their orders with limited penalties to be paid. In mitigation, Fitch deems drilling volume reduction unlikely in the medium term in Russia as local oil and gas producers, and Novatek in particular, are set to continue developing greenfield projects in response to output declines at mature fields.

Shareholder Distributions Assumed: As a privately-owned company, IGS is not committed to paying dividends and its track record suggests that the company prioritises development and value build-up over shareholder distributions. The company paid RUB500 million in dividends in 2015 as part of an agreement with Gazprombank JSC (GPB, BB+/Positive), when the bank exercised its option to sell its 40% stake in IGS. In the absence of a clearly defined dividend policy, we also conservatively assume dividend payments of at least RUB300 million p.a. in 2018-2021.

Treasury Shares Sale: IGS plans to sell the 40% stake currently held as treasury shares to an investor or carry out an IPO of the shares in the medium term. We do not incorporate the share sale in our rating case.

DERIVATION SUMMARY

IGS has significantly smaller scale than Eurasia Drilling Company Limited (EDC, BB/Stable), the largest independent Russian drilling company. EDC's metres drilled and EBITDA were almost 19x higher than those of IGS in 2016. IGS's business profile benefits, however, from a focus on higher-value-added horizontal drilling. Both IGS and EDC have high reliance on a single customer, but benefit from long-term agreements with Novatek and PJSC Lukoil (BBB+/Stable), respectively.

We estimate both EDC's and IGS's EBITDA margins at around 25% in 2017. Both companies have a comparable leverage profile with FFO adjusted net leverage below 2.5x, although we expect faster deleveraging for EDC. IGS's rouble income is matched by the company's rouble debt, while EDC is exposed to a currency mismatch. As EDC's debt is mostly in US dollars, which has lower interest payments, it has substantially better coverage ratios than IGS. Overall, we view IGS's and EDC's financial profiles comparable. The rating difference is explained by IGS's smaller size and market share as well as lower regional diversification.

Both companies' ratings also take into consideration the higher-than-average systemic risks associated with the Russian business and jurisdictional environment.

KEY ASSUMPTIONS

Fitch's Key Assumptions within our Rating Case for the Issuer Include:
- Metres drilled growing to around 300 thousand by 2021 from 254 thousand in 2016;
- Average price indexation of low single digits annually;
- Growing share of day rate contracts;
- Capex averaging RUB1 billion in 2017-2021; and
- Dividends of at least RUB300 million p.a. in 2018-2021.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
- We believe that IGS's limited scale and diversification are commensurate with a credit profile in the 'B' category and no further positive action is likely without a fundamental change in its business profile.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- Share of Novatek and its affiliates in total revenue consistently above 80% with evidence of customer-driven pressure on earnings and operating cash flows.
- FFO margin consistently below 10% (2016: 11%).
- FFO fixed charge coverage sustainably lower than 2.5x (2016: 2.9x).
- FFO adjusted net leverage sustainably exceeding 4x (2016: 3.1x).

LIQUIDITY

Adequate Liquidity, Manageable Debt Amortisations: IGS's short-term debt of RUB1.4 billion at 15 December 2017 was covered by a cash balance of RUB0.1 billion, Fitch-projected FCF of RUB1.2 billion and available long-term uncommitted credit lines from Russian banks of RUB1.2 billion. In the near future, IGS intends to re-negotiate a RUB0.5 billion undrawn credit facility that expired in December 2017. Gross debt amounted to RUB7.9 billion at 15 December 2017 and we expect the amortisation profile to remain manageable, with annual repayments below RUB2.5 billion, and positive FCF in 2019-2021 under our base case.

IGS's main bank loans are subject to financial covenants, some of which will tighten in 2018. We expect headroom to remain comfortable over 2018-2021 as debt is gradually reduced. During 2017, IGS reduced its exposure to GPB by RUB2.5 billion from RUB5 billion at end-2016. In December 2017, the company also made an early repayment on a RUB0.4 billion loan.

Limited FX Risks: IGS has minimal exposure to foreign currency fluctuations as its revenue, costs and debt are linked to roubles. FX changes may modestly affect the company's capex size.

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Date of Relevant Rating Committee: 26 December 2017.

Summary of Financial Statement Adjustments - No significant adjustments.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Criteria (pub. 07 Aug 2017) (https://www.fitchratings.com/site/re/901296)
Country-Specific Treatment of Recovery Ratings (pub. 18 Oct 2016) (https://www.fitchratings.com/site/re/887669)
Exposure Draft: Corporate Rating Criteria (pub. 14 Dec 2017) (https://www.fitchratings.com/site/re/907387)
Exposure Draft: Sector Navigators (pub. 21 Dec 2017) (https://www.fitchratings.com/site/re/914221)
Non-Financial Corporates Notching and Recovery Ratings Criteria (pub. 21 Dec 2017) (https://www.fitchratings.com/site/re/914144)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/1035231)
Solicitation Status (https://www.fitchratings.com/site/pr/1035231#solicitation)
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Solicitation Status

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