Georgia | Oil & Gas
Georgian Oil and Gas Corp
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Georgian Oil and Gas Corporation

Getting more Georgia

State-owned GOGC placed a debut 5-year US$ 250mn Eurobond at 7.125% YTM in May 2012. Active interest from investors points to their conviction in both the Georgian macroeconomic story and the company's prospects. Staunch government support and a solid cash flow generating profile leave us comfortable with GOGC's ability to respect Eurobond covenants and service the debt.

Continued active investor interest in Georgia

Georgian issuers are benefiting from active investor interest due to the country's prospects for continued economic growth and its low debt profile. At 34%, Georgia has one of the lowest general government debt-to-GDP levels among Eastern European peers, while the economy expanded 7% in 2011. In 2011, leading rating agencies upgraded the Georgian sovereign from B+ to BB-. Moreover, we view priced-in risk premiums on the back of Europe's debt crisis as excessive and believe Georgian exposure remains attractive.

Staunch state support

GOGC is the largest gas supplier to the domestic market, contributing around 1% of Georgia's GDP. Fully state-owned, the company enjoys staunch support from the government in the form of considerations of financial needs in setting dividend policy, equity contributions, and more. We believe the government will continue supporting GOGC's efforts to maintain an adequate liquidity profile.

Stable, solid cash flow

Visibility for GOGC's revenues is high owing to long-term gas supply and consumption contracts and fixed prices, and we see revenues growing at a 10% CAGR over 2012-17, mainly driven by the construction of new hydro plants. Gas sales (78% of 2011 revenues) are set to remain the main cash flow driver until the new hydropower production assets are brought online in 2015. Cash flow should further benefit from additional pipeline capacities in 2018. Our model shows GOGC comfortably adhering to all Eurobond covenants.

Hydropower to boost profitability

Proceeds from the Eurobond placement are earmarked for the construction of two new hydropower plants with 200 MW of installed capacity. Once fully operational, the high-margin assets will spur cash flow and add up to US$ 81mn in revenues (34% of total) in 2016, according to our estimates. High electricity prices in Turkey, projected strong demand, geographic location, and low costs should allow GOGC to export electricity and generate high margins.

Note: Please see a list of terms and definitions on page 21 of this report.

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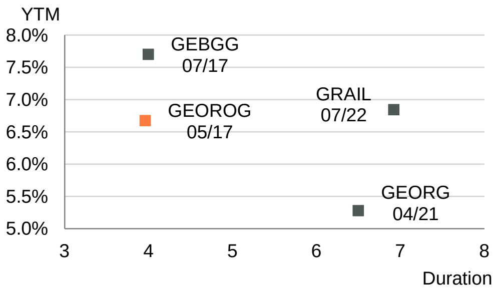
Georgian Eurobond universe



Source: Bloomberg

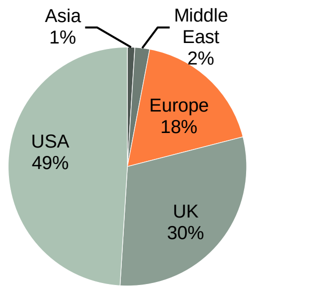
Georgian Eurobond parameters

	GOGC 05/17	Georgia 04/21	GR 07/22	BoG 07/17
Amt., US$ mn	250	500	500	250
Issue date	05/12	04/11	07/12	07/12
Maturity date	05/17	04/21	07/22	07/17
Coupon	6.875%	6.875%	7.750%	7.750%
Fitch/S&P/ Moody's	BB-/B/-	BB-/BB- /Ba3	BB- /BB-/-	BB-/BB- /Ba3
YTM(1)	6.67%	5.28%	6.84%	7.70%

(1) YTM as of August 3, 2012

Source: Bloomberg

GEOROG investors at placement by region



Source: Company data

Key financials (US$ mn) and ratios

	FY10	FY11	FY12E
EBITDA*	43.0	67.7	70.7
EBIT	56.3	71.7	58.7
Net income	44.7	67.7	57.4
Assets	228.8	255.4	517.5
Equity	195.4	214.6	260.6
Debt	6.3	6.6	247.7
EBITDA margin*	44.5%	47.6%	50.3%
EBIT margin	58.2%	50.4%	41.7%
Net debt/EBITDA*	-0.6 x	-0.2 x	0.3 x
Interest coverage*	4.3 x	55.4 x	6.0 x

**Excluding impairment loss reversal*
Source: Company data, Bank of Georgia Research

Company Overview

State-owned GOGC supplies gas to the domestic market. It holds the legal status of a National Oil Company and represents the state's interests in upstream crude oil and natural gas projects in Georgia via Production-Sharing Agreements (PSAs). GOGC is responsible for ensuring the security of gas supply to Georgia and accounts for around 1% of Georgia's GDP. GOGC employs over 2,000 people including contractors and sub-contractors.

GOGC was established to consolidate Georgia's energy assets under single management. GOGC was set up following the merger of two state-owned companies, Georgian International Oil Corporation (GIOC) in 2006 and Georgian Gas International Corporation (GGIC) in 2007. The Ministry of Energy and Natural Resources (MENR) holds the company's management rights and chairs GOGC's supervisory board.

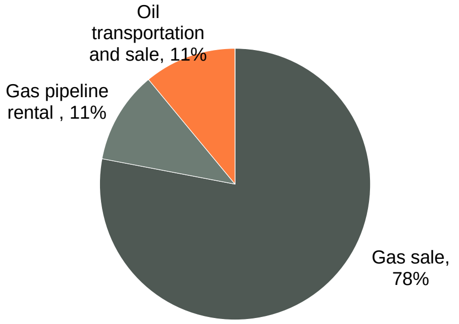
GOGC represents the state in international energy transit projects like the Western Route Export Pipeline (WREP), the Baku-Tbilisi-Ceyhan oil pipeline project (BTCP) and the South Caucasus Pipeline project (SCP).

GOGC owns Georgia's two key pipelines – the Main Gas Pipeline System (MGPS) and the Georgian section of Western Route Export Pipeline (WREP).

- The MGPS is a network of 4 gas pipelines, including the North-South Gas Pipeline (NSGP), which transports gas from Russia to Armenia, and three internal distribution pipelines. The MGPS accounted for 48% of Georgia's total gas transportation volumes (both internal transport and transit) in 2011.
- The WREP transports crude oil from Azerbaijan to the Black Sea coast for further shipping to global markets. The pipeline accounted for 12% of Georgia's total oil transportation volumes in 2011.

Gas sales account for the lion's share of GOGC's revenues (78%), with the balance coming from crude oil transport and sales (11%) and gas pipeline rentals (11%).

Figure 1: Breakdown of GOGC's revenue by sources, 2011



Source: Company data, Bank of Georgia Research

GOGC plans to expand and diversify its business by entering the electricity production segment by building a 200 MW hydropower plant (HPP) cascade. The cascade will consist of two HPPs: the Tvishi and Zhoneti plants, each with installed capacity of 100 MW. Construction is expected to start in Q3 2012 and be completed in 2015. GOGC estimates the total project cost at GEL 460mn (US$ 282mn at GEL/US$ exchange rate of 1.63).

Note: Please see Appendix for additional information on Georgia's pipeline network on page 16 of this report.

Overview of Business Lines

Gas Supply

GOGC is the major gas importer in Georgia. In 2011, GOGC imported 51% of Georgia's total gas consumption. The imported gas is then sold to the wholesaler, SOCAR Gas Export Import, which resells the gas to distribution companies. The remaining 49% of gas consumed in Georgia is imported by SOCAR directly. In 2011, Georgia consumed 1,782 mmcm of gas. Georgia's domestic consumption is mainly met by imports from Azerbaijan through the SCP and from Russia through the NSGP.

GOGC's gas purchase price is fixed by long-term purchase contracts. The company has long-term contracts with the operators of the two abovementioned pipelines and it also receives gas via PSAs.

- **Georgian Gas Transportation Company (GGTC) Agreement** – GOGC buys all the gas received by GGTC (state-owned operator) at a fixed price of US$ 110/mcm. As the operator of the MGPS, GGTC receives 10% of all the natural gas transported from Russia to Armenia via the NSGP as an in-kind transit fee. In 2011, GGTC sold up to 19% of the total gas bought by GOGC.

- **South Caucasus Pipeline (SCP) Option Gas Agreement** – GOGC has the right (but not the obligation) to purchase up to 5% of the natural gas transported through Georgia via the SCP. SCP Option Gas Agreements accounted for 26% of GOGC's total gas purchases in 2011.

- **SCP Supplemental Gas Agreement** – GOGC receives a fixed amount of gas from the Azerbaijan Gas Supply Company (AGSC) at a fixed price through the SCP. The agreement accounted for around 55% of GOGC's total gas purchases in 2011.

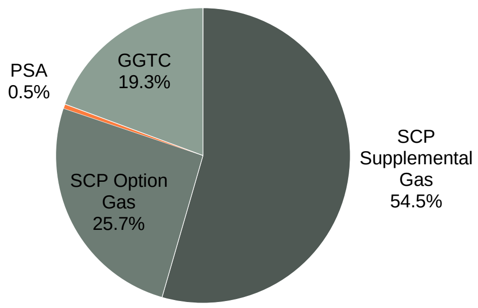
- **PSAs** – as a National Oil Company (NOC), GOGC received 2.0 mmcm of the Georgian state's share of extracted natural gas, and it purchased 2.3 mmcm of natural gas from investor companies at a price of US$ 140/mcm. PSAs account for only 0.5% of GOGC's total gas purchases.

Table 3: Terms of gas supply agreements signed by GOGC

Agreement	Duration	Price	Amount
GGTC Gas Sales Agreement	8 1/3 years	US$ 110/mcm	10% of gas transported through the NSGP
SCP Supplemental Gas Agreement	20 years	Initially fixed at US$ 55/mcm, subject to an annual 1.5% increase and further adjustments depending on the calorific value of the natural gas. As of 2011, the average purchase price was US$ 65.6/mcm	2006: 15 mmcm 2007-2008: 250 mmcm 2009-2010: 300 mmcm 2011-2025: 500 mmcm
SCP Option Gas Agreement	60 years	US$ 50.0/mcm, subject to an annual 2.0% increase. As of 2011, the average purchase price was US$ 52.0/mcm	5.0% of the natural gas transported through the SCP pipeline

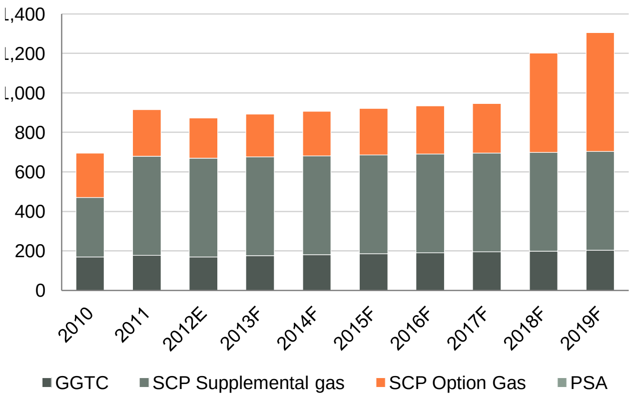
Source: Company data

Figure 2: GOGC's gas supply breakdown by sources, 2011



Source: Company data

Figure 3: Forecasts of GOGC's gas supply by sources, mmcm

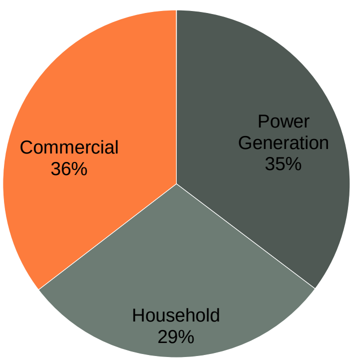


Source: Company data

We see Georgian gas consumption growing at an average annual 4% rate, 1.6ppts lower than the IMF's GDP growth projections of 5.6% until 2017. Households and the commercial sector will drive the growth, while the share of thermal power plants (35% of consumption in 2011) will remain around current levels, in our view. The development of free industrial zones in Poti and Kutaisi are likely to boost demand from the commercial sector, while thermal power is unlikely to be developed further due to its cost disadvantages vs. higher-margin hydro. Commercial gas is fully deregulated and prices are set by the market, while social gas tariffs are set by an independent regulator. Additional gas received after the SCP's expansion will allow GOGC to sell gas to commercial consumers and will contribute an estimated 30% of total gas revenues in 2019.

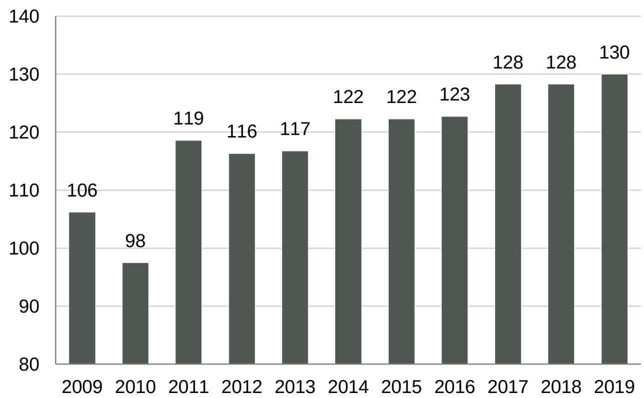
Armenian and Turkish gas consumption is likely to rise in-line with GDP growth. The region's continued economic development will require more gas transit, thus increasing GOGC's gas supplies. We expect the volume of gas transported from Russia to Armenia to increase on average 3% per year until 2019 (based on IMF forecasts of 4% average annual GDP growth in Armenia) and we expect natural gas volumes transported to Turkey through the SCP to grow 3.25% annually until 2017 (based on IMF forecasts of 3.8% annual average GDP growth in Turkey). The SCP is slated to increase its capacities after the completion of the second phase of the Shah Deniz project, expected to be completed in 2018.

Figure 4: Breakdown of Georgian natural gas consumption



Source: Company data, Bank of Georgia Research

Figure 5: Price of GOGC gas sales to SOCAR, US$/mcm



Source: Company data, Bank of Georgia Research

Limited sales risks, but single counterparty exposure is significant. SOCAR Gas Export-Import is currently the only wholesaler for all domestic gas traded in Georgia. Despite the obvious counterparty risk, we believe SOCAR is highly unlikely to exit the Georgian market over the medium term. Even if SOCAR decides to exit Georgia we believe it could be replaced by the GOGC or other operator, without a significant impact on the company's operations.

Table 4: Volumes and average price of natural gas sold by GOGC

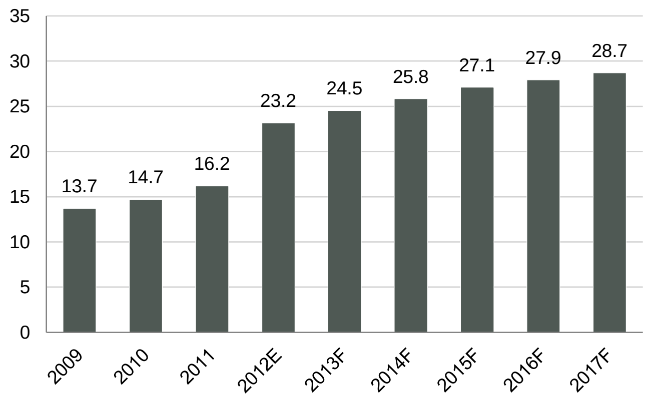
	2009	2010	2011
Volume (mmcm)	629.8	698.3	920.1
Average sales price (US$ per mcm)	106.2	97.5	118.6

Source: Company data

Pipeline Rental

Stability of rental revenues helped by long-term pipeline rental agreement. GGTC, as the operator of the MGPS, pays GOGC monthly rental fees of US$ 6.5/mcm for gas transported through the pipeline. Under the rental contract the fee will gradually increase to US$ 6.8/mcm in 2015. The agreement is due to expire in January 2020.

Figure 6: GOGC revenues received from GGTC, US$ mn



Source: Company data, Bank of Georgia Research

GOGC is responsible for capex on the MGPS, while operating and maintenance costs are covered by GGTC. Over 2007-2009, GOGC renovated 235 km of the NSGP, which more than doubled the NSGP's annual throughput capacity and reduced natural gas losses. Construction costs were funded by a grant from the Millennium Challenge Corporation (MCC). To increase the capacity of the Southern Branch, the Kakheti Branch, and the East-West Gas Pipeline (EWGP), GOGC has launched expansion and rehabilitation projects at an estimated cost of US$ 196.1mn. Nearly 41% of the costs are expected to be covered by USAID contributions, with the balance financed by internal cash flow.

Oil transportation and sale

WREP-transported oil volumes likely to remain stable. Oil transport and sales account for around 11% of GOGC's total revenues. According to a 30-year contract signed in 1996, GOGC as the owner of the WREP received from the Georgian Pipeline Company (GPC) a tariff of US$ 0.23/bbl of oil in 2011 for 28.3mn bbl transported. The WREP currently operates at 70% capacity load. Despite competing pipelines including the BTC, Caspian Pipeline Consortium Pipeline, and the Baku-Novorossiysk Pipeline, we believe current transportation volumes are sustainable, as the WREP's transportation fees are lower than other competing pipelines.

As a National Oil Company, GOGC has the right to manage, receive, and use income from PSAs. Crude oil from PSAs is sold directly to the market at market prices (average US$ 103/bbl in 2011).

Hydropower

Hydropower will boost liquidity and will account for 34% of total revenues in 2016, according to our estimates. Turkey's high electricity prices and its proximity to Georgia, as well as Georgia's low hydropower production costs, set a strong base for prospective electricity exports to Turkey. According to the Turkish Electricity Transmission Corporation, electricity demand in Turkey is expected to grow on average 7% annually with average electricity prices at around US$ 90/MWh vs. GOGC's US$ 25-30/MWh hydropower generation costs (including D&A costs). In our model we estimate that the HPP project will be fully equity funded.

Table 5: Key parameters related to hydro electricity and hydro power plants

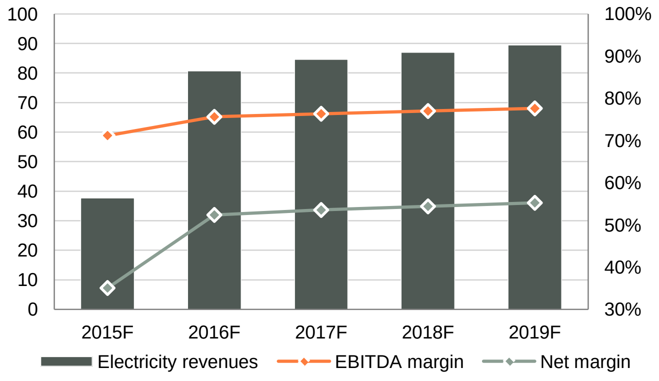
	2015F	2016F	2017F	2018F	2019F
Tariff, US$/MWh	84	87	89	92	95
Power output, GWh	425	884	901	901	901
Capacity, MW	200	200	200	200	200
Capacity use	50%	52%	53%	53%	53%

Source: Bank of Georgia Research

GOGC intends to use proceeds from its debut Eurobond sale to partially fund the construction of two HPPs with 200 MW total installed capacity, or annual generation of 901 GWh.

GOGC's prospects for selling electricity look strong. In addition to exports to Turkey, the domestic market is also able to absorb additional generating capacities. The Electricity System Commercial Operator (ESCO), which is responsible for balancing the electricity market in Georgia, is committed to purchasing electricity from the HPPs at US$ 60/MWh until 2025 following the launch of the HPP. With operating costs at around US$ 32/MWh, we estimate HPPs will be able to generate a 52% net margin in 2016. We also expect 80% of its hydropower will be sold to Turkey during the winter at an average of US$ 90/MWh as the latter is expected to have a deficit of 118 TWh by 2020, according to the Turkish Electricity Trading and Contracting Company. The remaining 20% should be set aside to meet local demand. We estimate GOGC will sell electricity at an average US$ 84/MWh tariff in 2015.

Figure 7: Projected HPP revenues (US$ mn) and margins

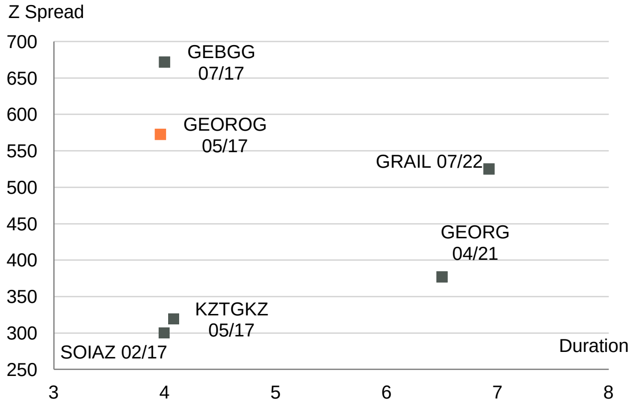


Source: Bank of Georgia Research

Debut Eurobond Issue

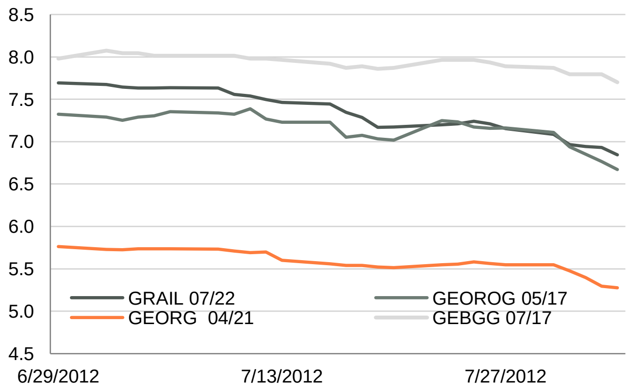
On May 16, 2012, GOGC completed a debut US$ 250mn Eurobond placement. The 5-year notes carry a 6.875% coupon and were issued at 98.964% of face value, resulting in 7.125% yield to maturity. The placement yield was the lowest for any Georgian corporate and equaled the placement yield of Georgia's 10-year Eurobond issued in April 2011. The final order book captured interest from over 100 accounts in 20 countries and was nearly 4x oversubscribed. Proceeds will be used to construct two HPPs with total installed capacity of 200 MW.

Figure 8: Comparable Eurobonds



Source: Bloomberg

Figure 9: Georgian Eurobonds YTM



Source: Bloomberg

Table 6: Comparable Eurobonds

Issuer	Ticker	Amount, US$ mn	Coupon	Maturity date	Ratings (Fitch/S&P/Moody)	Mid price, US$	Mid yield, %	Z-spread
Bank of Georgia	GEBGG 07/17	250	7.75%	05/07/2017	BB-/BB-/Ba3	100.19	7.70	671.90
Georgia Sovereign	GEORG 04/21	500	6.88%	12/04/2021	BB-/BB-/Ba3	111.00	5.28	377.10
Georgian Railway	GRAIL 07/22	500	7.75%	11/07/2022	BB-/BB-/-	106.45	6.84	525.20
GOGC	GEOROG 05/17	250	6.88%	16/05/2017	BB-/B/-	100.80	6.67	572.70
Intergas Central Asia	KZTGZ 05/17	540	6.38%	14/05/2017	BB+/BB+/Baa3	110.25	4.00	319.20
SOCAR	SOIAZ 02/17	500	5.45%	09/02/2017	BBB-/BB+/Ba1	106.50	3.86	300.50

Source: Bloomberg

Table 7: Key terms of GOGC debut Eurobond (GEOROG 05/17)

Ratings:	B Stable (S&P) / BB- Stable (Fitch)
Issue format:	RegS / 144A
Issue size:	US$ 250,000,000
Pricing date:	9-May-12
Maturity date:	16-May-17
Coupon:	6.88%
Price:	98.96%
Yield:	7.13%
Benchmark:	UST 0.875% due April 30, 2017
Spread to benchmark:	637.5bps
Spread to mid swaps:	604.5bps
Joint lead managers:	Goldman Sachs, J.P. Morgan
Governing law:	English
Listing:	London Stock Exchange

Source: Bloomberg

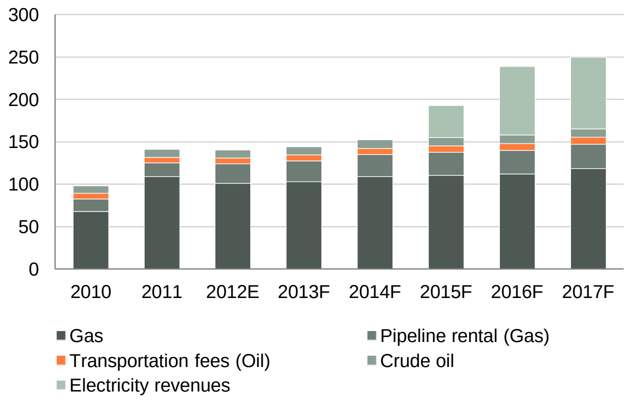
Key covenants

- Notes are unsecured and unsubordinated.
- In case of change of control (if the state sells 50%, directly or indirectly) noteholders have the right to require early redemption.
- The company is required to provide full-year audited IFRS financial statements within 6 months and unaudited interim financial statements within two months.
- Net debt-to-EBITDA capped at 3.5x.
- Limitation on the disposal of core assets – the Main Gas Pipeline System and the Western Route Export Pipeline, subject to a materiality threshold of 10% of core asset book value, but excluding the forthcoming investment in a new hydroelectric power plant.

Financial and Credit Analysis

We see revenues growing at a 10% CAGR over 2012-17, mainly driven by new HPPs. The HPPs will boost sales by 57% from 2014 to US$ 239mn in 2016. In 2011, revenues increased 47% y/y to US$ 142mn supported by a 60% y/y increase in gas sales to US$ 109mn. Pipeline rental fees grew 10% y/y to US$ 16mn, while revenues from oil transport and sales remained modest, up just 3% y/y to US$ 15.7mn. In 2011, gas trading accounted for 78% of revenues, followed by pipeline rental, and oil transport and sales (11% each). The new hydro assets should diversify revenue sources once operational in 2016 – our projections show hydropower accounting for 34% of 2016 revenues, with gas trading down to 47%, and pipeline rental and oil transport holding 11% and 7% shares, respectively.

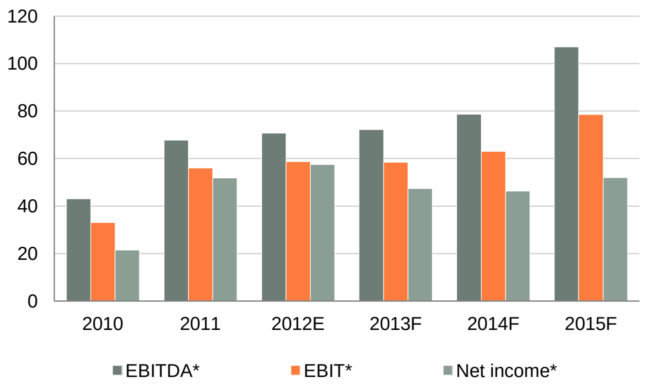
Figure 10: Revenue growth forecast, US$ mn



Source: Company data, Bank of Georgia Research

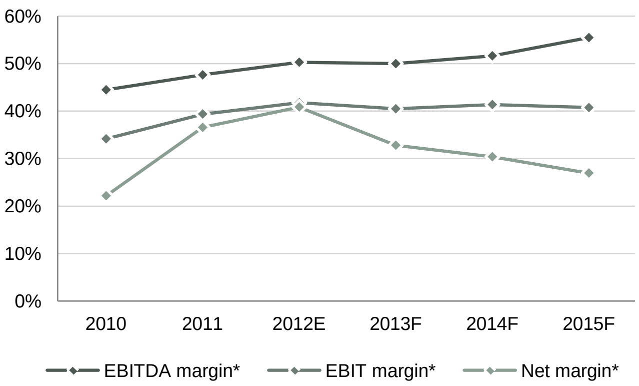
Profitability margins will remain lofty. EBITDA margin (excluding impairment loss reversals) was 47.6% in 2011 up 3.1ppts y/y, supported by increased natural gas sales. In 2012-2014, we see the EBITDA margin remaining at around 50% but rising further from 2015 due to the launch of new HPPs and the expansion of the SCP. Net margin (excluding impairment loss reversals) grows in 2012 and then gradually decreases until 2015 due to increased interest expenses. The margin rebounds in 2016 after the HPPs become fully operational.

Figure 11: Profitability, US$ mn



**Excluding impairment loss reversal*
Source: Company data, Bank of Georgia Research

Figure 12: Profitability margins



**Excluding impairment loss reversal*
Source: Company data, Bank of Georgia Research

We expect no significant FX-related impact on costs. The company's exposure to FX risks is limited as gas purchase/sale prices and transportation tariffs are largely fixed in US$.

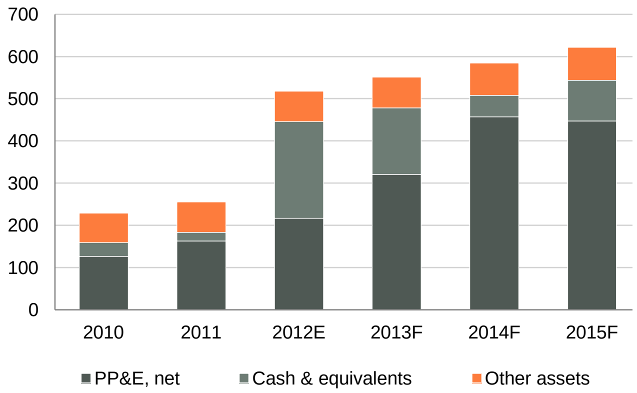
Table 8: FX rate change on interest coverage ratio

	2012	2013	2014	2015	2016	2017
-15%	5.7 x	3.1 x	3.3 x	4.4 x	6.7 x	14.2 x
-10%	5.8 x	3.2 x	3.4 x	4.4 x	6.5 x	13.9 x
-5%	5.9 x	3.3 x	3.5 x	4.4 x	6.4 x	13.7 x
0%	6.0 x	3.3 x	3.6 x	4.4 x	6.3 x	13.5 x
5%	6.1 x	3.4 x	3.6 x	4.5 x	6.3 x	13.3 x
10%	6.2 x	3.4 x	3.7 x	4.5 x	6.2 x	13.2 x
15%	6.2 x	3.5 x	3.7 x	4.5 x	6.1 x	13.0 x

Source: Bank of Georgia Research

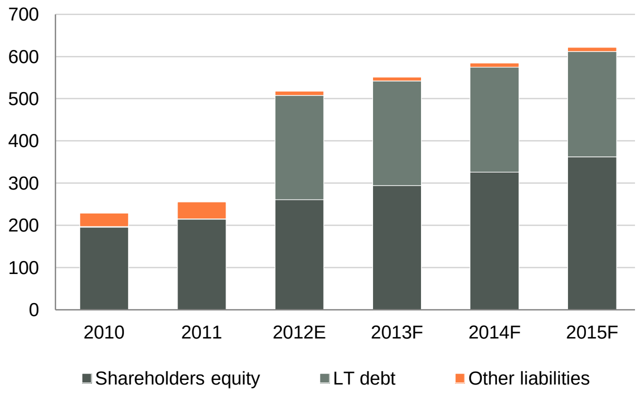
Reasonably leveraged with debt-to-equity at less than 1x in 2012, up from 0.03x before the bond sale. We don't expect more debt in the mid-term and we see debt-to-equity decreasing gradually to 0.6x in 2016, prior to debt redemption in 2017.

Figure 13: Asset structure, US$ mn



Source: Company data, Bank of Georgia Research

Figure 14: Equity and liabilities structure, US$ mn



Source: Company data, Bank of Georgia Research

Sufficient cash flow to fund capex. We estimate capex needs at around GEL 604mn (US$ 370mn at GEL/US$ exchange rate of 1.63) over the next 5 years: 76% for the construction of two HPPs and 24% for pipeline extension and rehabilitation projects. The full Eurobond proceeds are earmarked for the construction of the HPPs, while the remaining capex will be financed by internal cash flow and USAID funding.

Table 9: Planned capex, US$ mn

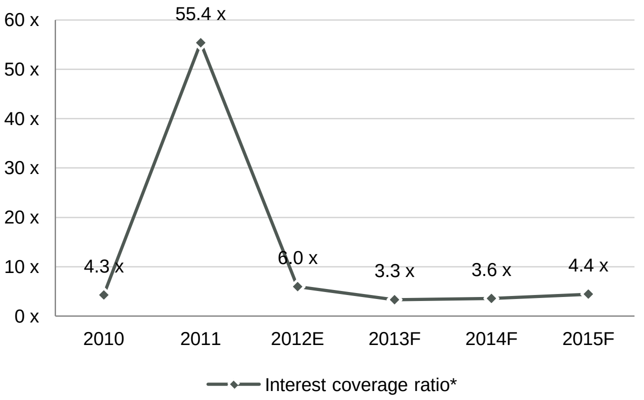
	2012E	2013E	2014E	2015E	2016E
Extension and rehabilitation of EWGP	3.7	0.0	14.1	17.4	18.8
Gasification and other projects	7.2	19.1	0.9	0.9	0.9
HPPs	46.8	97.7	137.8	0.0	0.0
Svaneti transmission line	4.9	0.0	0.0	0.0	0.0
Total capex	**62.6**	**116.9**	**152.8**	**18.3**	**19.7**

Source: Company data

No issues with Eurobond covenants. We estimate GOGC's FY12E net debt-to-EBITDA and gross debt-to-EBITDA at 0.3x and 3.5x, respectively. We see net debt-to-EBITDA growing over the next three years (to 2.5x in 2014, but with breathing room to the 3.5x covenant) and decreasing to 1.4x after the HPPs become operational in 2015 (HPPs become fully operational in 2016).

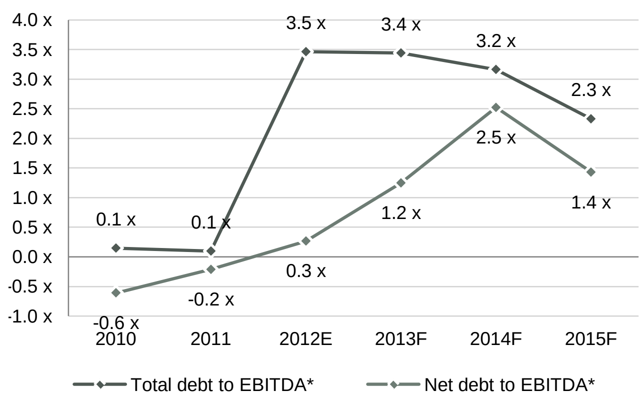
We see the interest coverage ratio decreasing to 6.0x in FY12E from 55.4x in FY11 as the company had nearly no debt on its balance sheet. The ratio should fall further to a trough of 3.3x in 2013. Beyond 2013, profitability growth should support the ratio at a sufficiently high level. From 2010 to 2011, the interest coverage ratio grew from 4.3x to 55.4x, as financial expenses decreased 88% y/y to US$ 1mn in 2011.

Figure 15: Interest coverage ratio



Excluding impairment loss reversal
Source: Company data, Bank of Georgia Research

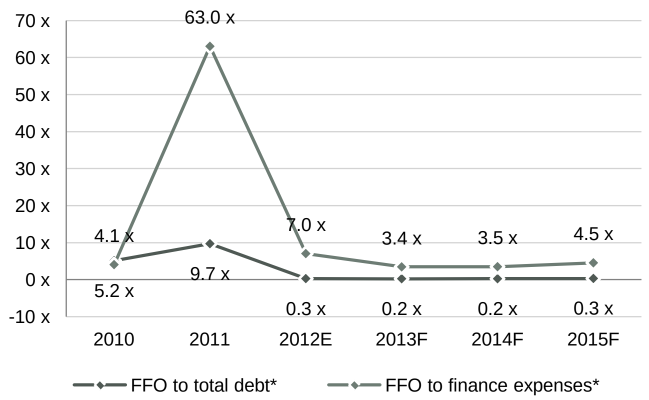
Figure 16: Debt/EBITDA ratios



Excluding impairment loss reversal
Source: Company data, Bank of Georgia Research

Liquidity position to improve further after HPP construction. We see GOGC's liquidity position weakening during the construction period due to negative Free Operating Cash Flows (FOCF) caused by high capex. We estimate funds from operations-to-total debt will decline to 0.2x in 2013 and start recovering in 2015 to 0.3x.

Figure 17: Liquidity

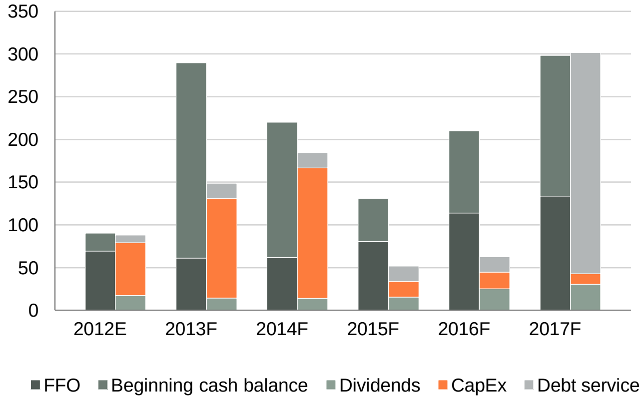


Excluding impairment loss reversal
Source: Company data, Bank of Georgia Research

We believe GOGC will have sufficient funds to repay the principal in 2017. Pursuant to a government decree, GOGC is barred from paying dividends in excess of 35% of net income; historically the dividend payout ratio hasn't exceeded 11%. If GOGC were to pay 35% of its annual net income as a dividend, our estimations show the company would need around US$ 18mn in short-term debt to fully repay its

Eurobond. In our model we assume a 30% dividend payout ratio per year, which would allow GOGC to make the redemption without additional funding.

Figure 18: Available cash vs. cash outflows, US$ mn



Source: Company data, Bank of Georgia Research

Rating Agencies

Fitch: Long-term BB- stable and short term B+ corporate credit rating. The decision is based on GOGC's strong government support. On a standalone basis the company's operations were rated B+. According to Fitch, the company has a solid and largely predictable cash flow generating profile.

Any revision of GOGC's corporate credit rating will largely depend on the sovereign rating. According to Fitch, GOGC's credit rating will track the sovereign, but this link will break down if the Georgian sovereign moves to investment grade.

S&P: long- and short-term B corporate credit ratings. According to S&P, GOGC will remain a strategically important asset for the government and it will enjoy solid state support. On a standalone basis, S&P sees the company's dependence on a single buyer as the key constraint of its credit rating.

Key Risks

Single counterparty exposure is the key risk. GOGC sells gas only to SOCAR Gas Export/Import. However, the single buyer issue does not reduce GOGC's leverage to negotiate on terms, as the relationship with SOCAR should be viewed against the background of broader energy policy interdependencies between Azerbaijan and Georgia.

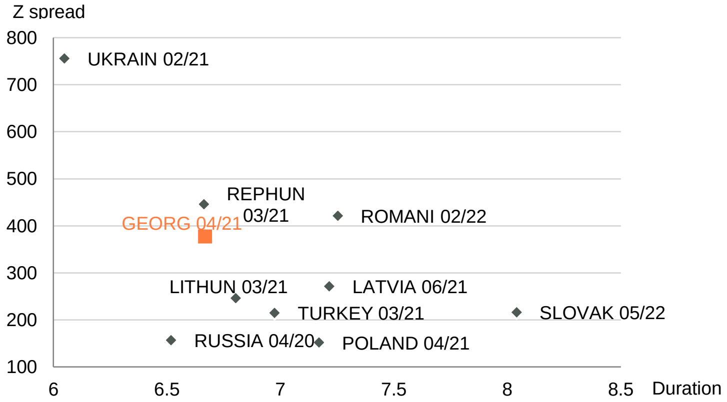
GOGC's plan to diversify to hydropower generation is also a key risk due to the company's lack of experience in the hydropower business. However, we believe the HPPs will strengthen the company's profitability profile, as Georgian hydropower assets enjoy high profitability margins.

Georgia Attracts Investor Interest

Georgian issuers are benefiting from strong investor interest due to the country's prospects for continued economic growth and its low debt profile. At 34%, Georgia has one of the lowest general government debt-to-GDP levels among Eastern European peers, while the economy expanded 7% in 2011. The government posted a 2011 budget deficit of 0.9% of GDP and the gap is expected to remain below 2% in the coming years. In 2011, leading rating agencies upgraded the Georgian sovereign from B+ to BB-, and the potential for further upgrades remains. Moreover, we believe risk premiums have been excessively priced in on the back of Europe's debt problems.

In our view, GRAIL and GEOROG carry similar fundamental risk, as the market perceives them to be supported by the Georgian sovereign. However, GOGC carries an illiquidity premium, while GRAIL is EMBI Index-eligible and therefore enjoys higher liquidity and support from index buyers. Also, as a standalone risk, GOGC is rated lower by S&P.

Figure 19: Z – spread and duration comparison



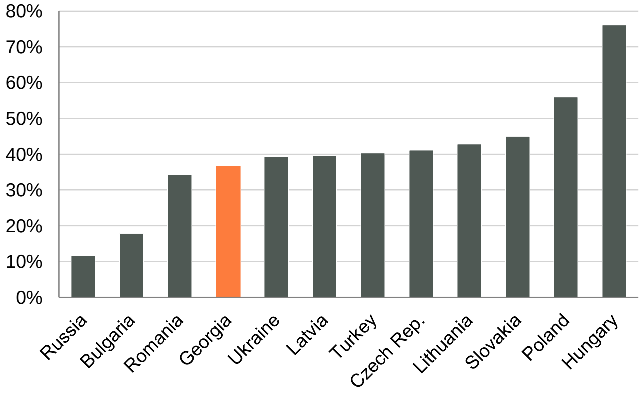
Source: Bloomberg

Table 10: Eastern European sovereign 10-year Eurobond performance

Issuer	Amount, US$ mn	Coupon	Maturity date	Ratings (Fitch/S&P/Moody)	Mid price, US$	Mid yield, %	Z-spread
Bulgaria	323	5.00%	19/07/2021	BBB/-/-	105.08	4.31	49.00
Czech Republic	2,000	3.88%	24/05/2022	A+e/-/A1	110.74	2.62	75.00
Georgia	500	6.88%	12/04/2021	BB-/BB-/Ba3	111.05	5.27	377.10
Hungary	3,000	6.38%	29/03/2021	BB+/BB+/Ba1	102.89	5.94	445.70
Latvia	500	5.25%	16/06/2021	BBB-/BBB-/Baa3	107.50	4.23	271.10
Lithuania	1,500	6.13%	09/03/2021	BBB/BBB/Baa1	115.68	3.95	245.90
Poland	2,000	5.13%	21/04/2021	A-/A-/A2	115.84	3.04	151.60
Romania	2,250	6.75%	07/02/2022	BBB-/BB+/Baa3	107.01	5.78	421.10
Russia	3,500	5.00%	29/04/2020	BBB/BBB/Baa1	114.22	2.93	156.50
Slovakia	1,500	4.38%	21/05/2022	A+/A/A2	104.76	3.79	215.80
Turkey	2,000	5.63%	30/03/2021	BB+/BB/Ba1	114.54	3.65	214.50
Ukraine	1,500	7.95%	23/02/2021	B/B+/B2	93.75	9.01	755.80

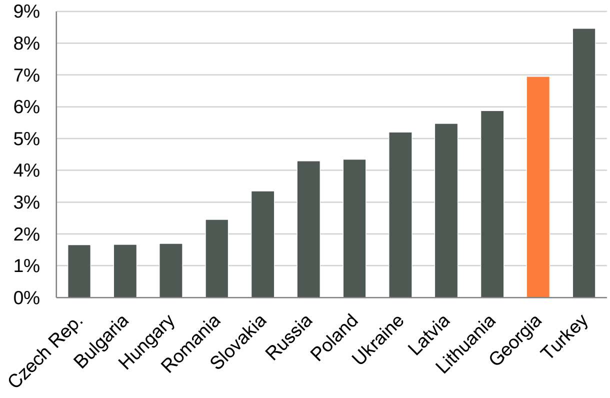
Source: Bloomberg

Figure 20: General government debt as % of GDP, 2011



Source: Bloomberg

Figure 21: GDP growth rate in 2011



Source: Bloomberg

Appendix: Pipeline Network

Georgia's geographical location favors GOGC's operations. Georgia's location makes it a transport corridor for natural gas and crude oil supplies to European markets, and the country offers the only route for the transport of Russian natural gas to Armenia. The transport corridor through Georgia allows the EU to diversify its supply, with Georgia representing the shortest route. In 2010, 60% of EU gas imports came from Russia, Norway, and Algeria. Georgia's favorable geographic location has prompted significant investments into its oil and gas transportation infrastructure in the past, including the construction of the SCP and the BTCP, the rehabilitation of the WREP by British Petroleum, and others.

Map 1: Map of gas pipelines in Georgia

Source: Company data, Bank of Georgia Research

Gas pipelines

Georgia's main natural gas pipelines are the Main Gas Pipeline System (MGPS) and the South Caucasus Pipeline (SCP).

Main Gas Pipeline System

The MGPS pipelines are operated by state-owned Georgian Gas Transportation Company (GGTC). GOGC holds exclusive purchase rights for gas from GGTC, which receives gas as an in-kind pipeline usage fee from the North-South Gas Pipeline (NSGP). The NSGP, which is a part of the MGPS, transports gas from Russia to Armenia, and other pipelines transport gas within Georgia. The MGPS includes four pipeline sections:

- North-South Gas Pipeline (NSGP)
- East-West Gas Pipeline (EWGP)
- Southern branch
- Kakheti branch

South Caucasus Pipeline

The SCP is owned and operated by the South Caucasus Pipeline Company (SCPC), itself owned by a consortium that includes BP and Statoil (25.5% each). The pipeline runs in the same corridor as the BTCP and transports natural gas from Azerbaijan to Turkey through Georgia and from Turkey further to the EU. The consortium plans to expand the pipeline's capacity by 2018.

Table 1: Gas pipelines in Georgia

Pipeline	Ownership	Operator	Route	Length, km	Capacity, per annum	Throughput, 2011
MGPS	GOGC (100%)	GGTC				
EWGP	GOGC (100%)	GGTC	National network	410	4 bcm	1.8 bcm
Southern Branch	GOGC (100%)	GGTC	National network	195	0.5 bcm	
Kakheti Branch	GOGC (100%)	GGTC	National network	345	0.5 bcm	
NSGP	GOGC (100%)	GGTC	Russia-Georgia-Armenia	235	12 bcm	1.6 bcm
SCP	SCPC	Technical: BP Commercial: Statoil	Azerbaijan-Turkey	692 (249 in Georgia)	8 bcm	3.7 bcm

Source: Company data

Oil pipelines

Georgia's main oil pipelines are the Western Route Export Pipeline (WREP) and the Baku-Tbilisi-Ceyhan Pipeline (BTCP).

Western Route Export Pipeline

The WREP transits crude oil from Azerbaijan to the Black Sea coast for onward shipping to global markets. The Georgian Pipeline Company (GPC) operates the section of the pipeline located in Georgia. BP Exploration (Caspian Sea) Limited (BP) acts as the technical operator. GOGC receives regular tariffs based on transported volumes of oil from GPC.

Baku-Tbilisi-Ceyhan Pipeline

The BTCP transits crude oil from Azerbaijan to Turkey on the Mediterranean Sea. The pipeline is owned by the Baku-Tbilisi-Ceyhan Pipeline Company, which is owned by a consortium of 11 international oil companies. GOGC does not own any part of the BTCP but acts as the representative of the Georgian state in the implementation of Environmental and Social Impact Assessment projects. The company receives no compensation for these activities.

Table 2: Oil pipelines in Georgia

Oil pipeline	Ownership	Operator	Route	Length, km	Capacity, per annum, mn tonnes	Throughput, 2011, mn tonnes
WREP	GOGC (100% of Georgian Section)	GPC, BP	Azerbaijan-Georgia (Black Sea coast)	833 (375 in Georgia)	7.6	3.8
BTCP	Baku-Tbilisi-Ceyhan Pipeline Comp.	BP	Azerbaijani-Georgia-Turkey	1768 (249 in Georgia)	60	30

Source: Company data

Financials

Income statement, US$ mn

	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
Net revenue	96.7	142.3	140.6	144.3	152.3	193.0	238.8	250.0
EBITDA[(1)]	43.0	67.7	70.7	72.1	78.6	107.0	142.5	151.8
EBITDA margin[(1)]	44.5%	47.6%	50.3%	50.0%	51.6%	55.4%	59.7%	60.7%
D&A	10.0	11.7	12.0	13.7	15.6	28.4	30.3	32.2
EBIT	56.3	71.7	58.7	58.4	63.0	78.6	112.2	119.6
EBIT margin	58.2%	50.4%	41.7%	40.5%	41.4%	40.7%	47.0%	47.8%
Financial expenses (income), net	5.0	-5.6	-8.9	2.7	8.6	17.4	14.0	0.0
Non-operating income/costs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
PBT	51.4	77.3	67.5	55.7	54.4	61.2	98.2	119.6
Tax expense	6.6	9.7	10.1	8.4	8.2	9.2	14.7	17.9
Net income	44.7	67.7	57.4	47.3	46.3	52.0	83.5	101.6
Net margin	46.3%	47.5%	40.8%	32.8%	30.4%	26.9%	35.0%	40.7%
Profit from discontinued operations	10.0	5.0	0.0	0.0	0.0	0.0	0.0	0.0
Net income after discontinued operations	54.7	72.7	57.4	47.3	46.3	52.0	83.5	101.6

[(1)] Excluding reversal of impairment losses of US$ 23.3mn in 2010 and US$15.7mn in 2011

Balance sheet, US$ mn

	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
Non-current assets	150.4	188.9	243.5	347.0	485.7	476.0	466.0	447.3
Net PP&E	126.8	162.6	217.1	320.3	457.5	447.3	436.8	416.7
Other	23.6	26.3	26.3	26.7	28.2	28.7	29.2	30.6
Current assets	78.4	66.4	274.0	204.3	99.0	145.7	214.9	55.5
Cash & equivalents	32.5	21.0	228.6	158.2	50.4	96.2	164.5	2.9
Receivables & prepayments	14.4	18.2	18.2	18.4	19.5	19.8	20.2	21.1
Other	31.5	27.2	27.2	27.6	29.1	29.7	30.2	31.5
Total assets	228.8	255.4	517.5	551.2	584.7	621.8	680.9	502.8
Shareholders equity	195.4	214.6	260.6	293.7	326.1	362.5	420.9	492.1
Non-current liabilities	5.8	6.8	254.0	254.6	255.5	256.2	256.8	7.4
LT interest bearing debt	1.3	0.4	247.7	248.2	248.7	249.2	249.7	0.0
Other	4.5	6.4	6.4	6.5	6.8	6.9	7.1	7.4
Current liabilities	27.6	34.0	2.8	2.9	3.0	3.1	3.1	3.3
ST loans	5.0	6.2	0.0	0.0	0.0	0.0	0.0	0.0
Trade payables & prepayments	1.7	1.6	1.6	1.6	1.7	1.8	1.8	1.9
Other	20.9	26.2	1.2	1.2	1.3	1.3	1.4	1.4
Total liabilities & equity	228.8	255.4	517.5	551.2	584.7	621.8	680.9	502.8

Cash flow, US$ mn

	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
Cash flows from operating activities	45.4	46.7	45.5	61.0	60.0	80.1	113.4	132.0
Net income	54.7	72.7	57.4	47.3	46.3	52.0	83.5	101.6
Depreciation and amortisation	10.7	12.4	12.0	13.7	15.6	28.4	30.3	32.2
Reversal of impairment losses	-21.4	-16.2	0.0	0.0	0.0	0.0	0.0	0.0
Change in working capital	-8.9	-20.9	-24.2	-0.6	-2.4	-0.9	-0.8	-2.1
Other	10.2	-1.2	0.3	0.5	0.5	0.5	0.5	0.3
Cash flows from investing activities	-8.8	-38.8	-61.2	-117.2	-154.3	-18.8	-20.2	-13.5
Capital expenditures	-8.3	-38.7	-61.2	-117.2	-154.3	-18.8	-20.2	-13.5
Other	-0.4	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Cash flows from financing activities	-9.0	-21.3	220.4	-14.1	-13.5	-15.5	-24.9	-280.2
Net borrowings (repayments)	-3.9	0.0	237.7	0.0	0.0	0.0	0.0	-250.0
Dividends paid	-5.1	-4.4	-17.2	-14.2	-13.9	-15.6	-25.0	-30.5
Other	0.0	-16.9	-0.2	0.1	0.4	0.1	0.1	0.3
Net cash inflows (outflows)	27.7	-13.3	204.6	-70.4	-107.8	45.8	68.3	-161.7
Beginning cash balance	4.9	32.5	21.0	228.6	158.2	50.4	96.2	164.5
Foreign currency translation gain (loss)	-0.1	1.9	3.0	0.0	0.0	0.0	0.0	0.0
Ending cash balance	32.5	21.0	228.6	158.2	50.4	96.2	164.5	2.9

Source: Company, Bank of Georgia Research

Financial ratios

	2010	2011	2012E	2013F	2014F	2015F	2016F	2017F
Profitability								
ROA[(1)]	9.9%	21.1%	14.9%	8.9%	8.1%	8.6%	12.8%	17.2%
ROE[(1)]	14.4%	24.9%	24.2%	17.1%	14.9%	15.1%	21.3%	22.3%
Liquidity and Solvency								
Current ratio	2.8 x	2.0 x	96.9 x	71.2 x	32.7 x	47.2 x	68.4 x	16.9 x
Quick ratio	2.6 x	1.9 x	96.8 x	71.1 x	32.6 x	47.1 x	68.3 x	16.8 x
Cash ratio	1.2 x	0.6 x	80.9 x	55.2 x	16.7 x	31.2 x	52.4 x	0.9 x
Total debt/Equity	0.0 x	0.0 x	1.0 x	0.8 x	0.8 x	0.7 x	0.6 x	0.0 x
Net debt/Equity	-0.1 x	-0.1 x	0.1 x	0.3 x	0.6 x	0.4 x	0.2 x	0.0 x
Total debt/EBITDA[(1)]	0.1 x	0.1 x	3.5 x	3.4 x	3.2 x	2.3 x	1.8 x	0.0 x
Net debt/ EBITDA[(1)]	-0.6 x	-0.2 x	0.3 x	1.2 x	2.5 x	1.4 x	0.6 x	0.0 x
Financial leverage	1.2 x	1.2 x	2.0 x	1.9 x	1.8 x	1.7 x	1.6 x	1.0 x
Interest coverage[(1)]	4.3 x	55.4 x	6.0 x	3.3 x	3.6 x	4.4 x	6.3 x	13.5 x
FFO to total debt[(1)]	5.2 x	9.7 x	0.3 x	0.2 x	0.2 x	0.3 x	0.5 x	nm
RCF to net debt	-1.1 x	0.9 x	10.9 x	-0.8 x	-0.5 x	0.3 x	0.8 x	56.7 x
FFO to financial expenses[(1)]	4.1 x	63.0 x	7.0 x	3.4 x	3.5 x	4.5 x	6.4 x	15.1 x

[(1)] Calculated without reversal of impairment losses of US$ 23.3mn in 2010 and US$15.7mn in 2011

Source: Company data, Bank of Georgia Research

Terms and definitions

BTCP	Baku-Tbilisi-Ceyhan Pipeline
EWGP	East-West Gas Pipeline
GGTC	Georgian Gas Transportation Company is a state-owned operator, owned by GOGC before August 2011
GIOC	Georgian International Oil Corporation
GOGC	Georgian Oil and Gas Corporation
GPC	Georgian Pipeline Company
HPP	Hydropower Plant
MENR	Ministry of Energy and Natural Resources
MGPS	Main Gas Pipeline System
MMC	Millennium Challenge corporation
NOC	National Oil Company
NSGP	North-South Gas Pipeline
PSA	Production-Sharing Agreement
SCP	South Caucasus Pipeline
WREP	Western Route Export Pipeline

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