

Research Update:

Leviathan Bond's \$2.25 Billion Senior Secured Notes Rated 'BB-', Outlook Stable

August 17, 2020

Rating Action Overview

- Leviathan Bond Ltd. (or the project) priced its \$2.25 billion in senior secured notes in four bullet series with final maturities in 2023, 2025, 2027, and 2030.
- Following the transaction's completion, and upon receipt and satisfactory review of the documentation, S&P Global Ratings is assigning its 'BB-' rating to the notes.
- The stable outlook reflects our expectation that the project will produce and sell approximately up to 12 billion cubic meter (BCM) annually, leading to a debt service coverage ratio (DSCR) of more than 3x in the next 24 months.
- The 'BB-' rating, with a stable outlook, is in line with the preliminary rating we assigned on July 27, 2020.

Project Description

The Leviathan field is an offshore gas field, discovered in 2010, located in the eastern Mediterranean, and is the largest natural gas reserve in Israel. According to a reserve report prepared by the independent engineering consultant, Netherland, Sewell & Associates Inc. (NSAI), the field has proved developed producing reserves (1P) totaling 11,380.0 billion cubic feet (BCF) of gas and 20.4 million barrels (MMbbl) of condensate oil as of June 2020, when it started producing an annual capacity of 12 BCM.

The rights to explore and produce petroleum and gas in the Leviathan field were granted to Delek Drilling (45.34%), Noble Energy Mediterranean Ltd. (Noble Energy; 39.66%), and Ratio Oil Exploration (15.00%) under a production lease until February 2044, which may be extended by up to an additional 20 years in case partners continue to produce from the Leviathan field. The operations and associated infrastructure are defined under a joint operating agreement (JOA) among the three parties in the respective proportion in the Leviathan lease. The operations of the field are performed by Noble Energy under the terms defined in the Leviathan lease and JOA.

Given these unique characteristics, we rate the project based on our "Principles Of Credit Ratings" methodology. In particular, we have assessed the cash flow coverage according to Delek Drilling's 45.34% working interest and the JOA. The latter defines that operating committee proposals need

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to reach at least a 60% approval by the vote of two non-affiliate partners. While there's no majority control by any party, we view the risk of Delek Drilling having a non-controlling stake as mitigated by this voting procedure, because decisions can't be reached without its vote. The repayment of the notes will consist of the pro-rata revenue stream of Delek Drilling's share from the sale of gas and condensate produced at the field. We also acknowledge the risk of having Delek Drilling as part of the project under the sponsor loan. However, we don't limit the rating on the notes to the credit quality of Delek Drilling, because we see cross-default mitigation in the project's structure and the risk of default under the JOA as remote at this stage.

Rating Action Rationale

The rating mainly reflects the operational risk in the production of natural gas field and a low market risk exposure. As we cannot assess the creditworthiness of some of the offtakers, we assume that 60% of gas produced will be dispatched in the market, exposing the project to volume and price risk, and consequently to fluctuating cash flows.

We believe the project will generate relatively predictable cash flow from the gas sales purchase agreements (GSPA). That said, we lack visibility on the quality of this cash flow because around 60% of the offtakers (excluding all volume sold to Dolphinus under its respective contract) are not rated or do not publicly share sufficient financial information for us fully assess their credit standing. As such, we only consider the GSPA of 40% of the contracted capacity to the offtakers that we were able to assess its credit quality (including the portion sold to Nepco), and the remainder as exposed to market risk.

Therefore, in our base-case scenario, we assume 60% of sales exposed to market prices for gas, in accordance with S&P Global Ratings' common assumptions for oil and gas projects, whereas Leviathan's contracts have floor prices. This scenario envisages a minimum annual DSCR of 1.49x in 2026 and an average of 1.76x until the end of the refinancing period, which we define as 2044, when the lease agreement matures.

We view positively the extensive experience that Noble Energy has in operating in the region, performing with over a 99% availability in the adjacent field (Tamar) since it started operations in 2013. We estimate the project's gas production cost below \$0.5 per million cubic feet (mcf) and annual operating expenditure of around \$80 million (Delek Drilling share).

The capital structure consists of several bullet maturities, partially synthesizing an amortizing repayment profile. To ensure that sufficient funds are available to meet each bullet maturity, 12 months ahead of each amortization date, free cash flow from the revenue account is put aside in a principal reserve fund that accumulates cash of up to \$150 million. In our view, the long life of 1P provides a sufficient tail for refinancing of the notes. As such, the exposure to refinancing risk in 2023, 2025, 2027, and 2030 does not constrain the rating on the notes.

Finally, although 30% of the project's gas is purchased by a counterparty in Jordan (B+/Stable/B), the sovereign's credit quality does not limit the rating on the project. This is because Leviathan comfortably passes a hypothetical sovereign stress scenario (the project's cash sources-to-uses ratio remains above 1.0x under the exercise due the low operating cost of the field, the bullet debt payments, and existence of debt reserve accounts). All payments are deposited in accounts in Israel, while all cash is held offshore Jordan, compensating for the foreign-exchange conversion risk. We do not apply the typical cash haircut, because all cash is held in Israel, invested under permitted investment-grade titles.

Outlook

The stable outlook reflects our assessment that Leviathan's operations is unlikely to encounter substantial setbacks, and that the project has contracted a reasonable proportion of its production capacity with floor prices. Given the bullet nature of the notes, we expect the project to generate DSCRs above 3.0x in the next two years.

Downside scenario

We could lower the rating if the operations come up against production issues, resulting in lower uptime and higher operating cost, reducing minimum DSCR below 1.4x. In addition, we could revise our gas price assumption if conditions in the oil and gas industry continue to deteriorate, complicating the project's ability to sell its production capacity at favorable prices, leading to lower cash flows and higher refinancing risk. We could also lower the rating if the credit quality of the offtakers deteriorate, in particular Jordan, which guarantees Nepco's GSPA.

Finally, we could lower the rating if the partners of the field were to engage in aggressive expansion commitments, which could reduce the net cash flows for the repayment of the notes, and result in extraordinary obligations of Delek Drilling to pay its participating interest in related joint account expenses.

Upside scenario

We could raise the rating if the project sells its remaining capacity to counterparties of stronger creditworthiness, reducing its market risk exposure and enhancing the blended-average credit quality of its revenue stream, which could reduce risks and might raise minimum DSCR above 1.5x.

Liquidity

- We assess the project's liquidity as neutral given a cash-funded \$100 million debt repayment fund. Even though this is not a standard debt service reserve account, the resources are sufficient to cover more than one semi-annual interest payment of the all series of the notes.
- Additionally, the issuer accumulates cash one year ahead of any scheduled principal repayment, under a principal reserve fund, which it will use along with the debt payment fund and the cash flows to repay the bullet notes as they become due. The principal reserve fund is limited to a maximum amount of \$150 million.

The project is not subject to financial covenants, which could cause an event of default or an acceleration of the notes payment. The transaction structure has a forward-looking distribution lock-up test, based on 1.5x NPV10/net debt test (remaining net present value discounted at 10%, according to the reserve consultant report, using Bloomberg Brent Forward Curve prices for the initial plus four years and then inflated at 2% per year). Although we typically expect lock-up mechanism within the next 12 months of operations to allow for seasonality and volatile cash flows and to effectively preserve additional cash to meet project liquidity needs, we view the proposed lock-up mechanism as neutral.

Rating Score Snapshot

Construction phase SACP (Senior Debt)

- Not under construction

Operations phase SACP (Senior Debt)

- Operations phase business assessment: 8 (on a scale of '1' [lowest risk] to '12' [highest risk])
- Preliminary SACP: bb-
- Downside impact on preliminary SACP: bb (no impact)
- Liquidity: Neutral
- Comparative analysis assessment: Neutral
- Adjusted preliminary operations phase SACP: bb-
- Operations counterparty ratings adjustment: bb-
- Financial counterparty ratings adjustment: A+ [1]
- Operations phase SACP: bb-

Modifiers (Senior Debt)

- Parent linkage: De-linked
- Structural protection: Neutral
- Sovereign rating limits: bb (not capped)
- Senior debt issue rating: BB-

[1]HSBC Bank is the Trustee and the Account Agent.

Recovery Analysis

Key analytical assumptions

- S&P Global Ratings believes that lenders would achieve the greatest recovery amounts through reorganization of the project, rather than liquidation, given consistent demand for gas in the region.
- The '1' (95%) recovery rating indicates that we expect full recovery in this default scenario.
- We value the asset using the net present value of future cash flows of the field's expected remaining life through 2044, when the lease agreement ends.

Simulated default assumptions

- Simulated default year: 2023
- Under our hypothetical default scenario, we assume deterioration of the oil and gas industry in 2023, when the project is expected to refinance the first series of the new notes. The failure to place new notes would potentially trigger a default.
- In our recovery forecast, we assume there would continue to be a viable business model driver by the ongoing demand for gas in the region and the strength of the project's historically solid operations, supporting its ability to protect the existing GSPA.
- We discount the cash flow over the remaining life of the charter at a 15% rate--we usually apply a 10% discount based on the valuation method that follows the U.S. Securities and Exchange Commission guidance, but we use a higher discount in this analysis, because 40% of volumes were assumed sold under contracted prices higher than the commodity benchmark and other commonly parameters used in the industry--and deduct 5% of administrative expenses to arrive at the net value.
- We add six-month pre-petition interest to the estimated debt at the time of default.

Simplified waterfall

- Debt outstanding at the hypothetical default (including pre-petition interest): \$2.0 billion
- Estimated net value of the project: \$2.0 billion
- Recovery expectations: Rounded to 100% (recovery rate of '1' [95%]).

Related Criteria

- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Operations Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Transaction Structure Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Key Credit Factors For Oil And Gas Project Financings, Sept. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of

- 'D' And 'SD' Ratings, Oct. 24, 2013
- Criteria | Corporates | Project Finance: Project Finance Construction And Operations Counterparty Methodology, Dec. 20, 2011
 - General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Presale: Leviathan Bond Ltd., July 30, 2020
- Leviathan Bond Ltd.'s Proposed \$2.25 Billion Senior Secured Notes Rated Preliminary 'BB-', Outlook Stable, July 27, 2020

Ratings List

New Rating		
Leviathan Bond Ltd.		
Senior Secured	BB-	
Recovery Rating	1(95%)	

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