

# ARC Ratings affirms the "B+" rating, with Positive outlook, assigned to Zenith Energy

<b>ISSUER</b>	<b>ISSUER RATING</b>
Zenith Energy Ltd.	<b>B+</b> Medium and Long Term (B+, with positive outlook)
<b>RATING DATE</b>	<b>NEXT REVIEW DATE</b>
8 October 2019	8 October 2020

**A**RC Ratings, S.A. (ARC Ratings) has affirmed the final public "B+" issuer medium and long-term rating, with a Positive outlook, assigned to Zenith Energy Ltd. (Zenith), based on the huge potential for high cash generation from its on-shore oilfield concession in Azerbaijan and, on the other hand, its current still fragile financial situation and the risks and challenges to monetize its assets' value.

## **ISSUER PROFILE**

Zenith, incorporated in 2007 and domiciled in Canada, is the holding company of an international junior energy production and exploration group (Zenith Group) operating the largest onshore oilfield in Azerbaijan. The Group also has interests in natural gas, natural gas condensate and electricity production assets in Italy.

Zenith is a public company with listing on the Toronto Stock Exchange Venture (under the ticker symbol "ZEE"), on the Main Market of the London Stock Exchange (under the ticker "ZEN") and, since November 2018, on Merkur Market of the Oslo Børs (under the ticker "ZENA:ME").

## **RATING RATIONALE**

Zenith's key rating drivers are the following:

- Huge potential for high cash generation – Zenith Group is executing an investment plan to bring into production a large number of oil wells in its oil concession in Azerbaijan, forecasting to achieve CAD 34.5 million of revenue in the full year ending (FYE) in September 2020 (compared with CAD 6.6 million in the FYE March 2019).
- Relevant oil reserves within a long-term concession contract – The Group's share of total estimated proved plus probable oil net reserves was assessed at 30,564 MSTB (thousands of stock tank barrels) of oil as of 31 March 2019 by the Competent Person and the concession was granted for 25 years since 2016.
- Low cost production – Average cost of production is currently around USD 21 per barrel (USD/bbl) and this is estimated to fall with the forecasted production increase. In recent months the price of Brent crude has been fluctuating between 60 and 70 USD/bbl, in last 2 years the minimum achieved was 52.2 USD/bbl in December 2018 and in last 5 years the minimum achieved was 27.88 USD/bbl in January 2016.
- Equipment Ownership – The Group has a strategy to own its drilling equipment in order to lower costs and to assure continuity of work. At the end of July 2019, the newly refurbished 1200hp drilling rig (BD-260), acquired in September 2018, commenced operation, which is a relevant milestone for the Group's development.

- Proven track record of operational success in exploration and appraisal activities – The Group considers that it has a strong and committed management team that has substantial, relevant industry knowledge and a proven track record of operational success. The group believes that its management team has favourably positioned itself to successfully implement its growth strategy and productivity initiatives regarding its existing projects.
- Commitment of Top Management – Zenith's Executive Directors have a strong commitment to the Group with proven support.

Zenith's key rating constraints are the following:

- Fluctuations in oil price – Zenith is a price taker and the company's current policy is to not contract derivatives to hedge / reduce this risk. As already referred above, oil prices have been presenting large volatility in the last 5 years, with increasing lows (Brent crude used as reference): 27.88 USD/bbl in January 2016, 45.54 USD/bbl in June 2017 and 52.2 USD/bbl in December 2018. In recent months, oil prices have been fluctuating between 60 and 70 USD/bbl.
- Investment risk – The huge potential for the Group's cash flow increase depends on its capacity to execute a challenging investment plan, that is currently much more achievable with the commencement of operations of the acquired drilling rig.
- Risk of losing concession due to a material breach – The Group is committed to meet a minimum level of production during 90 days until 3 October 2019 in order to avoid a material breach of the Rehabilitation, Exploration, Development and Production Sharing Agreement (REDPSA) with the State Oil Company of Azerbaijan Republic (SOCAR), which may result in a loss of title to the Azerbaijani oil and gas asset, and this is already not achievable. In the event of a material breach and subject to receipt of written notice, the Group will have 90 days to (a) start actions reasonably necessary to cure or remedy such material breach; or (b) to refer the question of material breach to arbitration – in each case a termination of the agreement will not occur until final developments. Also, Zenith's Directors "believe that should the obligation within the REDPSA not be achieved within the aforementioned timescale, SOCAR would not exercise its right to take ownership of the project, which is based on the Directors operational experience and supported by research undertaken by the Group into similar Companies who have breached similar REDPSA terms with SOCAR".
- The risk of operation stoppages namely due to accidents, labour strikes, or other reasons.
- Financing constraints – The Group has been successful in recent months in obtaining new funding through the issuance of new equity shares and medium-term bonds to finance its investing phase, while cash generation from operations has been used to repay existing maturing loans, overcoming a previous situation of financing constraints.
- Regulatory risk – By its nature, and despite being regulated by contracts, Zenith Group's activity and profitability may be affected by Government decisions that may increase operational costs, royalties or taxes, and / or impose hydrocarbon exports restrictions. It is important to underline that in Azerbaijan, by law, the Group's concession is exempt from any taxation.
- Political risk – Despite being stable for several years and the absence of any signs of instability, Azerbaijan, where the Group has its main operation, is in a region where a number of political and military disputes have occurred recently.
- Operations' concentration – The two previous constraints are exacerbated by the present concentration of the Group's activity in only two locations (Azerbaijan and Italy); Azerbaijan is the most relevant place of operations presently and forecasted. However, the Group intends to diversify through new acquisitions.

- Limited insurance policies – Considering the developing phase of its main operations, the Group has no insurance policies for business interruption or for damages to third parties.

## **DEVELOPMENTS AND OUTLOOK**

Presently, the Zenith Group has two operations:

- an onshore oilfield in Azerbaijan – the Group's primary operational focus;
- a number of energy production assets (or interests in production assets) in Italy, producing natural gas, condensate gas and electricity.

Besides the development of these assets, the Group intends to grow through new acquisitions. The Group has been careful with new acquisitions.

In the Azerbaijani oilfield, the results from workovers and refurbishments of the existing wells has been disappointing due to the very poor condition of many of the existing wells, the challenging geology of the field and the unreliability of well data and historical records from the Soviet era which have rendered workovers in some wells extremely challenging. Initially, the Group had increased production by 25 bopd to 300 bopd, but in the meantime the Group closed several wells that were performing uneconomically due to excess water production and the Group's production decreased to 234 bopd.

At the same time the Group completed two geological studies, enhancing the Group's understanding of the field's geology. By the end of July 2019, the Group started operating its 1200hp drilling rig (BD-260) that was acquired in September 2018 (it was in meantime refurbished and transported from Italy to Azerbaijan). This is a modern drilling rig capable of drilling down to 4,500 m, having an expected economic life of up to 20 years.

Reflecting the workover disappointment, the results from these studies and the start of operation of its own deeper drilling rig, the Group changed its focus to the deepening of two wells: C37 and C30. The deepening of C37 is complete and it is forecast to achieve production in a very short-term. On 3 October Zenith announced that despite experiencing well casing liner hanger failure (currently being investigated, as well as other measures and interventions to maximise production) initial testing of the well has indicated that, if placed in full openhole production, it can produce up to 100 bopd with a water cut of approximately 50%. The deepening of C30 will follow and will take 20 to 30 days to achieve production. The Group were expecting to achieve an average of 200 bopd for each of these wells.

ZENITH ENERGY - CONSOLIDATED FINANCIALS AND RATIOS (THOUSAND CANADIAN DOLLARS)

	FYE Mar 2015	FYE Mar 2016	FYE Mar 2017	FYE Mar 2018	FYE Mar 2019	2018 Apr to Jun	2019 Apr to Jun	FYE Sep 2020 (F)
<b>REVENUE</b>	4,784	2,075	4,424	5,019	6,567	1,881	1,557	34,522
<b>EBITDA</b>	(459)	(2,274)	(3,554)	(6,421)	(3,584)	(790)	(206)	14,447
<b>NET PROFIT</b>	(2,376)	(7,674)	567,378	(9,918)	(9,762)	(2,623)	(956)	12,950
<b>Coverage of Net Interest Costs by EBITDA (x)</b>	(0.8)	(1.5)	(17.3)	(8.1)	(3.0)	(4.8)	(0.9)	13.4
<b>Net Financial Debt / EBITDA (x)</b>	-	-	-	-	-	-	-	(0.4)
<b>Equity / Assets (%)</b>	22.3%	(14.0%)	53.3%	52.8%	52.3%	52.9%	52.4%	53.0%

*Notes:*

Figures rounded.

Accounts adjusted by ARC Ratings for analysis purposes.

The historic annual accounts were audited by PKF Littlejohn LLP (FYE Mar 2017 and FYE Mar 2019) and MNP LLP (FYE Mar 2015 to FYE Mar 2016).

(F) = Forecasts.

*Sources:*

ZENITH ENERGY

In the FYE March 2019 Zenith Group's revenue increased 30.8% to CAD 6.6 million from CAD 5.0 million in the previous year, but in the quarter from April to June 2019 it decreased 17.2% year-on-year to CAD 1.6 million. In the FYE March 2019 Azerbaijani operations represented 87.3% of the Group's revenues, while Italian operations represented the remaining 12.7%.

Italian operations are small but reaching an equilibrium with positive EBITDA and net profit. Azerbaijani operations are in a developing phase and the Group's EBITDA and net profit are being affected by the fact that most of the investment expenses are recorded as operating expenses. Also, the consolidated EBITDA and net profit have been affected by the recording of significant corporate costs and expenses relating to equity capital increases, bond issues and the studying of new acquisitions. Interest costs have been also increasing due to the financial debt increase to finance the investing phase.

Net losses in the FYE March 2019 (CAD 9.8 million) were almost in line with the previous year (CAD 9.9 million), but in the quarter ended June 2019 losses improved to CAD 1.0 million from CAD 2.6 million, reflecting the closure of non-economic wells and lower non-current costs.

Since the last report and as planned, Zenith has diversified its sources of funding with the issuance of bonds. Thus, between the end of June 2018 and the end of June 2019 the Group had the following main sources of funding:

- CAD 4.2 million of proceeds from the issue of share capital and the exercise of options.
- CAD 4.8 million from the issuance of Euro Medium Term Notes, with 3-years maturity.
- CAD 0.8 million from the net increase of financial loans, including two convertible loans.

Total financial debt increased to CAD 11.0 million at the end of June 2019 from CAD 5.5 million one year before. Net financial debt increased to CAD 5.3 million from CAD 2.4 million.

At the end of June 2019 total assets were CAD 1,087.8 million, mostly composed of non-current assets. Equity / assets ratio was 52.4% at the end of June 2019 (-0.5 percentage point (pp) compared with the end of June 2018).

The forecasts prepared by Zenith Group for the FYE September 2020 considered the development of the Group's business as it is now progressing (i.e. with no new investments besides those planned for the Azerbaijani operations), the gradual and consecutive increase of oil production in Azerbaijan from the current 234 bopd to 450 bopd in October 2019 and to 2,340 bopd in September 2020 (with the deepening of wells C30 and C37 and the drilling of four new wells), average oil prices of 57 USD/bbl, financing from the cash flows generated from operations and from the issuance of new equity shares (CAD 3.5 million) and from the issuance of bonds (CAD 4.7 million), and no payment of dividends.

With these assumptions the Group forecasts to achieve revenues of CAD 34.5 million in the FYE September 2020 with an EBITDA (considering all the capex as operational expenses) of CAD 14.0 million and a net profit of CAD 13.0 million. Considering Zenith's forecasts, ARC has estimated that the Zenith Group will achieve a positive cash position (net of financial debt) of CAD 6.2 million at the end of September 2020.

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