Research Update:

Sweden-Based Lundin Energy Assigned 'BBB-' Rating; Outlook Stable

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Rating Action Overview

- Sweden-based oil and gas exploration and production company Lundin Energy AB has highly concentrated reserves and production, albeit in a geopolitically stable, area.
- We consider Lundin Energy to be one of the most profitable offshore operators, with high efficiency and low operating costs, supporting strong cash flow per barrel, which will allow for stronger credit metrics next year.
- We are assigning our 'BBB-' issuer credit rating to Lundin Energy.
- The stable outlook reflects our expectation that the company will continue to expand in Norway while funds from operations (FFO) to debt improves to about 45% and discretionary cash flow (DCF) remains at least neutral over the business cycle.

Rating Action Rationale

Very low production costs and high-quality assets support a satisfactory business risk profile, despite relatively small scale. Despite recent rapid growth, mainly thanks to its world class discovery Johan Sverdrup, and to a lesser extent Edvard Gried, Lundin Energy has a smaller reserve base and production level than 'BBB-' rated peers. 2020 production is anticipated to be about 155,000-160,000 barrels of oil equivalent per day (kboepd), lower than cimarex at about 250-265kboepd or Aker BP at 215kboepd. However, the quality of reserves, with operating expenditure (opex) per barrel at about $3, is stronger than peers', providing the capacity to generate operating cash flows similar to those of larger companies and above-average unit profitability. For example, Aker BP's opex per barrel for 2020 is anticipated to be $7-8$ per barrel, while in the U.K., despite large reductions in previous years, opex is typically above $15 per barrel.

High asset concentration poses risks of business interruption, mitigated by a strong track record and insurance policies. With the Johan Sverdrup field representing more than 70% of the group's proven reserves, there is a key risk that a major incident could materially reduce production levels, and subsequently cash flow generation. This concentration highlights the importance of having the highest operating standards and sound contingency plans. With Equinor, the largest and most experienced company on the Norwegian continental shelf operating Johan Sverdrup, and business interruption insurance (alongside other insurance policies) in place, we see a relatively low likelihood of a major incident. However, if a serious incident were to occur, Lundin Energy has the ability to continue servicing its debt due to significant insurance protection and production from other fields.

Resilience to oil price volatility strengthened in the near term with Norwegian tax reform and a dividend cut. Lundin Energy's lower cost structure than peers, particularly those based in the U.S. focusing on shale, provides stronger resilience to lower oil prices. This has been enhanced by the supportive fiscal environment in Norway. The authorities have recently allowed companies to deduct a larger portion of their capital spending in the first year, significantly reducing cash tax payments over the next few years. Not only does this help liquidity but also encourages investments to fuel growth and is another indication of the political support for the industry in Norway. In addition, we note that production costs reduce when oil prices fall, as the Norwegian krone tends to depreciate as well.

Financial risk will likely increase in the current market environment, but we expect a quick rebound of credit metrics. The tax regime and low-cost operations support Lundin Energy during weak industry conditions. However, the severe drop in oil prices in early 2020 and our anticipation of the Brent crude price at $30 per barrel on average for the remainder of this year will translate into diminishing operating cash flow per barrel of production. Although volumes will likely be much higher than in 2019, we expect little change in operating cash flows. As such, we anticipate FFO to debt will be at 30%-35% in 2020 before improving above 50% in 2021 as prices gradually improve. That said, even in a downside scenario with Brent averaging $40 in 2021, FFO to debt would still be at around 40%, reflecting resilience of the business.

Financial policies have been supportive and early action was taken to cut dividends when oil prices collapsed.

We consider Lundin Energy to have prudent financial policy focusing on risk mitigation. The company reduced dividends to $1 per share from $1.8 early on during the COVID-19 pandemic that led to a further drop in oil prices. We expect, however, that once oil prices recover the company will increase dividend payments, albeit maintaining positive DCF over the cycle. We also note Lundin Energy's measures to strengthen liquidity, notably via additional bank financing sources and capital expenditure (capex) management.

Lundin Energy's operating track record and expertise in exploration have fueled growth, but the future is uncertain. Lundin has an exceptional history of exploration successes. Having discovered both Johan Sverdrup and Edvard Gried, among others, the company has built inhouse capabilities than are superior to peers' in our view, as reflected in the results. Since exploration carries high rewards as well as high risks, it provides potential for future growth. However, at this stage, the impact on future cash flow inflow is uncertain.

Outlook

The stable outlook reflects our expectation that Lundin Energy will achieve FFO to debt of about 45% in 2021, thanks to lower dividends and taxes, supporting positive DCF. Although high capex can result in a temporary increase in leverage, this would occur in the context of the favorable Norwegian fiscal regime.

Downside scenario

We could lower the ratings if Lundin's credit measures do not improve as anticipated, or if liquidity deteriorates. This could be the case if:

- There is a further drop in oil prices, which stay well below $40 per barrel in 2021-2022 leading FFO to debt to remain well below 45%.
- Material debt-funded growth prevents improvement of credit metrics.
- An increase in dividends leads to materially negative DCF.
- Insurance covering production from Johan Sverdrup and Edvard Gried, an important cushion to event risk, lapses or is cancelled.
- Refinancing issues lead us to reassess liquidity as less than adequate.

A temporary drop in FFO to debt below 45% would not necessarily lead to a negative rating action if we believe DCF would remain positive or be negative only during one year.

Upside scenario

We view an upgrade over the next 12-24 months as remote, given Lundin Energy's asset concentration and relatively small size. The company would also need to maintain a very conservative capital structure, with FFO to debt at about 60% under prevailing industry conditions, which we view as unlikely.

Company Description

Established in 2001, Lundin Energy is an independent Swedish oil and gas producer, operating in Norway. Lundin is focused on oil and gas upstream operations, from several offshore fields on the Norwegian Continental Shelf, and has made a relatively small investment in renewable energy as well. Its proven reserves as of year-end 2019 totaled 693 million barrels of oil equivalent, split 90% oil and 10% natural gas. Its average daily production was 93 kboepd in 2019.

Lundin Energy is publicly listed on Nasdaq Stockholm, and its major shareholders are the Lundin family through Nemesia (33% of shares on July 7, 2020), with the rest of shareholders being a variety of institutional and retail investors.

Our Base-Case Scenario

Assumptions

- S&P Global Ratings' price deck for Brent oil of $30 per barrel (bbl) for the remainder of 2020, $50/bbl in 2021, and $55/bbl thereafter,
- Production increasing to 157,000 barrels of oil equivalent per day in 2020, and 170,000-180,000 in 2021.
- Capital spending of $700 million-$800 million annually in 2020 and 2021.
- Negative DCF in 2020 of up to $100 million, but turning positive in 2021.

Key metrics

- FFO to debt of 30%-45% in 2020 and 50%-60% in 2021.
- Free operating cash flow to debt of 5%-10% in 2020 and 25%-30% in 2021.
- Negative discretionary cash flow to debt to in 2020 and about 15%-20% in 2021.

Liquidity

Lundin Energy's liquidity is adequate. We project its cash sources will cover cash uses by more than 1.2x over the next 12 months, but just short of 1x in the subsequent 12 months. This is because the company relies mainly on a $5 billion reserve-based facility that starts amortizing in 2021. We expect, however, that the company will proactively refinance its capital structure so that debt maturities become better spread out and long term.

Principal liquidity sources for the 12 months started April 1, 2020:

- Estimated unrestricted cash on the balance sheet of $90 million;
- Availability of about $1.2 billion under the reserve-based facility; and
- FFO of about $1.3 billion.

Principal liquidity uses over the next 12 months:

- Short-term debt of $1.3 billion;
- Capex and decommissioning costs of about $750 million; and
- Dividends of about $310 million.

Covenants

Lundin Energy has two main covenants under its RBL facility, namely net debt to EBITDAX (EBITDA before exploration expense) lower than 3.5x and EBITDAX to net financing costs greater than 4.0x. There is ample headroom under both under our base case.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable/--

Business risk: Satisfactory

- Country risk: Very low
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb-

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

New Rating	
Lundin Energy AB	
Issuer Credit Rating	BBB-/Stable/--

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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.