Rating-Agentur Expert RA downgraded the credit rating of Zenith Energy Ltd. from 'B+' to 'B-' according to the international scale. The rating outlook is developing.

Rating-Agentur Expert RA downgraded the credit rating of Zenith Energy Ltd. from 'B+' (Moderately low level of creditworthiness) to 'B-' (Moderately low level of creditworthiness) according to the international scale. The rating outlook is developing which means that in the mid-term perspective there is an equal probability of downgrade, upgrade or maintenance of the rating score.

CORPORATE INDUSTRY RISK ASSESSMENT:

The company's operations (in terms of revenues) as of December 2019 were concentrated in the following countries: 87% in Azerbaijan and 13% in Italy. The company is specialized on the following industries: Oil and Gas industry. The overall corporate industry risk for the rated company was assessed as adequate. However, we expect the share of revenues per country to change drastically (and so will the weighted country risk) going forward, as the company is ending operations in Azerbaijan, has acquired new assets in the Republic of the Congo and has signed a conditional sale and purchase agreement to acquire assets in Tunisia, and it is planning to operate in other countries in Africa. We will update the country-industry risk assessment once the acquisitions go through and operations are running.

MAJOR FACTORS THAT INFLUENCED THE RATING:

Positive factors:

- Low dependence of the company on one single creditor. The company does not have significant financial debt concentrated in one single entity;
- According to the latest information provided by Zenith, the level of short-term debt declined down to CAD 1,2 m as of 8 May 2020, a reduction of around 70% in the last 12 months. This level of debt is currently covered by cash by around 1,1x. On 22 April 2020, Zenith settled in full what represented its single largest liability on the balance sheet an important step towards short-term debt reduction. However, as long as operating cash flows remain negative the cash balance will continue to decline; thus, either debt will have to be refinanced or additional equity will need to be issued;
- Documentation provided by Zenith shows that corporate governance practices are in accordance with industry standards. The company has internal procedures in place keeping in check the activities of the directors, management and members of the board;
- The risk management policies in the company are present and they include procedures to analyze and report developments regarding all types of financial and operational risks. However, implementation of these policies, especially operational risk, needs to be adequately revised in order to avoid cases such as the one in Azerbaijan;
- The company's transparency is acceptable. All the company's relevant information, such as financial and general information is disclosed on its website. However, some of the information is published with significant lags. The company confirmed they are in the process of building a new website where all the pertinent information will be published in real time, including the prices of relevant commodities.

Restricting factors:

- The company's strategy changed drastically in terms of geographic allocation of production but remains unchanged in regard to the objective of seeking potential productive assets. In general, Zenith has been partially executing the strategy as expected. On the one hand, the company keeps pursuing the identification and eventual acquisition of assets, which, according to the company, have potential of being productive and profitable. This has been last seen in the acquisition of Anglo African Oil & Gas Congo S.A.U. (AAOGC) in order to operate the Tilapia asset in the Republic of Congo as well as in the signing of the conditional sale and purchase agreement (SPA) to acquire assets in Tunisia, whose completion is dependent on approval being granted by the *Comité Consultatif des Hydrocarbures of the Republic of Tunisia*. Moreover, the company has the intention to acquire additional assets in other African countries, as well as in Italy. On the other hand, the company has not succeeded in further developing the assets it has had in place, namely Azerbaijan, as the Rehabilitation, Exploration, Development and Production Sharing Agreement (REDPSA) has been, for the most part, terminated[1]. In our initial review, we anticipated lower-than-projected numbers in Azerbaijan as the company's experience had showed that conditions were not optimal to operate. We mentioned that *"in view of past results in workover and drilling operations in these fields, more conservative assumptions in terms of oil production could better reflect the mid-term perspective of the company"*. As of today, we can observe that these concerns materialized as the company has ended operations in the South Caucasus country. On the funding side, the company has been promoting a strategy based on avoiding diluting the shareholders and to finance development with additional debt and, mainly, with organic growth translated in operating cash flows. However, despite the fact that around CAD 1,3 m worth of bonds were sold during March and April, the Euro Medium Term Note (EMTN) program has not being fully subscribed. Thus, the company has continued to issue equity and the cash has mostly been used to cover operating expenses. Nevertheless, the company still owns two drilling rigs, which are expected to be moved to Africa anytime soon. While we praise the strategy of owing its own drilling equipment, constant movement and underuse of the rigs could potentially generate very high costs for the company. Zenith Energy's 2P reserves amounted to 16,2 BCF[2] of natural gas in Italy. This is expected to increase as Zenith is planning to takeover an additional asset in Italy. In addition, the level of 1P reserves in Tunisia are equivalent to 5 million barrels of oil and the level of 2P reserves in the Republic of Congo are also equal to 5 million barrels of oil, while the amount of potential reserves in the other acquisition targets is, as of now, unknown;

- As mentioned previously, we keep our current Country and Industry Risk (CIR) score unchanged, as this is based on the latest reported operations of the company. However, we do expect radical changes to materialize soon, which would change the structure of the geographic locations of Zenith's operations. Besides from the AAOGC deal, which was recently completed, if the rest of the announced acquisitions do materialize in full, the company is forecasting to have revenue proceeds as follows by March 2021: 52% in a new incoming acquisition in Africa, 20% in Congo, 17% in Italy and 11% in Tunisia. Taking these shares into account, and in a conservative scenario (a higher share of revenues in riskier countries), we estimate the corporate industry risk for the rated company to be from "adequate" to "moderately high"[3]. The target countries are all rated below 'B-' or equivalent and are characterized by low levels of government effectiveness, political stability and regulatory quality[4], factors which increase the overall systematic risk for the company. On the other hand, if these deals were to materialize, the company would also benefit from the diversification effect;

- The diversification of product types remains moderate. The company is concentrated on the production of oil as 87% of the revenues were attributed to this product by the end of

[1] The company is still allowed to perform exploration activities, but Zenith is not committed to do so in the near future.
[2] Billions of standard cubic feet of gas.
[3] Please refer to the first table of our CIR methodology to observe the levels of risk: CIR Methodology
[4] According to the Worldwide Governance Indicators prepared by the World Bank.

2019. This exposes the company's cash flow to volatility as a result of variation in oil prices, especially, since currently the company does not use any hedging instruments. Nonetheless, diversification could increase slightly if Zenith completes the acquisition of Coro Italy, which would increment its share in gas and electricity income;

- The company will remain exposed to a moderate currency risk given the nature of its oil and gas operations where there is a mismatch between the currency of incurred costs and the currency of revenues. Moreover, the company's operations involve five different currencies which increases the difficulty of overall management of the currency risk.

Negative factors:

- Growth prospects for the company were evaluated as positive in our first assessment; however, recent events in Azerbaijan and the current conditions in the oil markets paint a different picture going forward. In our view, the success of the company will largely depend on: (1) completing the acquisitions already announced, (2) achieving the production forecasts provided to the Agency by Zenith while, at the same time, (3) maintaining low productions expenses and (4) a steady recovery in oil prices;
- As of FY 3Q 2020 (December 2019), revenues declined by 24% y-o-y and we expect the decline to have steepened by FY 4Q 2020 (March 2020) as a result of the lethargic production and closure of unproductive wells in Azerbaijan. As previously mentioned, since the Azerbaijan asset is now out of operation, further turnovers will solely depend on, not only completing the announced acquisitions, but also on producing at the projected amount. According to the company's forecast, Zenith expects to increase revenues up to around CAD 22 m by the end of FY 2021 (March 2021). However, given the large discrepancies between the previous company's projections and the production results achieved, we will remain conservative on the projected growth until we observe steady production from the new assets. On a positive note, the completed acquisition in the Republic of Congo and the potential acquisitions of the aforementioned assets in other African regions could be a favorable sign towards the steady organic growth and positive operating cash flows of the company as long as the production is successful and costs are maintained low, especially in the current state of depressed oil prices;
- In regard to the recent AAOGC deal, the amount of GBP 200 000 paid for the acquisition was a result of improved negotiating conditions for Zenith due to the current coronavirus crisis, which pulled oil prices down, combined with the weak state of AAOGC. We anticipate a confirmation of the license renewal to operate the Tilapia field;
- In our view, the outlook for the development of the global oil industry is quite bleak. Short-term demand has been outstandingly impacted by the coronavirus crisis. Therefore, these events have caused the price of Brent oil to drop down to as low as USD 19 per barrel. Despite the slight recovery – currently standing at around USD 34 per barrel – we maintain our conservative assumption of prices around USD 35 per barrel by the end of 2020. Despite the recent expectation of a pick-up on demand, we do not anticipate a big increase in prices as demand for oil remains iffy. Thus, we expect a challenging environment for oil producers;
- The market position remains weak. As of March 2020, the company had only operations in Azerbaijan, producing 180 bopd, which it will exit at the end of May as the concession has been handed over. The company has also a minor operation of gas and electricity production in Italy. Zenith Energy's general small size and market share makes the company vulnerable to competition from other exploration and production companies which have more resources. As mentioned in our previous review, this specifically could affect further expansion of the company in different geological basins. Even if the announced acquisitions go through, the market position of the company is expected to remain low as compared to other oil producers in the regions;
- Very low current geographic diversification of production. As of FY 3Q 2020 (December 2019), the company's oil operations were concentrated exclusively in Azerbaijan.

However, we expect this factor to improve as the company is set to start operations in the Republic of Congo and, subsequently in Tunisia once the deal is approved. Moreover, the geographic diversification could be enhanced further as Zenith is planning to acquire additional assets in other region in Africa and Italy;

- The liquidity stance of the company continued to worsen. We expect the current liquidity ratio to stand at around 0,45 while the absolute liquidity ratio was 0,16 by FY 4Q 2020 (March 2020). In our initial review, we anticipated this metric to improve due to new debt issuance as well as an increase in operating cash flows; however, the metrics did not show positive developments as we initially expected. This was mainly a result of initial undersubscription of their bond program combined with continuous negative operating cash flows far from the initial forecast presented by the company, as well as the recent repayment of a substantial amount of short-term debt. These developments caused current assets to decline rapidly. As mentioned previously, the improvement of these ratios will fully depend on the materialization of the acquisitions and its subsequent operational success; nevertheless, if this does not occur and the level of operating cash flows does not recover as expected, the company might suffer from liquidity constraints as access to the market to seek funding, albeit successful in the past, is not guaranteed going forward and a substantial amount of CAPEX and working capital is still necessary for Zenith Energy to continue developing assets. According to the document provided from the company, an amount of at least CAD 15 m is necessary to develop the assets in the next two years;
- The overall level of debt stood at CAD 8 m by end-2019. However, as previously mentioned, since EBITDA and FFO remain negative, levels of debt cannot be covered by operating cash flows, thus, approaching debt maturities will have to be covered by balance sheet cash or additional equity issuances;
- The net profit for Zenith Energy remained negative reflecting the very low production rate in Azerbaijan combined with elevated administrative production expenses;
- The company has no insurance coverage for its main assets.

ESG Disclosure

Inherent factors:

- Owners, Current decision-making practice, Efficiency of relations with subsidiaries and affiliates (S&A), Degree of information disclosure, Quality of strategic business planning, Risk management organization and Insurance coverage.

Drivers of change factors:

- None.

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- A continued increase in production as forecast alongside maintaining low levels of production costs which would translate in consistently positive operating cash flows;
- Substantial geographic diversification of production, which would reduce the company’s exposure to systematic risk of one single economy combined with an improvement in the market and competitive position in the countries where the company operates;
- Improvement of the liquidity position of the company.

The following developments could lead to a downgrade:

- Non-materialization of the acquisition targets, which would make it harder for the company to generate organic growth;
- Lack of additional funding which would raise concern on the ability of the company to fund the required investments and repay its obligations;

- Continued underachievement of production targets causing operating cash flows to remain negative increasing the pressure of seeking non-cash flow funding to finance operations.

JUSTIFICATION OF THE RATING:

The Agency has downgraded the credit rating of Zenith Energy Ltd. from 'B+' to 'B-' with a developing outlook. The reduction in the rating level is mainly due to the termination of the agreement in Azerbaijan, the current lack of sustained and profitable production, as well as the adverse outlook for the global oil industry as a result of the coronavirus crisis. Moreover, if the announced acquisitions are not completed or if production of the target assets is not as expected, the company could experience major liquidity constraints. However, corporate governance and risk management policies remained assessed as positive. The developing outlook indicates our view that the rating level is still very much dependent on short-term developments, specifically the completion of the announced acquisitions and whether or not the company's forecasts are achieved. Thus, we will perform a reassessment within a three-month span in order to confirm the impact on the rating derived from whether or not and in which way the acquisitions go through.

Our internal evaluation of the Country and Industry Risk (CIR) continues to reflect an adequate level of risk for the oil and gas industry in Azerbaijan. For this review, we are keeping our CIR assessment of Azerbaijan as the company's latest financial results are from FY 3Q 2020 (December 2019). Going forward, the CIR score will be applied depending on the stable production locations of the company. In any case, we have already calculated, but not applied, a new CIR score based on the company's revenue forecast for the next 10 to 12 months which show the following distribution: 52% in a new incoming acquisition in Africa, 20% in the Republic of Congo, 17% in Italy and 11% in Tunisia. The obtained level of weighted systematic risk using this combination of geographic distribution, does not differ greatly from level of risk currently observed.

We consider the oil and gas industry to be sensitive in terms of cyclicality as it has a very inelastic demand with respect to price. For this reason, revenues in the oil and gas industry tend to follow the economic cycle but with a much lower volatility. Oil and gas prices (and therefore companies' revenues) are more sensitive to supply. Moreover, the prices in this industry tend to be very volatile and cannot be controlled by the company, as we have recently observed. On the other hand, we consider this sector to have high barriers to entry. The most notable barriers are the significant capital costs and long lead times to get a facility up and running. The constraints posed by governments permitting of new wells and of major upgrades to existing wells are significant. In some countries, the permitting process is considered so cumbersome that construction of new greenfield facilities is highly unlikely. Meaningful changes in an existing facility could take up to a year or longer to execute and require significant capital. Another factor that could inhibit new entrants is government regulations concerning refinery emissions (air, water) and environmental remediation of spills. Thus, we assess this Industry to have an adequate level of risk.

Zenith Energy's core strategy changed dramatically in terms of geographic distribution of its operations; however, it remains unchanged in terms of goals as it still focuses on acquiring and developing proven onshore oil and gas fields where there is a potential to achieve considerable production rates after investing in reparation of existing wells and/or drilling of new wells. The company mainly is concentrated on targeting fields previously operated by oil majors and state oil companies. Even though the strategy is clear, and the company has pursued goals related to this core strategy, we consider that it has not been able to enforce it properly, especially in the oil business. The main reason for this conclusion is the recent handover of the Azerbaijan concession as the company could not achieve the production goals it had set. Zenith has cited that the reason it did not succeed was mainly due to inconsistent documentation of the fields alongside the very poor state of the wells and overall technical difficulties. In regard to the gas and electricity sector, the Group continues to operate in Italy and is seeking to expand its business there through the announced desire to acquire Coro Energy Plc.

As in our initial assessment, we remain very conservative in our analysis in regard to the forecasts presented by Zenith as we have yet to see consistent production throughout the history of the company. We still consider a fundamental part of the strategy the fact that the company invests in its own drilling equipment, as it has a focus on reducing costs, increasing efficiency and it targets technological development. However, a drawback of this strategy is that the company might incur in high repair or corrective maintenance costs in case of an equipment malfunction. In addition, the constant movement of this equipment could also increase the costs substantially.

In our initial review of Zenith, we highlighted as a positive factor the company's pursuit of geographic diversification. This has partially materialized given the current acquisition of AAOGC in order to operate the Tilapia field in the Republic of Congo. Moreover, the company has announced advanced level of negotiations in regard to additional three deals. Zenith has reported that it is in a final stage of negotiation to acquire two assets in another African country. Here, one of the wells is expected to be in production at 650 bopd, while the other well will need interventions in order to restart production. The company has also signed a conditional sale and purchase agreement to acquire a working interest in the North Kairouan permit and the Sidi El Kilani concession in Tunisia. The Sidi El Kilani field currently produces 700 bopd and the interest of the company would be 22,5%. Finally, Zenith has signed a share purchase agreement to acquire Coro Energy Plc in order to increase its natural gas production.

Growth prospects for the company are unclear as these depend entirely on going through with the announced acquisitions but, most importantly, they depend on accomplishing the forecast production rate as well as the cost optimization plan prepared by the company. In addition, a recovery in oil prices will also help to increase the margins for Zenith once production is underway.

In terms of investments, Zenith Energy will have to commit substantial funds in order to develop the newly acquired asset in Congo as well as the potential new acquisitions. According to the plan provided by the company, at least CAD 15 m will be needed as capital expenditures to achieve the forecast production rates in the next 1-2 years. However, despite the company having so far, no issues in regard to funding availability, it is not certain the company can continue to raise funds, especially if financial results do not turn out to be positive in the mid-term perspective.

The debt situation of the company is mixed. On the one hand, short-term debt has been reduced substantially in the past 12 months. On the other hand, the level of debt remains uncovered by EBITDA or operating cash flows as these have remained negative. Until the company turns this situation around and starts generating operating profit, the debt will continue to be serviced by available cash or additional funding sources, otherwise, debt levels will have to be refinanced, which could be challenging if operating margins remain negative.

We assess corporate governance practices to be favorable within the company. Even though the company has not adopted a Governance Code, it has internal procedures in place keeping in check the activities of the directors, management and members of the board. In addition, The Group's Board of Directors has three committees: the Audit Committee, the Remuneration Committee and the Corporate Governance Committee; these committees ensure that the company complies with all key operational and managerial expectations. Even though it has not been reflected so far, we still consider that, based on the information provided by the company, the management team has vast experience and an extensive background in the sector which underpins the basis to successfully implement the proposed strategy.

Zenith Energy's transparency is acceptable in regard to publication of Financial Statements according to regulatory requirements, as well as other relevant corporate documentation and board activities. Moreover, the company issues press releases in order to inform the public of all significant activities. However, some information is published on the website with lags. In addition, the risk management policies in the company remains assessed positively as all systems are checked by the Audit Committee of the Board and, in our view, Zenith Energy has an effective policy which analyses and reports developments in regard to credit risk, liquidity risk, FX risk, commodity price risk and interest rate risk. However, the operational risk of the company was not adequately measured as we observed negative developments in this area in the Azerbaijan operations. Finally, the company has no insurance coverage for its main assets.

Even though the company produces oil, electricity and gas, the activity diversification remains limited as Zenith produces mostly oil. This structure of revenues in term of production exposes the company to fluctuations in oil prices, as we are experiencing in the current economic situation. However, as the company is expected to increase its production of gas and electricity, we expect to observe better diversification once and if the Coro Energy deal is completed. What is more, we also anticipate diversification in terms of geography to improve going forward in case the announced acquisitions are completed.

In our view, Zenith Energy is exposed to a moderate currency risk. There is a currency mismatch between revenues and costs. As Zenith is about to start operations in the Republic of Congo, we observe that the monetary arrangement of the CFA franc between the Republics of Central Africa does provide certain stability to the currency. The CFA franc is backed by the French treasury who provides a guarantee of convertibility against the EUR, thus providing a tool to cushion potential shocks. Moreover, the global presence of the Group results in moderate currency risk as the company engages in operations with GBP, CFA franc, USD and EUR, while the reporting currency is CAD.

The market position of the company weakened further as it currently does not have any oil production. In Italy, however, the company has a minor operation of gas and electricity production and it could increase substantially if the Coro deal materializes. Zenith Energy's general small size and market share makes the company vulnerable to competition from other exploration and production companies which have more resources. As mentioned in our previous review, this specifically could affect further expansion of the company in different geological basins. Even if the announced acquisitions go through, the market position of the company is expected to remain low.

The net profit for Zenith Energy continues to be negative. This is a result of the high level of production expenses and administrative costs, combined with depressed revenues due to very low oil production in Azerbaijan. As of FY 3Q 2020 (December 2019), ROE and the EBITDA margin stood at -1,1% and -91,5% respectively. The recovery of these metrics will be challenging going forward considering the current state of oil prices combined with the effects of the coronavirus crisis.

COMPANY PROFILE:

Zenith Energy Ltd. is a company operating in the oil and gas sector registered in Canada but also trading in London and Oslo. The company's main operations will be located in the Republic of Congo in the near future. Moreover, Zenith Energy also operates and has interests in Italy through gas production and exploration concessions, as well as, production of electricity and condensate.

For further information contact:

Responsible expert:
Hector Alvarez, Associate Director of Rating-Agentur Expert RA
+49 (69) 3085-45-00, ext. 1213
alvarez@raexpert.eu

Reviewer:
Vladimir Gorchakov, Associate Director of Rating-Agentur Expert RA
+49 (69) 3085-45-00, ext. 1211
gorchakov@raexpert.eu

Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

RATING HISTORY:

Date	Review reason	Rating Score	Outlook
30.04.2020	Unscheduled review	B+	On watch
18.11.2019	Initial assignment	B+	Stable

Minute’s summary:

The rating committee for Zenith Energy Ltd was held on 25 May 2020. The quorum for the rating committee was present. After the responsible expert presented the factors which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Corporate methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the rating class voting.

The rating was disclosed to the rated entity prior to the publication and was not changed during the process of coordination.

The following methodology was used for the rating assessment:

- Methodology for Assigning Corporate Credit Ratings – Full Version (from November 2018)
- Methodology for Assigning Country and Industry Score – Full Version (from November 2018)

Descriptions and definitions of all rating categories can be found under the Rating scale section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

The definition of default can be found on the Agency’s website in the section for Internal policies.

This rating is solicited. The rated entity participated in the rating assignment process.

No other third party participated in the preparation of the rating.

Main sources of information:

- Questionnaire from Zenith Energy based on the form provided by the Agency
- IFRS Quarterly reports for the past five years
- Audited IFRS Annual reports for the past five years
- Company’s 2019 Investor Presentation
- Zenith Energy Anti-Corruption and Bribery Policy
- Zenith Energy Group Chart
- Answer for additional request based on the form provided by the Agency
- Other relevant documentation was also provided by the company
- Information from media and other public sources.

ESG Disclosure

We consider Environmental, Social, and Governance (ESG) risks and opportunities in the creditworthiness analysis of our Sovereign entities. The disclosure document can be found on the Agency’s website in the section: ESG factors in RAEX-Europe's Credit Ratings

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information as well as non-public information (obtained from the rated entity and/or other third parties) which was considered to be reliable, complete and non-biased. The responsible expert performed rating assessment of the company with information considered as the most reliable and up to date in accordance to the overall position of the company and the Agency’s internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. The experts involved in the rating assessment and revision of the rated entity showed no conflict of interests before initiation of the rating process**.**

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies from RAEX group.

Risk warning

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency’s press-release.

This press-release represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.