BBB

ISSUER RATING

Long-Term

Outlook	Stable
Initiation date	29/11/2022
Rating date	10/07/2023

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RATING ACTION AND RATIONALE

- EthiFinance Ratings reaffirms its long-term corporate rating for Galp Energia, SGPS, S.A. (Galp, or 'the group/the company') at BBB, maintaining a Stable outlook.
- The rating is supported by (i) Galp's scale of operations as an integrated oil & gas company with strong market share in downstream activity in Portugal; (ii) Galp's positive operating performance in the past few years leading to sound profitability margins (adjusted EBITDA margin of 14.4% in FY22); and (iii) a financial policy in line with the company's solid financial profile. Despite the capital-intensive nature of its activities, Galp has managed to improve its EthiFinance Ratings-adjusted net leverage ratio to 0.8x at YE22 (vs 1.6x at YE21).
- The rating is mainly constrained by (i) Galp's exposure to oil price volatility, particularly in the Upstream division (core generator of profitability of the group); (ii) the expected decline in demand for oil & gas products in the coming years; and (iii) the group's low geographic diversification, as the majority of its upstream assets are located in Brazil, accentuated by the sale of its exploration & production assets in Angola (to be completed in 2H23).
- According to our methodology, the Oil & Gas industry has high ESG risks (heatmap score between 4 and 5) given its impact on the environment, which constrains our industry assessment. Our assessment of the company's ESG policy is neutral (company ESG score between 2 and 4), resulting in our rating being constrained by industry-related ESG considerations.

ISSUER DESCRIPTION

Headquartered in Portugal, Galp is an integrated Oil & Gas company, with its activities ranging from exploration & production (upstream) to refining and supplying oil & gas products (downstream). With a distribution network of 1,273 service stations in Iberia, Galp is the leader in the fuel retail segment in Portugal and a significant player in Spain. The company also operates the Sines refinery, one of the largest in Iberia, with a capacity to process 226k barrels of oil per day (bpd). Through its upstream assets, Galp produced around 127k bpd in 2022, mostly from Brazil (86%) and Angola (8%). More recently, Galp has been building a renewable energy portfolio and has developed an important position as a solar player in Iberia, with 1.9TWh of energy generated in 2022 and an installed capacity in operation of 1.4GW at YE22 (0.2 GW under construction and 7.4GW under development). Over 2022 Galp generated revenues of €26.8bn, with adjusted EBITDA of €3.9bn (14.4% margin) and net adjusted leverage of 0.8x.

FUNDAMENTALS

BUSINESS RISK PROFILE

INDUSTRY RISK ASSESSMENT

- **Decline in long-term drivers expected in the coming decades for the Oil & Gas industry**

Most of the demand for this industry's products is related to the use of fossil fuel, leading to significant CO2 emissions. In order to address the need to change the traditional business model, given efforts to reduce fossil fuel consumption to contain global warming, most Oil & Gas companies have embarked on a plan to invest in renewable energy.

- **Exposure to oil price volatility, particularly in the Upstream division**

As Upstream is Galp's main unit in terms of profitability (80.1% of adjusted EBITDA in FY22), the company is significantly exposed to oil prices volatility with a sensitivity of +/- €150m EBITDA variation (c.4% of FY22 adj. EBITDA) if oil prices change by +/- $5 a barrel, as disclosed by the company. In FY20, Galp was strongly adversely impacted as a result of the oil price collapse. By the same token, in FY22 Galp benefited from elevated oil prices.

- **Strong barriers to entry as significant investments and know-how are required**

Oil production in Brazil is offshore deep-water, a complex technology typically operated through consortiums in which Petrobras is often the operator. Galp has overall CapEx of around €1bn a year in order to continue to prepare for upstream growth (oil in Brazil and gas in Mozambique), improve its retail network in Iberia, optimize its refinery activity, and expand its renewables portfolio. These heavy requirements mean high barriers to entry.

COMPANY'S COMPETITIVE POSITIONING

- **Rating supported by Galp's integrated business model with a strong market position in Portugal**

We view positively Galp's scale and range of operations - with revenues of €26.9bn in FY22 (+66.5% vs FY21) - as an integrated Oil & Gas company with strong market share in downstream activity in Portugal as well as a presence in Spain. Galp's integrated business model mitigates its exposure to oil price volatility particularly in the upstream division, with the group delivering resilient profitability in the past few years. The group's oil production has continued to increase over the past few years and we expect to experience c.20% growth by 2025, mostly from already validated projects with less reliance on new exploration. Also, Galp's oil & gas reserves life has remained stable at around 8-9 years over the past few years. As a result, the Upstream division is the main unit of the group in terms of profitability, representing around 80% and 85% of the group's adjusted EBITDA in FY22 and FY21, respectively.

- **Strong market position in distribution is partially offset by decreasing demand for oil products**

Strong market position and resilient cash generation from its downstream operations in normal years. In order to adapt to the medium-term outlook of decreasing demand for oil products, Galp decided to close one of its two refineries in Portugal (the only two in the country) in 2021, which has reduced its refinery capacity from 330k to 226k bpd. With its network of 1,273 service stations at YE22 in Iberia, Galp is the #1 in the Portuguese fuel retail segment and a significant player in Spain (26% market share in Portugal and 4% in Spain), having supplied 7.4m tons of oil products directly to consumers in 2022.

- **Rating constrained by significant asset concentration in Brazil for the Upstream division**

Even though Galp is an integrated Oil & Gas company with upstream and downstream operations, it has a very high asset concentration: Brazil for the former, Portugal the latter. In FY22, 86% of its oil production came from Brazil and 8% from Angola. It is important to note that Galp announced it will complete the sale of all its Angolan assets in 2H23, further accentuating this concentration in Brazil.

- **Galp continues to expand its renewable energy portfolio, with a focus on solar power**

Galp is continuing the development of its renewables portfolio and targets an installed capacity of around 4GW by 2025 and 12GW by 2030. In order to achieve this, the group has increased its stake in Titan (joint venture with ACS Group) from 75% to 100% in 2022 and continues to acquire different solar plants in Spain, Portugal, and Brazil. At end-2022, Galp owned a portfolio including 1.4GW of solar plants in operation, 0.2 GW in construction, and 7.4GW under development. However, the contribution of the renewable energy division to the group's EBITDA remains limited, representing c. 5% in FY22.

GOVERNANCE

- **Balanced shareholder structure**

Amorim Energia, B.V. (Amorim), a pure holding company, is the major shareholder of Galp with a 33.9% stake. Amorim is directly and indirectly owned (55%) by Américo Amorim Group, the eponym holding of the Portuguese family. Parpublica, which owns a c.7.6% stake, is a state-owned entity which manages Portuguese state holdings in several companies. Galp is listed on Euronext Lisbon with a market cap of around €8bn (at market close on June 20th, 2023) and around 59% of Galp's stock is free-float.

- **Adequate financial policy with a good management track-record**

The management has a good track-record in our view. We assess Galp's financial policy as adequate and in line with the company's solid financial profile. Additionally, despite the capital-intensive nature of its activities and paying sizable and recurring dividends, Galp has managed to improve its EthiFinance Ratings-adjusted net leverage ratio to 0.8x at YE22 (vs 1.6x at YE21), respecting its long-term reported net leverage ratio target of 1.0x (reported net leverage ratio of 0.4x at YE22). We note that Galp may perform additional distributions to its shareholders, mainly through share buybacks (€500m to be executed throughout FY23 after €150m executed in FY22), as long as its reported net leverage ratio is in line with the long-term target.

- **ESG Policy**

Going forward, as the world progressively shifts towards clean energy sources, the Oil & Gas industry faces the critical challenge of balancing short-term profitability with long-term viability. Considering this, Galp's strategic approach has been to: 1) focus on low cost & low carbon intensity upstream assets, with a portfolio carbon intensity of 10.1kgCO2/barrel of oil equivalent (boe), below the industry average of 18.3kgCO2/boe (according to IOGP 2021); 2) expand its renewables portfolio (installed capacity target of 4GW by YE25) by taking advantage of the supportive oil & gas price environment to accelerate investments (30% of CapEx on renewables in 2022); and 3) lower environmental footprint of the Sines refinery through investments in energy efficiency optimisation, expanding biofuel production and green hydrogen.

Like most of its peers, Galp has established a decarbonisation roadmap to carbon-neutral by 2050 and is on track to achieve its 2030 targets (with 2017 as a base year) which include the reduction of its overall scope 1 & 2 emissions and production carbon intensity by 40% (-20% and -14%, respectively, in 2022 vs 2017) as well as all downstream sales carbon intensity (scope 1, 2 and 3) by 20% (-4% in 2022 vs 2017). However, the most important emission for Galp stems from its scope 3 emission and consumption of oil products whose related emissions will be difficult to reduce.

FINANCIAL RISK PROFILE

CASHFLOW AND LEVERAGE

- **Strong operating performance boosted by favourable market conditions**

A favourable (for the company) market environment in 2022, marked by strong rises in oil and gas prices following the start of the war in Ukraine, enabled Galp to deliver a strong financial performance. The group's revenues increased by 67% yoy to €26.8bn. In terms of profitability, Galp's adj. EBITDA increased by 66% yoy to €3.9bn, with a stable adj. EBITDA margin of 14.4%, on the back of higher oil & gas prices and a substantially higher refining margin ($11.6/boe vs $3.3/boe in FY21), even though higher production costs ($2.8/boe vs $1.6/boe in FY21) constrained the margin improvement. We expect the group's adjusted EBITDA margin to drop slightly to 14.1% in FY23 and FY24, mainly as oil & gas prices as well as Galp's refining margin progressively decrease (while remaining at high levels compared to the pre-energy crisis period), while production costs remain relatively stable (around $3/boe in the forecast period) and downstream demand for oil & gas products continues its post-pandemic recovery.

Over FY22 Galp generated €1.1bn EthiFinance Ratings-adjusted free cash flow (after a €420m dividend payment), mainly driven by strong cash generation from operations and a positive change of €245m in working capital (vs -€1.2bn in FY21), benefiting from the expected unwind of all gas derivatives margin account balances. This compensated for a higher total CapEx of €1.1bn, mostly directed towards upstream project execution and maintenance and expanding the group's renewables portfolio. For the remainder of our forecast period, we expect the group's adjusted free cash flow (after dividends) to remain at positive levels in FY23 and FY24, supported by solid cash generation from operations and normalization of working capital. We expect this to offset the higher CapEx (around 6-7% of revenues for FY23-25), crucial for the development and maintenance of upstream projects as well as to reach its renewables installed capacity target of 4GW by YE25 (vs 1.4GW at YE22), and high level of return to shareholders.

At end-2022, the EthiFinance Ratings-adjusted net leverage ratio (including IFRS 16 lease liabilities, pension obligations and origination fees) had improved to 0.8x (from 1.6x at YE21 and 2.2x at YE20), further cementing the group's already solid financial profile. In addition, Galp's liquidity position is quite good, with €2.4bn of cash in hand at YE22 and around €1.5bn of undrawn credit facilities. Going forward, we expect Galp's adjusted net leverage ratio to remain relatively stable at around the 1.0x level over our forecast period, mainly as profitability remains at solid levels and the group continues to sell its more mature upstream assets in line with its decarbonization strategy (e.g. the sale of its Angolan upstream assets for €770m net of tax to be completed in 2H23), which compensates for higher expected CapEx.

SOLVENCY AND LIQUIDITY PROFILE

- **Moderate solvency ratio**

At end-2022, Galp's total adjusted debt (including IFRS 16 liabilities) was down slightly to €5.5bn vs €5.7bn at end-2021. It is mainly composed of IFRS 16 lease liabilities, amounting to €1.5bn, as well as around €1.4bn of floating rate notes and two €500m EMTN bonds maturing in 2023 and 2026, respectively. We have included a €250m adjustment related to employee benefits and €13m for origination fees. We view Galp's debt maturity profile as adequate, mainly as c.56% of total debt matures over the next 3 years, despite some concentration of repayments in 2023 (c.20%).

At end-2022, the group's solvency ratio was moderate at c.93%, and we expect the ratio to remain in a 90-100% range during our forecast period.

- **Adequate liquidity profile**

We assess the liquidity profile of Galp as "Adequate" (the best of the three profiles according to our long-term methodology), reflecting the company's strong refinancing profile and high liquidity level.

RATING MODIFIERS

- **Controversies**

No controversies have been identified.

- **Country risk**

Despite a very high asset concentration in Brazil in its upstream division, we estimate the country risk to be not significant given that Galp operates through consortiums (with other large oil & gas players) in which Petrobras (majority-owned by the Brazilian state) is often the operator.

MAIN FINANCIAL FIGURES AND FORECASTS

Main financial figures €m	FY21	FY22	FY23e	FY24e	FY25e	22vs21
Revenues	16 118	26 840	21 149	20 657	20 095	66,5%
EBITDA adjusted (RCA) (1)	2 319	3 859	2 992	2 909	2 857	66,4%
EBITDA Margin	14,4%	14,4%	14,1%	14,1%	14,2%	0,0pp
EBIT adjusted (RCA) (1)	1 372	2 346	1 800	1 745	1 724	71,0%
EBIT Margin	8,5%	8,7%	8,5%	8,4%	8,6%	0,2pp
EBT	1 247	2 200	1 595	1 523	1 485	76,4%
Total Assets	14 912	16 096	15 665	15 847	15 679	7,9%
Equity	3 970	5 117	4 757	4 845	4 899	28,9%
Total Financial Debt	5 737	5 527	5 245	5 140	4 957	-3,7%
Net Financial Debt	3 795	3 095	3 187	2 869	2 768	-18,4%
Equity/TFD	69,2%	92,6%	90,7%	94,3%	98,8%	23,4pp
NFD/EBITDA	1,6x	0,8x	1,1x	1,0x	1,0x	-0,8x
Funds From Operations	1 893	2 457	1 826	1 764	1 715	29,8%
FFO/NFD	49,9%	79,4%	57,3%	61,5%	62,0%	29,5pp
EBITDA/Interest	18,6x	26,4x	14,6x	13,1x	11,9x	7,9x

(1) Replacement Cost Adjusted (RCA) basis, excluding special items and the inventory effect.

RATING SCORECARD

Credit Rating Snapshot	
Business Risk Profile	**BB+**
Industry Risk Assessment	*BB-*
Industry ESG Assessment	*Negative*
Competitive Positioning	*BBB-*
Governance	*BBB+*
Financial Risk Profile	**A-**
Cash flow and leverage	*A*
Solvency	*BBB-*
Company's ESG Assessment	*Neutral*
Anchor Rating	**BBB**
Modifiers	-
Rating	**BBB**

RATING SENSITIVITY

- **LT Rating : BBB**

Factors that may (individually or collectively) impact the ratings:

- **Long-term rating positive factors (↑)**

Galp's rating already reflects a solid financial profile and we view an upgrade based on this criterion as unlikely. Consequently, a rating upgrade could be triggered by a combination of better assets diversification in terms of geographic concentration and lower dependence on its Upstream division, currently Galp's core generator of profitability, which is significantly exposed to oil price volatility and declining long-term growth drivers.

- **Long-term rating negative factors (↓)**

A rating downgrade could be entailed by a sustained deterioration in Galp's financial profile, which could be a consequence of a more aggressive financial policy, particularly in the case of a significant increase in its dividend payout ratio and/or considerably higher share buybacks. For the same business risk profile, an increase in the group's EthiFinance Ratings-adjusted net leverage ratio above 2.0x for a sustained period of time could entail a long-term rating downgrade to BBB-.

REGULATORY INFORMATION

LEI: 2138003319Y7NM75FG53

Initiation report: No

Rating initiation: BBB for long-term rating on 29 November 2022.

Last rating action: Initiation of long-term rating at BBB on 29 November 2022

Rating nature: Unsolicited (this report is paid by investors, not the issuer).

With rated entity or related third party participation: Yes, the report was published with having been reviewed by the issuer

With access to internal documents: No

With access to management: No

Ancillary services provided to the entity: In accordance with Article 6 (2), in conjunction with Annex I, section B (4) of the Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009, it is reported that during the last 12 months EthiFinance Ratings has not provided ancillary services to the rated entity or its related third parties.

Name of the rating committee chair: Marc Pierron, Senior Director

Material sources used to support the rating decision:

- Annual report (2020, 2021, 2022)
- Quarterly reports, presentation slides and conference call
- Bloomberg

Limitation of the Rating action:

EthiFinance Ratings believes the quality and quantity of information available on the rated entity is sufficient to provide a rating.

EthiFinance Ratings has no obligation to audit or verify the accuracy of data provided.

Principal methodology used in this research available at:

https://files.qivalio.net/documents/methodologies/CRA_190_V3.CorporateRatingMethodology_Long_Term.pdf

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