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ZENITH ENERGY Ltd (Holding Company)

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AUGUST 2020		
CREDIT RATING OF A GROUP OF COMPANIES		**Initial Rating**
Date of Rating Committee:		**14.08.2020**
Date of Publication:		**25.08.2020**
ZENITH ENERGY Ltd	**Long-term rating:**	**B-**
	Outlook:	**stable**

Notes:
1) Prior to the present publication, the credit rating and rating outlook were disclosed to the rated entity or related third party. Following that disclosure amendment in the credit rating and the rating outlook have not been executed;
2) During the last 2 years, BCRA Credit Rating Agency AD has not provided ancillary services to the rated entity or a related third party.

BCRA – Credit Rating Agency (BCRA) *is the third qualified rating agency in the EU, registered under Regulation (EC) No. 1060/2009 of the European Parliament and the Council. The credit ratings, assigned by BCRA, are recognized throughout the EU and are entirely equal with the other ratings, recognized by European Securities and Markets Authority (ESMA), without any territorial or other limitations.*

At a session of the Rating Committee of BCRA, held on **13.08.2020** a report of the review of the credit rating of the **Zenith Energy Ltd** has been discussed. The session was run by D.Sc. (Econ.) Kiril Grigorov, in his capacity as a Chairman of the Rating Committee. The members of the Rating Committee discussed the grades of numerous credit rating factors and **took the following decision:**

BCRA assigns the following credit rating to

Zenith Energy Ltd:

- Long-term Rating: B- ;

- outlook: “stable” ;

The officially adopted methodology of BCRA for assigning credit rating of a group of companies and/or individual companies in the group is used: ***(https://www.bcra-bg.com/files/Holding_Methodology_2016_en.pdf).***

The users of the rating can find information on the meaning of each rating category, including the definition of default in the published Global rating scale on the BCRA's website: ***(https://www.bcra-bg.com/files/global_scale_en.pdf)***

For the elaboration of the report and assignment of the ratings, information from European Central Bank, the BCRA database, consultants and other sources of public information is used.

History and Structure of ZENITH ENERGY Ltd

Zenith Energy Ltd was incorporated and registered in British Columbia, Canada in September 2007 under the Business Corporations Act (British Columbia) as a corporation with the name Canoel International Energy Ltd. according to a shareholders' resolution dated 30 September 2014, company's name was changed to Zenith Energy Ltd.

Zenith Energy as a parent company of the group is a holding company with operations carried out through its operating subsidiaries.

The company's primary activity is international oil and gas exploration, development and production business. Currently, Zenith has a portfolio of oil and gas assets in Italy and Africa.

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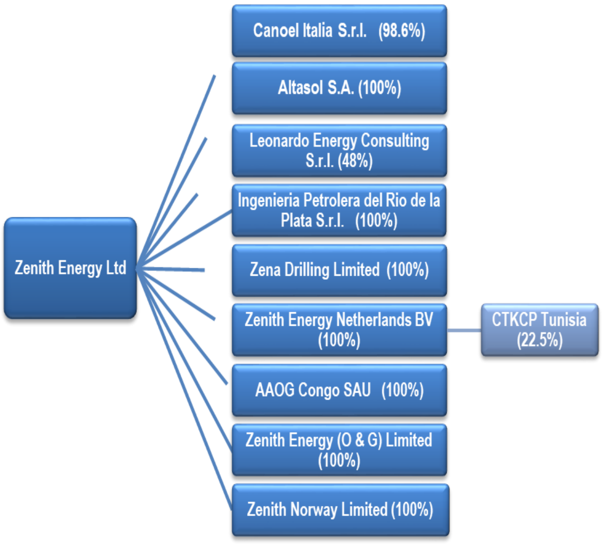
***Figure 1**: Holding Structure of Zenith Energy Ltd*



The Group's principal assets are held through three main companies:
- Canoel Italia S.r.l.
- Anglo African Oil e Gas Congo SAU ("AAOGC")
- Zenith Energy Netherlands BV (with shares in CTKCP Tunisia – 22.5%).

The history of **Canoel Italia S.r.l. ("Canoel")** dates back to March 2011, when Zenith established the company as an Italian subsidiary. The company operates or has working interests in a number of energy production assets, producing natural gas, condensate and electricity.

Company's assets are comprised of six operated and three non-operated onshore gas production concessions; an operated exploration permit (Montalbano - 57.15% working interest) and three exploration permit applications. Most of the Gas Licenses are located onshore in southern Italy, in the regions of Puglia, Basilicata, Molise, Abruzzo and Marche. The exploration permit and exploration permit applications are located in Southern Italy and cover an area of 1,285 sq. kilometres.

In October 2015, Canoel acquired cogeneration equipment and infrastructure. The acquisition has enabled the Company to produce electricity using Torrente Cigno' sub-standard natural gas production from the Masseria Vincelli 1 well and sell it directly into the national grid.

In April 2020, Zenith announced that its newly created wholly-owned subsidiary, **Zenith Energy Netherlands B.V.**, had signed a conditional sale and purchase agreement with KUFPEC (Tunisia) Limited for 22.5% acquisition of 100% subsidiary of Kuwait Foreign Petroleum Exploration Company K.S.C.C (*a subsidiary of the State of Kuwait's national oil company, for the acquisition of a working interest in*), inter alia, the North Kairouan permit and the Sidi El Kilani Concession. This concession contains the **Sidi El Kilani oilfield** ("SLK"), which covers an onshore area of 204 square kilometres in the Pelagian Basin, Eastern Tunisia.

Zenith's partners in the Tunisian Acquisition include the national oil company of Tunisia, Entreprise Tunisienne d'Activités Pétrolières (ETAP), with a 55% interest and China National Petroleum Corporation (CNPC) with a 22.5 % interest.

On May 5, 2020, Zenith announced the successful completion of the acquisition from AIM listed **Anglo African Oil & Gas plc** of a 100% interest in its fully owned subsidiary in the Republic of the Congo, Anglo African Oil & Gas Congo S.A.U, which has a 56% majority interest in and is the operator of the **Tilapia oilfield**.

In March 2020, Zenith announced that, in view of its strategic focus on pursuing large-scale oil production and development opportunities in Africa, it will handover the Contract Rehabilitation Area ("CRA") to SOCAR and has ceased all oil production operations in the Republic of Azerbaijan (which have been carried out since January 2016 by a fully owned subsidiary, **Zenith Aran Oil Company Limited ("Zenith Aran").** In June 2020, the handover process was concluded. Till the end of the fiscal year 31-3-2020, Zenith Aran was the main company in the holding.

Currently, Zenith is in the final stage of negotiations to acquire assets in **Nigeria and in another Western African country to be named**

Operating Environment

Industry-specific risks

Oil and natural gas are internationally traded commodities, subject to significant price variations over time. A prolonged period of low oil, gas or petroleum product or electricity prices may affect Zenith´s ability to maintain its long-term investment program, which is based on certain assumptions concerning price developments.

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The spread of COVID-19 has disrupted global financial and commodity markets, as well as the oil and gas industry, due to drastically reduced global demand. Brent crude oil prices have declined by 70% between their peak in January 2020 and their trough in April 2020, as mitigation measures taken to slow the spread of coronavirus have resulted in an unprecedented collapse in travel and transport.

The oil market remains fragile, but the modest recovery in prices suggests that 2020 may end on a more optimistic note. Brent crude oil spot prices averaged $40/b in June, up to $11/b from May. Lockdowns are lifted, so the demand is rising. However, there is a risk for a second global coronavirus peak, and accordingly – reversal of mitigation measures.

Country-specific risks

Zenith Energy is currently only involved in oil production in the Republic of Congo and Tunisia, and natural gas and electricity production in Italy. Therefore any legal, regulatory or other change of the framework conditions in one of those national industries may have a substantial negative effect on the financial situation of the whole group since it will likely not be able to compensate negative effects that appear in one field of business with its business activities in another area of operations. In particular, Zenith's operations in Africa are subject to greater risks than operations in more developed markets, due to higher political instability, lower security standards and less developed legal systems.

***General conclusions**:*

- ***The negative traits*****:** Companies in the industry now operate under the huge pressure of low oil prices and global uncertainty. Many of them will be forced to announce revised budgets with cost cuts, strategic reviews of projects and timelines, while some may even halt operations. In addition, risks to the economic recovery in 2021 are rising as infection rates resurge.

- ***The positive traits:*** However, the depressed market is indeed a favourable chance for companies to expand by reaching oil and gas production assets deals that a year ago were far beyond their financial reach, while African countries represent prospective hydrocarbon locations.

Zenith Energy Ltd is a smallholding public company, listed on the London Stock Exchange Main Market under the ticker symbol, "ZEN", and with its entire common share capital admitted to trading on the Merkur Market of the Oslo Børs under the ticker "ZENA-ME".

Zenith Energy's issued share capital currently (06.08.2020) comprises of 942,072,921 common shares of no par value with one voting right per common share (792,072,921 as of 26.06.2020). Zenith holds 25,395,828 (4,395,828 as of 26.06.2020) common shares (2.7% of total) in treasury. Andrea Cattaneo, the CEO, is the largest individual shareholder with 6.15% (8.15%).

The company has a solid management team where each individual senior executive has more than 25 years of experience and expertise within the oil & gas industry. The board members and their familiaries collectively hold 18% of the equity, thus having interests that are aligned with the broader investor base.

Mr. Andrea Cattaneo has been a director of the company since 9 December 2008 and has served as President and CEO of the Company since 2009. He is one of Zenith's founders and largest shareholders, a proven deal maker and government advisor with specific expertise in FSU and African countries and has more than 30 years of experience in sovereign loans, capital markets and oil trading between Western and emerging countries.

Group's board have members with sufficient knowledge and experience to manage the company. The management policies put in place are clear and comprehensive and provide a sufficiently reliable base for covering the main management risks.

BCRA has analysed separately the three main activities of Zenith Energy and has found the following:

<u>Canoel Italia S.r.l.</u>

In the last three years, the company's **revenues** have remained relatively stable, recording annual deviations below 6% in both directions. The sales of electricity production shape the main part of the revenues (~40%), followed by the reimbursed costs of joint ventures (~30%). In the last two years, the revenues from services provided entirely to the parent company (activities performed by Canoel's

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staff in favour of Zenith's UK office) were an important factor for the net financial result.

Production costs in the last three years (2017-2019) constantly exceeded sales revenues (with an average level of 102.2%), thus, forming **operating losses**. At the end of the analysed period, the **increase in indebtedness** and **increased value of assets** were observed. The company maintains an **adequate level of liquidity**. Despite the growth of liabilities, interest costs have witnessed a descending trend. Revenues from sales of products were insufficient to achieve positive operating results and their amount in the last two years was highly dependent on services invoiced to the parent company.

Table 1: *Key performance figures: 2017-2019*

TEUR	*2019*	*2018*	*2017*
Balance Sum	3 047	2 519	2 486
Fixed Assets	693	630	878
Current Assets	2 072	1 607	1 331
Equity	561	601	632
Total Net Sales Revenues	1 336	1 418	1 348
Total Net Revenues	1 336	1 418	1 348
Operating Result	-33	-12	-47
After-Tax Result	-41	-31	-72
EBITDA	102	290	144
EBITDA Margin	0.08	0.20	0.11
Leverage ratio (Liabilities / Total Assets)	0.37	0.30	0.37
Credit Liabilities / Equity	0.50	0.22	0.23
Profitability of Sales	* %	* %	* %
Current Liquidity	1.86	2.31	1.72
Instant liquidity	0.02	-0.01	0.01

** negative value*

<u>CTKCP Tunisia</u>

Zenith's interests are evolving through Zenith Energy Netherlands BV, as a holder of 22.5% interest in **Sidi El Kilani Concession in Tunisia**.

It is not possible to make an accurate estimate of the residual proven reserves in the project under consideration based on the data provided by the company and the available reference data. According to used models and studies, the residual reserves in the field are between 2.5 and 4.0 million barrels (corresponding to the daily production of 650 barrels), and the active service life is expected to be within 10-14 years. Given that the Sidi El Kilani field has been in active operation since the early 1990s, the daily production forecasts presented by Zenith are seen as optimistic. Additional proof of this is the flow of groundwater, which currently reaches about 50% of production. According to data presented by the operator in recent years (2017-2019), oil production decreased by an average of 5-6%, which is the second indicator of the last phase of development of the field.

Medium-term forecasts show that with overproduction of oil, prices by 2022 - 2023 will fluctuate between $40-30/b. Considering that the field is existing (in operational exploitation and no significant investments are planned) and operating costs remain constant**, we consider the risk in the accuracy of prognosis to be minimal, and in general, the investment to be good.** Under other circumstances (increasing the price of oil) and maintaining the projected production, profitability would increase significantly. Zenit Energy's participation in the project with less than 50% (22.5 - with an acquisition price of USD 500 thou) is an additional factor that minimizes the risk of significant investment problems.

<u>Anglo African Oil e Gas Congo</u>

The AAOGC Company, which was fully acquired in 2020, operates **Tilapia oil field** - located in the Lower Congo Basin and adjacent to multiple 1 billion-barrel fields, including the ENI operated Litchdjilii field and the 5,000 bopd Minsala Marine field. Tilapia is located just 1.8 kilometres off the coast of the Republic of the Congo and the licence covers an area of 50.51 km².

The Tilapia oilfield is drilled through deviated wells from onshore which results in a significant cost saving compared to offshore drilling but with the production and storage facilities land-based onshore. Lying in a prolific oil-producing region, it is estimated to contain P90 reserves of 7.6 million barrels in the existing R1/R2 horizons.

Seismic studies carried out by AAOG have indicated the presence of hydrocarbons in the Mengo and Djeno sands, as well as Vandji formation. The formations were not explored earlier due to the unavailability of extraction techniques. Recent drilling activity in well TLP-103C has confirmed the potential of the Mengo sandstones in the Tilapia licence, as one of the most productive reservoirs in the onshore Congo Basin. TLP-103C was a multi-target well drilled to a depth of 2,683m by the SMP-102 rig, which is a hydraulic-powered Dreco drilling rig constructed in 1996. The well encountered 56m of oil columns across multiple horizons, including the Mengo and Djeno reservoirs, and produced oil with an API of 43o from the Djeno reservoir.

The Djeno sandstones (Hauterivian age), are an exploration target which has successfully been tested during recent drilling activities in well TLP-103C. This reservoir has recently emerged as a potentially prolific horizon in Congo with significant discoveries being made in the Nene-Banga and Litchendjili offshore fields. Wells drilled in these licences have produced between 1,000 to 5,000 barrels of oil per day following fracking.

Based on the information provided by the company and through studies of the geology of the region and the field, it can be concluded that **a number of problems accompany the production from the field**. The characteristics of the reservoir, the way of oil and dissolved gas, the type of oil, the exploitation modes, etc., demonstrate constantly deteriorating productions. Newly drilled wells, in the initial stage of exploitation, produce significant amounts of oil 3,000-4,500 barrels per day. This production is achieved by further stimulating the reservoir, by acid treatment and/or fracking. Subsequently, the production is rapidly reduced due to the deterioration of the bottomhole characteristics and the production of the gas dissolved in the oil. These indicators are also evident from the presented data for the current year, which is in the order of 50 barrels per day.

In the future, Zenith plans to drill two new production wells in 2021 and 2022, through which to achieve a significant increase in production. Taking into account the data accumulated so far, it is theoretically achievable. **If in practical terms, the increase in production is not achieved, BCRA considers that meeting the Zenith's project targets would face significant difficulties.**

Zenith Energy Ltd

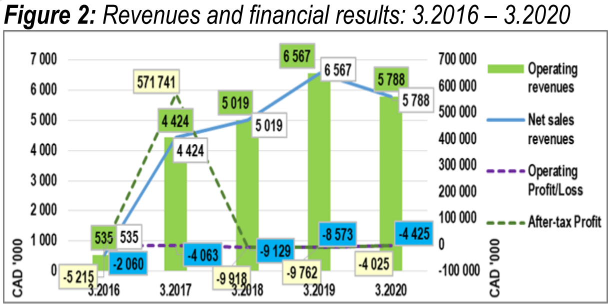
The activity of Zenith Energy according to its consolidated reports for the entire analysed five-year period (3.2016-3.2020) is strongly dominated by the activity of Zenith Aran Oil Company Limited (operator in Azerbaijan). The exit from those oilfields in early 2020 resulted in **significant changes in the financial condition** of the rated company.

After three consecutive years of insignificant changes in assets' value (less than 1%), in the last financial year (3.2019-3.2020) it declined markedly- by 63.7%, due to the release of Zenith Aran's assets, which was partially offset by the increase of assets acquired in Congo (Anglo African Oil & Gas Plc) and Tunisia (CTKCP).

Because of the announced withdrawal from Azerbaijan, the company will have to record an impairment for the assets' valuation of Azeri property. Indeed, the accumulated retained earnings as of end-March 2027 were formed because of the business combination for the acquisition of the assets in Azerbaijan. With the audited data, which will be divulged on the 30th of September 2020, we will see the exact size of the impairment as well as the value of business combinations for the new acquisitions in Africa.

Apart from 2017, which ended with profit, all other analysed reporting periods ended with significant accounting losses. The last financial year (3.2019-3.2020) was marked by a **decrease in the loss amount** - to CAD 4,025 thou after CAD 9,762 thou (3.2018) and CAD 9,918 thou (3.2019). The positive result was obtained despite the 11.9% lower sales revenue. In the previous three years, the growth in product sales proved insufficient to achieve positive financial results.

Figure 2: *Revenues and financial results: 3.2016 – 3.2020*



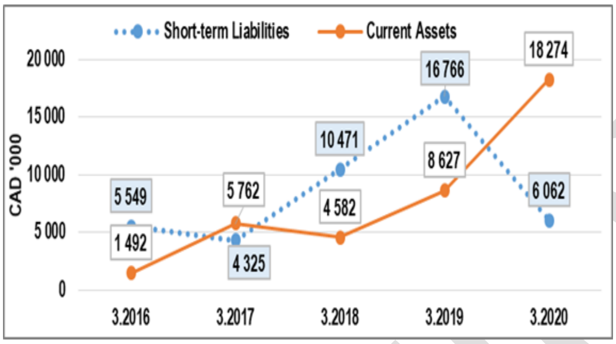
Zenith Aran has played a dominant role in sales revenue throughout the period, also supported by the relatively steady revenues of Canoel Italia.

The structure of assets is strongly dominated by the *Fixed (Non-current) assets*, in which *Property, plant and equipment* (above 95% throughout the period) account for the most. Regarding the value of this most significant group of assets, as there is no available market for group's oil and gas properties, their fair value is derived as the net present value of the estimated future cash flows arising from the constant use of the assets, incorporating assumptions that a typical market participant would take into account. **This creates a risk for the accurate valuation of the assets.**

In the last two years of the analyzed period, the **receivables** increased significantly (203.9% and 183.7% YoY) and in the last financial year, the **liquid assets** (cash and bank deposits) decreased by 40.4% YoY, reaching of CAD 1,823 thou as of 31.03.2020.

In the last financial year, a certain improvement was observed in the **structure of liabilities** as short-term liabilities decreased markedly, becoming three times lower than the value of current assets.

Figure 3*: Coverage of Short-term liabilities with Current Assets: 3.2016 – 3.2020*



After a sharp increase of **borrowed funds** in the financial year ending March 2017 and preserved gradual growth of these liabilities until end-March 2019, in the financial year ending March 2020, they declined considerably (by 77% on an annual basis).

The Company reported an increase in financing through issued **Non-convertible bonds** against the decrease in loan liabilities. The Company has issued European Medium-Term Notes (Program for the issue of EUR 25 mln - Prospectus from November 2019) to finance its development activities in Azerbaijan for a total amount of CAD 4,759 thou with a duration of 3 years. At the beginning of 2020 (11 February), the Company announced that new unsecured, multi-currency Euro Medium-Term Notes at par value have been issued (worth a total of EUR 3.9 million). The maturity date is January 27, 2024.

On the liabilities side, the withdrawal from Azerbaijan will bring more than 50% reduction in liabilities, in particular - the contingent liabilities for development work on the very large properties in Azerbaijan, which were placed on the assets side of last year balance sheet.

In addition, the trade creditors will disappear as they will remain with the joint venture in Azerbaijan.

Once the Audited accounts are released, we will able to see the exact size of the improvement on the liabilities side, which will be anyhow relevant as the Contingent liabilities and the Trade creditors in Azerbaijan were the core of the liabilities side in last year's account.

The following table presents the dynamics in key performance indicators of Zenith Energy Ltd, which have already been commented above.

Table 2*: Key performance indicators: 3.2016 – 3.2020*

CAD'000	*3.2020**	*3.2019*	*3.2018*	*3.2017*	*3.2016*
Balance Sum	394,810	1,088,688	1,082,468	1,079,096	16
Fixed Assets	376,536	1,080,061	1,077,886	1,073,334	15
Current Assets	18,274	8,627	4,582	5,762	1
Equity	253,391	569,081	571,894	575,447	-2
Liabilities	141,419	519,607	510,574	503,649	19
Total Sales Revenues	5,788	6,567	5,019	4,424	1
Total Revenues	6,188	6,567	5,019	583,846	1
Operating Result	-4,425	-8,573	-9,129	-4,063	-3
After-Tax Result	-4,025	-9,762	-9,918	571,741	-8
EBITDA	-1,817	-7,478	-7,697	573,673	-8
EBITDA Margin	-0.29	-1.14	-1.53	0.98	-10.24
Leverage ratio	0.36	0.48	0.47	0.47	1.14
Credit Liabilities / Equity	0.05	0.02	0.01	0.01	-1.71
Profitability of Sales	-**	-**	-**	-**	-**
Current Liquidity	3.01	0.51	0.44	1.33	0.18
Instant liquidity	0.30	0.18	0.24	0.91	0.02

** draft financial statement; ** negative value*

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General Conclusion: The Group demonstrates improvement in its balance items following the strategic decision to withdraw from business operations in Azerbaijan. To the extent that the expectations for the revenues from the new acquisitions exceed in value the ones realized in the last few years, an improvement in the general financial condition of the group can be expected. The increase in *Equity* and the *Liquidity*, as well as maintaining low *Leverage ratio* will have a positive rating effect.

A **conservative prognosis** of the financial cash flow for the period March 2021 – March 2023 has been prepared by BCRA based on:

- the strategy and business plans provided by the company's management and;
- an independent expert opinion on yield opportunities in West Africa.

The results show that if Zenith Energy fails to achieve the impressive planned level of oil production in Republic of Congo (or in other future activities in Nigeria and in another Western African country to be named), the company may have difficulties to generate sufficient cash flow to service its long-term liabilities.

In this case, the company may have to raise additional funds by placing shares.

Zenith Energy Ltd can be considered as a smallholding structure of companies, which has made a significant change in its business strategy - terminating unsuccessful business in Azerbaijan and transferring its oil and gas production activities to West Africa.

The company has ambitious plans. If the goals-set are achieved, it will be able to recoup the investments made in the acquisition of its new assets in a relatively short time.

Achieving a successful development of business activities, increasing capital and increasing operating profitability and efficiency are among the factors that may have a positive impact on the company's rating.

A significant increase in liabilities and unreached increase in revenues and financial results in the main companies from the group may lead to significant difficulties in servicing its obligations and to a credit rating downgrade, accordingly.

The assigned rating expresses an external, objective, and independent opinion for the capability of the rated Company to serve its liabilities in full, and on time.