

## **FITCH EXPECTS TO RATE PETROPERU'S \$2B PROPOSED NOTES 'BBB+(EXP)'**

Fitch Ratings-New York-01 June 2017: Fitch Ratings expects to assign a 'BBB+(EXP)' long-term rating to Petroleos del Peru S.A.'s (Petroperu) proposed senior unsecured bond of up to USD2 billion. The company expects to use the proceeds from the proposed issuance to finance the expansion of its Talara refinery.

### **KEY RATING DRIVERS**

Petroperu's ratings reflect its ownership by the Peruvian government, the company's strong strategic ties with the state, and its strategic importance to maintaining the country's energy supply. As a state-owned company, Petroperu's foreign currency (FC) IDR is strongly linked with the credit profile of the Peruvian sovereign (FC IDR 'BBB+';/ LC IDR 'A-', Outlook Stable). The government support has been evidenced by multiple recent actions including decrees promulgated to transfer all the company's pension liabilities to the state, recover the value added tax for the company's operations in the Amazonian region, and inject approximately USD315 million of additional capital for the Talara expansion (PMRT).

Further evidence of government support can be seen in the Republic of Peru's approval of a financial guarantee of up to USD1 billion to support the financing of the Talara project, although the precise mechanism by which this guarantee would be implemented is still being reviewed. Petroperu's stand-alone credit quality would be in line with a 'B' long-term rating if the company were not owned by the state and the Peruvian government were not to provide financial support should the company require it.

### **Government Support:**

Petroperu's ratings reflect its close linkage with Peru's ratings due to the government's control of the company and its strategic importance to the country as its largest hydrocarbon company and the strategic location of the company's refineries. Petroperu is the largest refiner in Peru with five refineries and approximately 100 thousand barrels per day (kbpd) of refining capacity. The government of Peru is currently Petroperu's only shareholder. The company's credit linkage to the sovereign is further demonstrated by the explicit support of the government through a financial guarantee for up to USD1 billion to finance the modernization of the Talara refinery.

### **Unsustainable Near-Term Capital Structure:**

Absent implicit and explicit government support, Petroperu's credit metrics are not consistent with the assigned rating. As of FY2016, the company reported total financial debt of PEN6.6 billion and total net debt/EBITDA of 5.8x, adjusted for non-recurring pipeline repair provisions. Gross leverage is expected to exceed 14x in the next three years as there will be an increase in debt to finance the PMRT and the expansion will still be under construction.

### **Cash Flow Stabilizing:**

In spite of the aforementioned price pass-through distortions and certain operational interruptions to its transportation business, Petroperu has been able to maintain fairly stable and healthy margins. Fitch expects this trend to continue with EBITDA margins over the next several years largely in line with the 7.6% that the company achieved in 2016. CFO is also projected to remain positive through the rating horizon. FCF is expected to be negative in light of the company's aggressive capex investments. Provided that PMRT is completed in accordance with the latest timing guidelines, significant changes to Petroperu's cash flow generation are unlikely before 2021.

### High-Volatility Sector:

Petroperu's sales prices are set based on international crude oil and derivatives prices and exposed to the cyclical nature and volatile nature of the industry. Refining remains one of the most cyclical of corporate sectors and is subject to periods of boom and bust, as well as sharp swings in crack spreads depending upon market conditions, most recently evident in the sudden improvements and contractions seen in the last two years. Fitch's assumptions going forward consider a marginal recovery in oil prices which should help stabilize Petroperu's crack spreads in the near term.

### Political Risk:

Petroperu is exposed to different changes in the Peruvian liquids fuel regulation, as occurred in 2010 with the prohibition of commercializing diesel with more than 50ppm of sulfur in Lima and Callao, then extended to other regions. This regulation affected Petroperu's cost of sales, which increased by +12% YoY in 2013, and forced the company to embark on a USD4.4 billion capex program for the modernization of the Talara refinery, including the expansion of the refinery and the inclusion of the desulfurization unit.

### KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- Petroperu's ratings assume the implicit support from the government given the company's strategic importance would materialize should the company need it;
- WTI oil prices of \$50/bbl in 2017, rising to \$62.5 in the long-term;
- 2017-2020 capex of \$3.5 billion mainly related to the modernization of the Talara refinery;
- Crack spreads generally stabilize over the forecast period as crude price movements smooth out;
- Additional debt issuance of approximately USD2 billion in addition to the proposed debt issuance.

### RATING SENSITIVITIES

An upgrade of Petroperu could result from an upgrade of the sovereign coupled with significant and sustained improvements in operating and financial performance.

A negative rating action could be triggered by a downgrade of the sovereign's rating, the perception of a lower degree of linkage between Petroperu and the sovereign, and/or a substantial and sustained deterioration in the company's credit metrics.

### LIQUIDITY

Petroperu's near-term maturities are manageable. Pending maturities include \$862 million due 2017, which is expected to be paid in full with the proceeds of the various debt issuances in 2017 totalling approximately PEN10 billion (USD3 billion). At 6.2x as of year-end 2016, Petroperu's adjusted leverage metrics remain high for the rating category and is expected to continue increasing through the next few years as Talara-related debt is incurred. Fitch expects total debt to peak at between USD4 billion-USD5 billion with gross leverage at or above 14x.

### FULL LIST OF RATING ACTIONS

Fitch has assigned the following expected rating:

Petroleos del Peru S.A. (Petroperu)

- Proposed senior unsecured notes 'BBB+(EXP)'

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#### Applicable Criteria

Criteria for Rating Non-Financial Corporates (pub. 10 Mar 2017)

<https://www.fitchratings.com/site/re/895493>

Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016)

<https://www.fitchratings.com/site/re/886557>

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