

Research Update:

Petroperu Rating Lowered To 'BB+' From 'BBB-' And Placed On CreditWatch Negative On Higher Governance Risk

March 15, 2022

Rating Action Overview

- Peruvian government-owned refiner and fuels supplier Petroleos del Peru S.A. (Petroperu or the company) recently announced that its auditor will not sign the contract for the audit of fiscal year ended Dec. 31, 2021. Amid uncertain political conditions in Peru, we consider this event as a clear sign of Petroperu's weakening governance, which exposes the company to a potential breach of covenants and potentially to a significant deterioration of its liquidity and financial flexibility.
- Therefore, on March 15, 2022, S&P Global Ratings lowered its global scale foreign currency rating on Petroperu to 'BB+' from 'BBB-' and placed it on CreditWatch with negative implications. We also lowered the stand-alone credit profile (SACP) to 'b' from 'b+' and maintained our view of the likelihood of support from the government, its owner, as very high.
- The CreditWatch negative captures our view that there's a chance we could downgrade the company multiple notches in the next 90 days related to the uncertainties about how Petroperu will execute its plan to address the 2021 audit.

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Rating Action Rationale

Petroperu's announcement about its audit triggered us to review our management & governance (M&G) score and the company's SACP. We revised our management and governance score for Petroperu to weak from fair, reflecting our view that Petroperu has a lower ability than we expected to identify, anticipate, and effectively control certain critical risks, illustrated by the virtual impossibility to release timely audited statements for 2021 due to the disagreement between the company and its auditor. The audit situation also comes amid uncertain political conditions in the country. We don't consider this situation as commensurate with an investment-grade rated issuer. The worsening M&G assessment also led us to revise downward the SACP by one notch, which resulted in a one-notch downgrade to the final rating.

If the information covenant isn't waived, it could constitute an event of default (EoD) under the terms and conditions of the existing debts, which could hurt liquidity. Petroperu is likely to miss the deadline to release its 2021 audited financial statements as required by its bonds agreement and the CESCE credit agreement, which is 150 days from closing (i.e., May 2022).

In addition, it will need to negotiate a waiver to avoid a technical breach of the documentation covenant. If it doesn't obtain a waiver, it would represent an EoD on the two main funding sources for the Talara refinery project (the international bonds and the CESCE facility), which could potentially result in debt acceleration, also cascading to other short-term uncommitted bank facilities in case of nonpayment due to the cross-default clauses.

This would severely damage the company's liquidity, financial flexibility, and capital structure. We note that in the current business conditions, access to credit could become tighter and more costly, particularly from international banks.

However, currently we aren't revising our liquidity assessment for Petroperu, which remains as less than adequate. In our opinion, it's too soon to consider liquidity as weak, given the available short-term facilities (which remain in place according to the latest information provided by the company's management team), the recovery of Petroperu's financial performance in 2021, the steady EBITDA we expect for 2022, and the support Petroperu has received so far from the financial community (for example, the renewal of short-term facilities), even under stressful conditions during the pandemic, which we attribute to the company's structure as a state-owned company. On this basis, we'll wait to see the effectiveness of the company's plan to address the situation and avoid an EoD.

Petroperu has announced a plan to address the audit delay. The company presented a plan to address the delay in the release of its audited 2021 statements and other related implications. We consider this a necessary step, yet not a positive one.

The plan includes resuming negotiations with other partners at PwC (the auditor) and launching a bid process for other audit firms to tender. The target is to have a contract signed by March 31 with either PwC or another auditing firm and start audit proceedings immediately after, on April 1. Petroperu's target date for releasing audited statements is June 15. Therefore, the company and its financial advisor will launch a standstill request immediately after it appoints the auditor.

We will monitor how the plan advances and the company's liquidity as the main drivers to our upside and downside scenarios.

We maintain our assessment of a very high likelihood of extraordinary support from the government. In our view, there's still a very high likelihood that the company will benefit from timely and sufficient extraordinary support from the government in the event of financial distress. We base this assessment on our analysis of the company's very important role in Peru's energy matrix. We also think Petroperu has a very strong link to the government. The latter is involved in key investment decisions and gives authorization to conduct significant investments and approval to raise debt. In the past, the government injected \$325 million in capital in January 2017, approved the law that provided \$1 billion in guarantees to support the financing of the Talara refinery's upgrade, and enacted the Law 033/2020 in response to the pandemic, which allowed Banco de la Nación del Peru to provide financial assistance in 2020 to Petroperu and other state-owned companies.

We will continue to monitor the relationship between Petroperu and the Peruvian government, including the latter's incentives, capacity, and actual tools to support the company, particularly in the uncertain global economic conditions.

CreditWatch

The CreditWatch negative captures our view that there's a chance we could downgrade Petroperu by multiple notches in the next three months, related to the uncertainties around the timely execution of its proposed plan to address the 2021 audit. These include the need to appoint an auditor, the need for a waiver consent to avoid a technical default, the uncertainty of effectively getting a clean and unqualified audit by June 15, and the potential severe impact on liquidity if, for any reason, the 2021 audit isn't delivered as planned and an EoD is declared. The audit situation also comes amid political uncertainty in Peru and extreme global volatility. We expect to resolve the CreditWatch in the next 90 days.

We could lower the ratings on Petroperu if the company doesn't address the audit of its 2021 statements satisfactorily, hurting liquidity. For example, if the company doesn't present the audited statements on time and no waiver is granted, it would constitute an EoD and potentially result in a debt acceleration, while Petroperu could see its access to credit and capital markets weaken significantly. In this scenario, liquidity could become weak and we could consider the company's capital structure as unsustainable, which could lead to a multi-notch downgrade.

We could also downgrade Petroperu to 'BB' or below if the likelihood of government support diminishes while other credit factors remain unchanged. That could occur, for example, if our view of the company's role to the government weakens or if Petroperu's importance to the Peruvian energy sector lessens.

We could remove the rating from CreditWatch and assign a stable outlook if the company presents to the market all necessary waivers to prevent an EoD from being declared, together with releasing its unqualified 2021 audited financial statements in line with its plan (by June 15 at the latest). In this scenario, we would also expect the maintenance of short-term credit facilities, which we typically consider as a relevant part of our liquidity assessment for Petroperu.

An upward revision of our M&G assessment would require our view and some track record that the company has strengthened its capacity to identify, anticipate, and more effectively control critical risks like the timely delivery of financial statements under discussion.

We could upgrade Petroperu if our view of the likelihood of extraordinary support increases, for example, if the company's role to the government--or link to it--rises.

Environmental, Social, And Governance

ESG credit indicators: To E-4, S-2, G-5; From E-4, S-2, G-2

We revised our governance score to '5' from '2'. Governance factors, as explained in this research update, are a very negative consideration in our credit rating analysis, affecting more than one analytical component or one severely.

Similar to other refineries, environmental factors are a negative consideration in our credit rating analysis of Petroperu. We view environmental risks in the refining and marketing sector as well above average because the refining process is an important source of carbon dioxide emissions and produces carbon-based fuels, demand for which will be affected by the energy transition. On this front, we acknowledge that the investment in Talara is designed to reduce the environmental impact, and we will monitor that accordingly. The sector also has material exposure to regulations on emissions and carbon taxes, as well as to pollution, transport spills, and contamination risks,

which may result in financial and reputational damage.

Social factors have an overall neutral influence on our rating analysis.

Ratings Score Snapshot

Issuer Credit Rating: BB+/Watch Neg/--

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Highly leveraged

- Cash flow/leverage: Highly leveraged

Anchor: b

Modifiers

- Diversification/portfolio effect: Neutral
- Capital structure: Neutral
- Financial policy: Neutral
- Liquidity: Less than adequate
- Management and governance: Weak (-1 notch)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: b

- Likelihood of government support: Very high (+4 notches from SACP)

Environmental, social, and governance (ESG) credit factors for this change in credit rating/outlook and/or CreditWatch status:

- Risk management, culture, and oversight
- Transparency and reporting

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Downgraded

	To	From
Petroleos del Peru Petroperu S.A.		
Senior Unsecured	BB+	BBB-

Downgraded; CreditWatch/Outlook Action

	To	From
Petroleos del Peru Petroperu S.A.		
Issuer Credit Rating	BB+/Watch Neg/--	BBB-/Stable/--

	To	From
Petroleos del Peru Petroperu S.A.		
Analytical Factors	b	b+

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