

Research Update:

Petroleos del Peru Petroperu S.A. Downgraded To 'B+' From 'BB' On Weaker Capital Structure; Outlook Stable

October 12, 2023

Rating Action Overview

- We view Petroleos del Peru's (Petroperu) capital structure as increasingly weak, although we expect financial performance to recover in 2024 once the Talara refinery becomes fully operational. 2023 will remain a very fragile year for Petroperu amid scarce liquidity that triggered a new aid request to the government and the need to negotiate covenant terms with Compañía Española de Seguros de Crédito a la Exportación (Cesce).
- Amid the tighter liquidity and higher leverage than we previously anticipated due to new support from government and new third-party funding, we revised downward the company's stand-alone credit profile (SACP) to 'ccc+' from 'b-'.
- Despite the company's weaker performance, we continue to think there's a very high likelihood of extraordinary support from the Peruvian government, which continues to be a key rating driver. We still expect the government would intervene to prevent a default of the company.
- On Oct. 12, 2023, S&P Global Ratings lowered its ratings on Petroperu to 'B+' from 'BB' due to the SACP revision. The outlook is stable.
- The stable outlook captures our assumption of the very high likelihood of extraordinary support, which we expect will be instrumental for bridging the liquidity needs during fourth-quarter 2023, in addition to the ongoing negotiations of certain terms with Cesce.

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Rating Action Rationale

Poor performance so far this year and support that translated into higher debt have weakened the company's capital structure, and we don't anticipate meaningful deleveraging from Talara's cash flows in 2024-2025. 2023 performance has been weak so far, hampered by Talara's bumpy ramp-up (requiring higher oil purchases and not resulting in sellable products), a falling market share affecting volumes, social unrest in Peru, and rough weather conditions, among other factors. Despite Petroperu's efforts, liquidity hasn't improved, resulting in a new

request for support to its shareholders for \$3.2 billion, the need to renegotiate some covenant terms with Cesce, and as a result, lower creditworthiness.

We view the company's capital structure as unsustainable at this point. The higher costs for Talara (budget increased to \$5.3 billion from \$5.1 billion before interest) and the financial assistance from the government resulted in higher debt, while the company still seeks to set up new funding sources to stabilize liquidity, which will further weaken capital structure. Although we expect higher EBITDA in 2024 (driven by Talara's operations and the stabilization of working capital), we don't expect meaningful deleveraging in at least the next 12 months.

With the company's total debt burden already at \$6 billion as of June 2023 (and potentially nearing \$7 billion by year-end, depending on how much the company manages to raise during this quarter), we consider our EBITDA expectation of about \$450 million as insufficient to cope with an interest burden of at least \$300 million, the \$144 million Petroperu repays yearly to Cesce, the repayment of the \$750 million to the Ministry of Finance (MEF), and capex of \$400 million-\$450 million (mainly maintenance and pending payments on Talara). The company remains extremely dependent on working capital dynamics, external credit, and ultimately on government support. As a result, the chance of a structural reduction of debt in 2024 appears slim. At this stage, we don't expect that the contribution from Talara in 2024 will result in a sustainable capital structure or a meaningful improvement of leverage metrics.

We note the stated goal of shareholders to restructure the company and regain market share.

This restructuring plan includes the comprehensive plan from the consortium Arthur D. Little LLC - Columbus HB Latam Inc., changes in key management positions, changes to the company's by-laws, and the set-up of the framework for a potential public offering; in addition to the still ongoing negotiations on pending initiatives to raise new third-party funding. However, in our view, this will take time to bear fruit while the company's creditworthiness has worsened.

In addition, we think that any potential recovery of EBITDA beyond our expectations will depend, among other factors, on the management's ability to effectively recover market share and put Talara's output in the market profitably, to implement the restructuring plan efficiently and timely, and to deliver audited statements on time (statements have been late the past two years). In view of the various changes of board members and other key managerial positions, we view management effectiveness as a crucial issue to monitor.

We continue to assess a very high likelihood of extraordinary government support because we expect it to materialize again to allow Petroperu to avoid a liquidity crunch or payment default.

The government has a long track record of supporting the company. We saw such support materialize when Petroperu's crisis began in early 2022. This support included the \$750 million loan from the MEF, the decree 023-2022 implementing a \$1 billion equity contribution, a guarantee for a \$500 million short-term facility from Banco de la Nación, and the set-up of a framework for the company's comprehensive restructuring, including a potential public offering. In our opinion, all these measures were essential for Petroperu's business continuity and instrumental in preserving fuel supply in Peru, to prevent business disruptions and a potential default in payments.

However, support hasn't conclusively solved -in our view- the company's increasingly levered capital structure, its scarce liquidity or restored market confidence. This is despite the company's efforts and the shareholders' stated intention to support the company to avoid defaults. Although we think amounts and mechanisms of support could be subject to discussion between the company and its shareholders, we also believe that the response from government officials suggesting a shift in government priorities may have raised concerns in the financial community.

As a result, we have reviewed our assessment for extraordinary support and decided to keep it unchanged at this stage. Our review included qualitative aspects like the effectiveness of oversight and supervision and the intention to have a partial public offering. We think that the government has the willingness and capacity to provide the necessary support to Petroperu in case of financial distress and to avoid a payment default. We base this view on the record of support and the repeated statements from government officials that they can't afford a default in payments by Petroperu or a disruption in Peru's fuel supply.

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

We continue to view liquidity as weak because the company's planned initiatives to restore it haven't yet materialized. Despite the release of the unqualified 2022 audit, Petroperu's liquidity remains under pressure and depends on third-party funding (including government support). The company has sent a new request for support to the government and continues to negotiate the reopening of uncommitted credit lines and the set-up of long-term facilities, all of which have taken longer than anticipated.

Outlook

The stable outlook on the company mainly reflects our view that Petroperu will continue playing a very important role in Peru's energy and infrastructure policy while its link to the government remains very strong. As such, it captures our expectation of a very high likelihood of extraordinary government support, which we expect will be instrumental for bridging Petroperu's liquidity needs in the fourth quarter, in addition to a satisfactory outcome from the ongoing negotiations of certain terms with Cesce.

Downside scenario

We could downgrade Petroperu if the company were to face an imminent default in payments, and absent any indication of ongoing or extraordinary support from the government. We currently view this as unlikely based on our assessment of government support.

We note that considering Petroperu's 'ccc+' SACP, a downgrade of the sovereign wouldn't translate into a similar action on the company. Likewise, if we revised our view of the likelihood of support downward, it would not affect the rating on the company.

Upside scenario

We could upgrade Petroperu following a similar action on the sovereign, which we view as unlikely given the negative outlook on Peru. We could also upgrade the company if our view of the likelihood of extraordinary support increases, for example, if the company's role to the government--or link to it--strengthens, which we don't envision in the next 12 months.

Finally, we could revise our SACP upward, and consequently raise the ratings (all else being equal), if we changed our view about the company's unsustainable capital structure. This could occur once Talara is fully operational and the company is able to reduce its total debt burden, resulting in debt to EBITDA of about 5x, consistently.

Company Description

Peru (foreign currency: BBB/Negative/A-2; local currency: BBB+/Negative/A-2) owns 100% of Petroperu, of which 60% belongs to the Ministry of Energy and Mines (MINEM) and 40% to the Ministry of Finance (MEF).

The company transports, refines, distributes, and markets fuels and other petroleum-derived products in Peru. Petroperu owns and operates three refineries (Talara, Conchan, and Iquitos) with a total refining capacity of 92,500 barrels per day (bpd). The company also owns and operates the Nor Peruano oil pipeline (approximately 1,100 kilometers in length), which is Peru's main transportation pipeline that connects all of the country's major oil blocks to the country's largest refinery and port. Petroperu distributes fuel through ships, trucks, and rail cars, and sells it mainly through affiliated retail stations that work exclusively with Petroperu.

Most of the company's revenue and EBITDA come from the refining, marketing, and distribution of oil products in the country. Petroperu is making a material investment to upgrade Talara, which will increase its refining capacity to 95,000 bpd from 65,000 bpd, and to a total of 122,500 bpd for all three operating refineries. This initiative explains the vast majority (about 85%) of Petroperu's total outstanding debt. Petroperu formally inaugurated the plant in April 2022, starting its ramp-up period. After several delays, the company expects the ramp-up to be completed by the end of October 2023 and be fully operational in November.

Our Base-Case Scenario

Assumptions

- We incorporate in our projections macroeconomic variables that we view as relevant for the refining segment, particularly GDP growth that's mainly correlated to energy demand and inflation that affects selling, general, and administrative (SG&A) expenses. Refer to "Credit Conditions Emerging Markets Q4 2023: High Interest Rates Sour The Mood," published on Sept. 26, 2023. We forecast Peru's weighted GDP growth of 1.7% in 2023, 2.4% in 2024, and 2.8% in 2025, and inflation rate at 6.6% in 2023, 3.2% in 2024, and 2.3% thereafter.
- Talara to be fully operational in November 2023, per the latest company disclosure. We expect 90,000-95,000 barrels per day (bpd) in 2024-2025, with a higher mix of in-house refining and a utilization rate between 70%-75%. We also expect a much higher share of crude oil versus refined products in Petroperu's total purchases in 2024 and onward.
- A more gradual recovery in volumes in 2024, because we find Petroperu's expectations overly optimistic. We also increase SG&A expenses +10% over inflation in 2024 to capture commercial efforts to regain market share. In other words, we do not include in our base case the recovery of market share lost during the last few years.
- Fuel prices, as well as prices for the purchase of oil and refined products, moving in tandem because both correlate to oil prices. We base our oil price assumptions on "S&P Global Ratings' Oil And Current Forecasts Previous Forecast Gas Price Assumptions Are Unchanged," published on Sept. 20, 2023. We assume a WTI price stable at \$80 per barrel in 2024-2025.
- Working capital changes to stabilize in 2024, after the material negative impact seen in 2022 that resulted in the company's capitalization by the government and stable performance in the first half of 2023. All else equal, more stable oil prices should translate into more stable

working capital needs.

- We maintain capex amounts following management's latest guidelines. We lowered 2023 capex expectations to \$511 million from \$820 million because some bills related to Talara can be pushed into 2024. We also adjusted 2024 capex upward to \$450 million from \$180 million-\$200 million.
- Capital structure and liquidity assumptions incorporate the latest changes such as the extension and amortization of the MEF loan into 2024, payable in 12 installments. We don't consider new inflows because none of the initiatives have materialized.
- No dividend payments.

Key metrics

We expect weak or no EBITDA in 2023, which remains dependent on the timing for Talara's completion. Once Talara is fully operational, we expect EBITDA to recover to about \$450 million in 2024 and 2025. Accordingly, leverage should decrease to about 16x after skyrocketing in 2022-2023. In addition, we expect EBITDA interest coverage to hover near 1.3x in 2024-2025 and free operating cash flow to remain negative in 2024.

Liquidity

We continue to assess the company's liquidity as weak because sources to uses of cash still indicate a material deficit in the next 12 months.

Our liquidity assessment also incorporates qualitative factors. For now, the company's liquidity remains dependent on government support until its access to uncommitted, short-term bilateral facilities is restored and the extension of the loan from MEF and the implementation of other long-term facilities is confirmed.

Liquidity continued to weaken in the third quarter, demonstrated by Petroperu's request for new government support and fueled by weak results released in the first half and the need to rediscuss terms with Cesce. The clean audit on 2022 statements has not restored liquidity or the company's reputation in the market.

Primary liquidity sources

- Cash and equivalents of \$141 million as of June 2023;
- Funds from operations expected to be negative for the next 12 months;
- Working capital inflows of about \$50 million as working capital stabilizes following Talara's completion; and
- No ad hoc inflows at this stage from potential equity contributions or new bank facilities, which they are still under discussion.

Primary liquidity uses

- Short-term debt maturities of \$1.4 billion as of June 2023, which include the repayment of \$375 million of the \$750 million MEF loan (already extended into 2024), drawings under the

short-term working capital facilities and the \$144 million payment due under the Cesce facility; and

- Total capex of about \$600 million.

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
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Oil Refining And Marketing Industry, March 27, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Downgraded

	To	From
Petroleos del Peru Petroperu S.A.		
Issuer Credit Rating	B+/Stable/--	BB/Stable/--
Petroleos del Peru Petroperu S.A.		
Senior Unsecured	B+	BB

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