



## RATING ACTION COMMENTARY

# Fitch Downgrades Petroperu to 'BBB-'; Ratings Placed on Negative Watch

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Fitch Ratings - New York - 08 Mar 2022: Fitch Ratings has downgraded Petroleos del Peru - Petroperu S.A.'s Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) to 'BBB-' from 'BBB'. Fitch has also downgraded Petroperu's senior unsecured notes to 'BBB-' from 'BBB'. The IDRs and notes have been placed on Rating Watch Negative (RWN).

The revisions and RWN reflect the company's lack of financial transparency and weakened governance, as evidenced by the significant delay in the company's 2021 year-end financial audit. As a result, Fitch lowered the ESG governance score for Financial Transparency to '5' from '3' and revised Petroperu's Standalone Credit Profile (SCP) to 'ccc' from 'b-'. This led to a reassessment of Petroperu's linkage with the sovereign per Fitch's Government Related Entity (GRE) Criteria, and a top-down-minus-one rating approach.

Petroperu's leverage profile and cash flow continue to be weak and are expected to remain so throughout the rating horizon. The RWN reflects uncertainty regarding the company's ability to provide audited financials by May 30, 2022, possibly breaching a covenant in its bond indenture. Fitch understands this to constitute an event of default, in the absence of a waiver. Should the company fail to provide audited financials and/or

does not receive a waiver, the ratings will be further decoupled from the sovereign rating and further downgraded.

## KEY RATING DRIVERS

**Government Related Entity:** Petroperu's ratings are linked with the sovereign's through Fitch's GRE Criteria. Following the downward revision of the company's SCP to 'ccc' from 'b-', Fitch has revised its assessment of the Financial Implications of a Default rating factor, as well as the Socio-Political Implications of a Default to 'strong' from 'very strong' per its criteria, which indicates that a 'very strong' designation is unlikely to be used when an issuers' SCP has deteriorated to the 'ccc' category.

The company's Support Track Record designation under Fitch's GRE criteria remains 'strong', while its Status, Ownership and Control designation has been determined to be 'very strong'. Petroperu is 100% owned by the Peruvian government, through the Ministry of Energy and Mines (60%) and the Ministry of Economy and Finance (40%). The company has five refineries, two of which are currently out of service, and approximately 100,000 barrels per day (bpd) of throughput capacity. The government has provided the company with a financial guarantee for up to USD1 billion to assist Petroperu in case of financial distress as a result of debt incurred for the Talara Refinery Modernization Project (PMRT) that is expected to be operational by 4Q22.

As a result of the designation of the four factors related to strength of linkage and incentive to support outlined in Fitch's GRE criteria, Petroperu's overall support score is 35, which coupled with the nine-notch differential between the sovereign's ratings and the company's SCP, results in a top down minus one approach for Petroperu's ratings.

**Weak Stand-Alone Credit Profile:** Petroperu's gross debt/EBITDA is estimated to have declined to around 16x during 2021 from 33x in 2020, primarily due to a rebound in sales during 2021. Fitch estimates Petroperu will maintain a structural debt slightly above USD5.0 billion during the next two years. Gross leverage is projected to be close to 15x in 2022 before falling to around 10x during 2023 as the PMRT is completed and the refinery ramps up production.

**Operational Cash Flow Volatility:** Petroperu's cash flow generation is sensitive to changes in oil prices. Given Peru's position as a net importer of crude, elevated oil prices result in a compression of its profit margins. Operational interruptions to its transportation business including disruptions related to actions of local communities

further exacerbate cash flow volatility. Petroperu's cash flow volatility experienced in 2021 will continue into 2022. The completion of the PMRT will dramatically lower capex for the company; it will also increase operational efficiency, and predictable crack spreads should translate into stronger EBITDA margins over the rated horizon.

**Regulatory Risk:** The company is exposed to changes in the Peruvian Technical Decree. For instance, during 2010, the prohibition of commercializing diesel with more than 50ppm of sulphur in Lima and Callao, was extended to other regions. This norm, combined with other factors, affected Petroperu's costs, reducing gross profit margins from around 15% to, or below, 9% after the implementation of the regulation. Consequently, it became necessary for the company to invest approximately USD5 billion, primarily for the PMRT, making Talara a highly complex new refinery.

Petroperu has an ESG Relevance Score of '5' for Financial Transparency, reflecting the governance issues and weakness related to financial transparency as evidenced by the delay in the financial audit of YE statements, and its strained relationship with the auditing firm.. ESG Relevance Scores of 5 are highly relevant credit considerations and impact the rating on an individual basis.

## **DERIVATION SUMMARY**

Petroperu's rating linkage to the Peruvian sovereign rating is in line with the linkage present for most national oil and gas companies (NOCs) in the region, including Empresa Nacional de Petroleo (ENAP; A-/Stable), YPF S.A. (CCC), Ecopetrol S.A. (BB+/Stable) and Petroleo Brasileiro S.A. (Petrobras; BB-/Negative).

In most cases in the region, NOCs are of significant strategic importance for energy supply to their countries, and a default could have potentially negative social and financial implications at a national level. Similar to its peers, Petroperu has strong legal ties to the government, through its majority ownership and strong operational control.

Petroperu's ratings also reflect the company's strong domestic market position, with 40% of the country's refining output. The ratings are constrained by Petroperu's weak capital structure and exposure to political interference risk.

## **KEY ASSUMPTIONS**

--Continuous implicit support, if needed, from the government given the company's strategic importance;

--Fitch's Brent oil price at \$70 per barrel (bbl) in 2021, and long-term prices at \$53/bbl;

--PMRT total cost of approximately USD5.7 billion (including financial expenses), considering an equity contribution from the Peruvian Government of USD325 million, and the remaining portion finance with debt;

--Roll over of short-term working capital facilities;

--PMRT to be fully operational by mid-2022 and generating refining crack spreads in the range of USD11 to USD12 per barrel.

## **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--A positive rating action on the Peruvian sovereign could lead to a positive rating action on Petroperu.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A downgrade of Peru's sovereign rating;

--A sustained deterioration of Petroperu's financial flexibility, combined with government inaction to support the company's liquidity restricting the access to capital markets;

--Persisting delays related to financial reporting and audits and/or failure to obtain consent to waive reporting requirement covenants.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and

worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

## LIQUIDITY AND DEBT STRUCTURE

**Adequate Liquidity:** Petroperu's liquidity position is supported by cash on hand and manageable short-term maturities, which are mostly related to uncommitted working capital financing for more than USD3.0 billion, of which the company has approximately USD2.3 billion available. As of December 2021, Petroperu reported cash on hand of USD239 million and short-term financial debt totaled USD 824 million, which Fitch expects will be rolled over.

## ISSUER PROFILE

Petroleos del Peru S.A. (Petroperu) is a Peruvian state-owned petroleum company under private law and dedicated to transportation, refining, distribution and marketing of fuels and other petroleum-derived products.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Petroperu's ratings are linked to the sovereign rating of Peru.

## ESG CONSIDERATIONS

Petroperu has an ESG Relevance Score of '4' for Governance Structure, due to its nature as a majority government-owned entity and the inherent governance risk that arise with a dominant state shareholder. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

## RATING ACTIONS

ENTITY / DEBT ↕

RATING ↕

PRIOR ↕

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Petroleos del Peru - Petroperu S.A.	LT IDR	BBB- Rating Watch Negative	BBB Rating Outlook Stable
	Downgrade		

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	LC LT IDR	BBB- Rating Watch Negative	BBB Rating Outlook Stable
	Downgrade		

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senior unsecured	LT	BBB- Rating Watch Negative	BBB
	Downgrade		

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## **APPLICABLE CRITERIA**

[Government-Related Entities Rating Criteria \(pub. 30 Sep 2020\)](#)

[Corporate Rating Criteria \(pub. 15 Oct 2021\) \(including rating assumption sensitivity\)](#)

[Sector Navigators - Addendum to the Corporate Rating Criteria \(pub. 15 Oct 2021\)](#)

## **APPLICABLE MODELS**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

[Corporate Monitoring & Forecasting Model \(COMFORT Model\), v7.9.0 \(1\)](#)

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Petroleos del Peru - Petroperu S.A.

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