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Research Update:

Petroleos del Peru Petroperu S. A. 'BBB-' Ratings Affirmed; Proposed Senior Unsecured Notes Rated 'BBB-'; Outlook Stable

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Research Update:

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Overview

- Peru-based oil refiner Petroperu plans to issue $2 billion in senior unsecured notes to fund the remaining cost of the Talara refinery's upgrade.
- We're affirming our 'BBB-' long-term corporate credit rating on Petroperu. At the same time, we're assigning our 'BBB-' rating to Petroperu's proposed senior unsecured notes due that would mature in 15 or 30 years.
- The stable outlook reflects our belief that the company will close the long-term financing for the modernization of the Talara refinery in 2017, thus reducing the concentration of short-term maturities.

Rating Action

On June 1, 2017, S&P Global Ratings affirmed its 'BBB-' long-term corporate credit rating on Petroleos del Peru Petroperu S.A. (Petroperu). At the same time, we assigned our 'BBB-' issue-level rating on its proposed $2 billion senior unsecured notes tht would mature in 15 or 30 years. We also kept the company's 'b+' SACP unchanged. The outlook on the corporate credit rating remains stable.

Rationale

Following the transaction, adjusted leverage will remain in line with our expectations, at debt to EBITDA of around 8x, given that we were already incorporating incremental debt in our base case to fund costs of the Talara Refinery's upgrade (estimated at $4.4 billion). We expect the works will likely be completed by the end of 2020 and will be financed mostly with debt, including the proposed issuance. We don't envision deleveraging in the near or medium term, or until the completion of Talara's upgrade. However, we believe the new issuance will help extend the maturity profile versus the existent concentration in the short term, which we view as a credit positive.

The ratings on Petroperu continue to reflect our opinion that there's a very high likelihood that its owner, the Republic of Peru (foreign currency: BBB+/Stable/A-2; local currency: A-/Stable/A-2) would provide timely and sufficient extraordinary support to the company in the event of financial distress. This reflects our assessment of the company's:

- Very important role for Peru. Petroperu is a leader in the refining and marketing of oil products in Peru, supplying about 50% of the domestic market's needs, and a key infrastructure asset for the country. Moreover, Petroperu is the only distribution company in the country that serves all of the country's departments and is of significant importance for the government's energy strategy. We believe that Petroperu's services can't be easily replaced in the short to medium term due to difficulty to build new refineries and/or pipelines and/or storage facilities given the amount of investments, environmental issues typically associated with the type of assets, and construction timeline.
- Very strong link to the Peruvian government. The government is the owner of Petroperu, provides a clear structure of corporate governance, and has a track record of business-decision making. Two out of six of the company's board directors are senior government officials. The government is actively involved in key investment decisions. Authorizations to conduct significant investments and approval to issue additional debt are credit strengths.

A track record of support for this entity underpins our assessment, which we expect to continue. Latest actions include the government's approval of a guarantee for new debt of up to $1 billion, which the company might apply to any financing for the upgrade of its largest refinery, Talara, and a capital increase of $315 million in January 2017. Finally, Petroperu is exempt from paying dividends.

The 'b+' SACP assessment continues to reflect Petroperu's strong competitive position as a leading oil refiner in the country that also has certain integration to the midstream and distribution segments. In addition, we positively incorporate in our analysis the ongoing support that Petroperu receives from the government--in the form of tax credits and recognition of certain pension liabilities, for example--as a comparable rating strength in relation to privately-owned peers. Petroperu's small scale of operations, the inherent volatility in its margins, as well as its highly leveraged capital structure partially offsets these strengths.

Through its four operating refineries, the company controls about 50% of the country's refining capacity, and is a leading supplier of refined products. A subsidiary of Spain-based Repsol S.A. controls most of the remaining market share in Peru through the operation of its refinery, La Pampilla, which is located near Lima. In addition, Petroperu owns and operates an oil pipeline that connects all of Peru's major oil blocks, which are located in the northeastern region of the country (blocks 8, 39, 64, 67, 95, 131, and 192), to its largest refinery and port. This allows the company to use about 80% of domestic oil, which translates into lower transportation, commercialization, and overall all-in feedstock costs. Finally, we view the company's distribution network through affiliations with 634 gas stations across the country, which operate under the Petroperu flag, as a rating strength. On the other hand, in our view, Petroperu's scale of operations is small, as seen in a total refining capacity of 94,500 barrels per day (bpd), and its geographic and asset diversification is limited. Moreover, we consider the cyclicality of the company's profitability, typical for the refining industry, and the lack of economies of scale and operating flexibility that in turn leads to lower margins than those of larger international peers, as business-related weaknesses.

Our base-case scenario includes the following assumptions in 2017 and 2018:

- We're incorporating in our projections macroeconomic variables that we view as relevant for the refining segment, particularly GDP growth that's mainly correlated to energy demand--as seen in the past 10 years--and inflation that affects SG&As (see, " Commodity Prices Give A Temporary Breath Of Fresh Air To Latin America, While U.S. Policy Uncertainty Lingers ," April 4, 2017). We assume a GDP growth of 3.5% and 3.8% and inflation of 3.2% and 3%, in 2017 and 2018, respectively.
- Approximately 71,000 bpd processed, assuming average utilization levels of 75%.
- Fuel price, as well as prices for the purchase of oil and refined products, moving almost in tandem because both correlate with the oil price. In 2017 and 2018, we expect oil prices to increase to $50 per barrel from $43 in 2016.
- EBITDA generation ranging from $300 million to $330 million, which represents a margin of approximately 8%.
- Capex of approximately $1 billion in 2017, $800 million in 2018, $330 million in 2019, and $240 million in 2020, mostly devoted to the modernization of the Talara refinery.
- New debt for approximately $4 billion in 2016-2019, approximately $1 billion of which will be guaranteed by the government.
- Capital injection of $315 million, which the company already received from the government in January 2017.
- No dividend payments.

Under those assumptions, we arrive to the following credit metrics in 2017 and 2018:

- Debt to EBITDA above 8x;
- FFO to debt below 10%; and
- EBITDA interest coverage of around 2x.

Liquidity

We continue to assess Petroperu's liquidity as less than adequate mainly because the company's cash uses are larger than its sources for the next 12 months. However, we acknowledge Petroperu's well-established relationship with banks due to its government ownership. In our view, Petroperu won't have trouble to continue to rollover its short-term maturities until the long-term financing for the Talara project is closed.

As of March 31, 2017, Petroperu was in compliance with existing covenants (EBIT interest coverage higher than 2.5x and minimum net worth of $800 million).

Principal Liquidity Sources:

- Cash and equivalents of $166 million as of March 31, 2017; and
- FFO approaching $180 million in the next 12 months.

Principal Liquidity Uses:
- Short-term debt maturities of $2 billion as of March 31, 2017;
- Total capital expenditures of approximately $1 billion, most of which corresponds to the modernization of Talara and maintenance capex of only $80 million; and
- Marginal working capital outflows.

Outlook

The stable outlook reflects our expectation that Petroperu will continue to play a very important role in Peru's energy and infrastructure policy, while its link with the government continues to be very strong. The outlook further reflects our belief that the company will close the long-term financing for the modernization of the Talara refinery in 2017, thus reducing the concentration of maturities in the short term.

Downside scenario

A downgrade is possible if the company doesn't close its long-term financing for the Talara refinery in 2017, which in our view, will erode the company's capital structure due to the concentration of short-term debt. In addition, if we revise our view of the likelihood of government support to high from very high, we could also downgrade Petroperu to 'BB+', assuming that its SACP remains at 'b+'. That could occur, for example, if our view of the company's link with the government weakens.

Upside scenario

Given the higher capital investment over the near term and until Talara's modernization is completed, we view a higher rating as unlikely in the next 12 months. In any event, a higher rating would require debt to EBITDA to remain at less than 5x and FFO to debt to surpass 12%. In addition, we could upgrade Petroperu if our view of the extraordinary likelihood of support improves, for example if our belief that the role has become critical or the link strengthens to integral.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/--

Business risk: Satisfactory
- 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 (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+ 1 notch)

Stand-alone credit profile: b+
- Sovereign rating: BBB+/Stable
- Likelihood of government support: Very High (+4 notches from SACP)

Related Criteria

- 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: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

New Rating

Petroleos del Peru Petroperu S.A.	
Senior Unsecured	BBB-

Ratings Affirmed

Petroleos del Peru Petroperu S.A.	
Corporate Credit Rating	BBB-/Stable/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.