FitchRatings

Fitch Affirms Petroperu's Foreign Currency Rating at 'BBB+'

Fitch Ratings-New York-24 May 2018: Fitch Ratings has affirmed Petroleos del Peru - Petroperu SA.'s Long-Term Foreign Currency Issuer Default Ratings (IDR) at 'BBB+' and Local Currency (LC) IDR at 'A-'. The rating action affects USD2 billion of notes outstanding rated 'BBB+'. The Rating Outlooks are Stable.

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). Additionally, 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 activated is not yet conclusive.

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 when needed.

KEY RATING DRIVERS

Government Support: Petroleos del Peru - Petroperu S.A.'s (Petroperu) ratings reflect its close linkage with Peru's ratings due to the government's control of the company and its strategic importance as the largest hydrocarbon company in Peru and the strategic location of its refineries. Petroperu is the largest refiner in Peru with five refineries and approximately 100,000 barrels per day (mbpd) of throughput capacity. The government of Peru is currently Petroperu's only shareholder. The company's credit linkage to the sovereign is further evidenced by the explicit support of the government through a financial guarantee for up to US$1 billion to finance the modernization of the Talara refinery (PMRT).

Unsustainable Capital Structure: Absent implicit and explicit government support, Petroperu's credit metrics are not consistent with the assigned rating. As of FY2017, the company reported total financial debt of PEN10.7 billion and total debt /EBITDA of 10.2x, adjusted for non-recurring provisions for damage to its pipeline. Gross leverage could exceed 14x in the next 12 months, and is expected to remain elevated through the next three years, as there will be an increase in debt to finance the PMRT and the expansion/inclusion of the desulfurization unit will still be under construction.

Operational Cashflow Stabilizing: In spite of the price swings 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 ranging from 7% to 8% over the next several years. This is in line with the 8% that the company achieved in 2018. CFFO is also projected to remain positive through the rating horizon. FCF is fully expected to be negative in light of the company's aggressive capex investments. Provided that PMRT is completed with the latest timing guidelines, significant changes to the Petroperu's cashflow 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 and volatile nature of the industry. Refining remains vulnerable to periods of boom and bust, which results in sharp swings in crack spreads. This variabilty is a function of mismatch between feedstock prices incurred, which will generally lag selling prices. Fitch's assumptions going forward consider a shallow recovery in oil prices, which should help stabilize crack spreads in the near term.

Regulatory Risk: Petroperu is exposed to different changes in the Peruvian Technical Normativity. This last occurred in 2010 with the prohibition of commercializing diesel with more than 50ppm of sulfur in Lima and Callao, and then extended to other regions. This norm 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 in capex ($5.4 billion) for the modernization of the Talara refinery, including the expansion of the refinery and the inclusion of the desulfurization unit.

Political and Strategic Uncertainty: Executive roles at Petroperu tend to have high turnover and exposure to political cycles. Consequently, maintaining strategic focus and overcoming bureaucratic inertia is one of the company's principal obstacles. In mid-March 2018, Petroperu's chairman of the board Luis Garcia Rossell resigned his position due to his frustration with political gamesmanship and gridlock, which presented operational obstacles without providing the support necessary to execute strategic solutions. Rosell's departure came a day before Peru's president resigned following the initiation of impeachment proceedings. Consequently, the resulting vacancy left Petroperu's board with only three out of six voting members and no means to reach quorum.

In late April, representatives from the Ministry of Mines and Energy and the Finance Ministry appointed a new Chairman of the Board, James Atkins. In light of Petroperu's significant operational, political, and structural challenges -- including the Talara modernization, security and technology improvements to the oil pipeline, and reducing labor cost inefficiencies -- Fitch considers the absence of a stable and fully-staffed executive team as an ongoing handicap to an already-weak operating model.

DERIVATION SUMMARY

Petroperu's linkage to the sovereign is similar in nature to its peers, namely Petrobras (BB/Negative) and Ecopetrol (BBB/Stable). It also compares with Enap (A/Stable), Pemex (BBB+/Stable) and PDVSA (RD). These companies all have strong linkages to their respective sovereigns given their strategic importance to each country and the potentially significant negative social and financial implication a default could have on the national level.

Petroperu's ratings reflect its close linkage to the government of Peru and the company's fiscal importance to the sovereign and strategic importance to the country. Petroperu's ratings also reflect the company's strong domestic market position, with 40% to 50% of the country's refining output. The ratings are constrained by Petroperu's weak capital structure and exposure to political interference risk.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
--Petroperu's ratings assume the implicit support, if needed, from the government given the company's strategic importance;
--Long-term WTI oil prices of $55/bbl;
--2018-2021 capex of $2.7 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 of approximately USD1.6 billion over the forecast horizon;

--Refinery modernizations completed by 2021, with margins returning to pre-Normativity levels.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
--An upgrade of Petroperu could result from an upgrade of the sovereign coupled with significant and sustained improvements in operating and financial performance.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
--A negative rating action could be triggered by a downgrade of the sovereign's rating and/or the perception of a lower degree of linkage between Petroperu and the sovereign.

LIQUIDITY

Adequate Liquidity: Petroperu's near-term maturities are manageable. Short-term debt totalled USD1.3 billion at year-end 2017, which Fitch expects will be rolled over. At 10.2x debt-to-EBITDA as of year-end 2017, Petroperu's adjusted leverage metrics remain very high for the rating category. Leverage and coverage ratios are expected to continue to weaken 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 affirmed the following ratings
Petroleos del Peru - Petroperu S.A.
--Long-term Foreign Currency IDR at 'BBB+;
--Long-term Local Currency IDR at 'A-';
--Senior unsecured ratings on notes due 2032 and 2047 at 'BBB+'.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria

Corporate Rating Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023785)
Government-Related Entities Rating Criteria (pub. 07 Feb 2018) (https://www.fitchratings.com/site/re/10019302)
Sector Navigators (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023790)

Additional Disclosures

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