08 Jun 2020 | Affirmation

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

Fitch Ratings-Chicago-08 June 2020:

Fitch Ratings has affirmed Petroleos del Peru - Petroperu S.A.'s (Petroperu) Long-Term Foreign Currency (FC) Issuer Default Ratings (IDR) at 'BBB+' and downgraded the Local Currency (LC) IDR to 'BBB+' from 'A-'. The rating action affects USD2 billion of outstanding notes rated 'BBB+'. Rating Outlook is 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 FC IDR is strongly linked with the credit profile of the Peruvian sovereign (FC and LC IDR BBB+/Outlook Stable), and reflects the sovereign's incentive to provide financial support to the company, given its strategic importance for the country. The company is 100% owned by the Peruvian government, through the Ministry of Energy and Mines (60%) and the Ministry of Economy and Finance (40%).

Government support has been evidenced by multiple recent actions including the capital injection of USD325 million for the Talara Refinery Modernization Project (PMRT), transferring all of the company's pension liabilities to the state, and recovering some value-added taxes. 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, the precise mechanism by which this guarantee would be activated has not been yet committed, pursuant to Law 30,130. In addition, the Government enacted Decree 033/2020 through which Banco de la Nacion is allowed to provide financial assistance in 2020 to Petroperu and other state-owned companies due to coronavirus pandemic.

As a state owned company, Petroperu`s ratings are equalized to its sovereign's, the downgrade of Petroperu`s Long-Term Local-Currency Issuer Default Rating mirrors the recent sovereign rating action. On June 3, 2020, Fitch Ratings downgraded Peru's Long-Term Local-Currency Issuer Default Rating (IDR) to 'BBB+' from 'A-'. Fitch no longer considers Peru's public finances a strength relative to its external finances. Expenditure measures and lost revenues caused by the coronavirus pandemic are forecast to lift general government debt/GDP to 31.9% in 2020, up from 26.8% in 2019.

Petroperu's stand-alone credit profile (SCP) 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. Fitch expects Petroperu will soon resume the construction of PMRT with no significant delays to complete the project by the second half of 2021. Additional overrun costs combined with significant delays on PMRT`s construction, would be viewed negatively by Fitch as a deterioration of the company`s SCP, resulting in the downgrade of Petroperu, if the SCP goes to 'ccc' category.

Key Rating Drivers

Government Support: Petroperu ratings reflect its close linkage with Peru's ratings due to the strong government ownership and control and the very strong incentives to support the company is one of the largest liquids fuels suppliers. Petroperu has 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 USD1 billion to finance PMRT.

The ratings also reflect the strong incentives the Peruvian government has to support Petroperu in the event of financial distress given the company's strategic importance, as it secures the oil supply at the national level, representing approximately 44% market share in the domestic fuel market, combined with a strategic role in the energy supply chain to distribute and commercialize nationwide.

Weak Capital Structure: Absent implicit and explicit government support, Petroperu's credit metrics are not consistent with the assigned rating but are in line with a 'b' SCP. As of Dec. 31, 2019, the company reported total debt of USD4.3 billion and high leverage as measured by total net debt-to-EBITDA of 10.9x. Gross leverage is expected to remain high during 2020-2021, as the company completes Talara's new refinery with additional debt of USD1.1 billion. Fitch expects Petroperu's capital structure to remain pressured and in line with its 'b' SCP after completion of the refinery and for its rating to continue to be supported by the company's linkage with Peru.

Weak Demand due to Coronavirus: Extensive lockdowns in the country imply significant reductions in fuel demand that will likely continue beyond current quarantine restrictions. Social distancing measures combined with the shutdown of significant industrial sectors such as mining and cement are key elements considered in Fitch's current base case scenario. Fitch estimates a demand drop of around 12.5% in 2020, and a slow recovery in 2021 reaching 2019 volumes. In addition, depressed oil prices pressures Petroperu`s profitability due to the contraction on refining margins are also expected, estimating EBITDA margins reducing to nearly 4% in 2020 and improving to approximately 10% during 2021 as Talara starts its operations and there is an improvement in international oil prices.

Operational Cash Flow Volatility: Petroperu's cash flow generation is sensitive to changes in oil prices and certain operational interruptions to its transportation business. Fitch anticipates this trend to continue during 2020-2021 while the new Talara refinery is under construction and EBITDA margins improving after commencement of operations, expected for the second half of 2021. Cash Flow From Operations (CFFO) is projected to be positive through the rating horizon, while FCF is expected to be negative following the company's aggressive capex investments. Once PMRT is completed with the latest timing and calibration guidelines, significant changes to Petroperu's cash flow generation profile are unlikely before 2022.

Talara Delay and Costs-overrun: Fitch expects Petroperu will complete PMRT by the second half of 2021, due to coronavirus delays are related to the government requests of social distancing that have slow the construction of the project, as of May 2020, PMRT has a 89% completion, and Fitch expects the company will resume the construction during June 2020. PMRT`s costs-overruns reached USD700 million, out of an initial budgeted construction cost of approximately USD4 billion. Fitch expects Petroperu will secure the additional funding to complete the project, without affecting the company's ratings as long as these are not exacerbated.

Regulatory Risk: Petroperu is exposed to different changes in the Peruvian Technical Normativity, which is the primary catalyst for PMRT. During 2010, 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 a capex of more than USD5 billion, primarily for PMRT, including the expansion of the refinery and the inclusion of the desulfurization unit.

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/Negative), YPF S.A. (CCC), Ecopetrol S.A. (BBB-/Negative), 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 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%-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

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

-Fitch`s WTI oil price assumptions at $32/bbl, $42/bbl, $50/bbl during 2020, 2021 and 2022, respectively;

-Reduction in crack spreads during 2020 as crude prices contract;

-Additional debt of approximately USD790 million to complete PMRT and roll over of short-term working capital facilities;

-PMRT completed by second half of 2021.

RATING SENSITIVITIES

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

--An upgrade of Petroperu could result from an upgrade of the sovereign provided the company's SCP remains unaffected.

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

--Downgrade of the sovereign's rating and/or the perception of a lower degree of linkage between Petroperu and the sovereign;

--Additional overrun costs combined with significant delyas on PMRT`s construction that would deteriorate Petroperu's SCP to 'ccc' from its current 'b' level.

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 working capital financing reaching nearly USD2.9 billion, out which the company has available approximately USD1.4 billion. As of December 2019, Petroperu reported cash on hand of USD376 million and short-term financial debt totaled USD1.01 billion, which Fitch expects will be rolled over. The company still needs to raise approximately USD790 million of capital to fund Talara's capex.

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.

ESG Considerations

Petroleos del Peru - Petroperu S.A.: Waste & Hazardous Materials Management; Ecological Impacts: 4, Governance Structure: 4, Human Rights, Community Relations, Access & Affordability: 4

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

Petroleos del Peru - Petroperu S.A.; Long Term Issuer Default Rating; Affirmed; BBB+; RO:Sta
; Local Currency Long Term Issuer Default Rating; Downgrade; BBB+; RO:Sta
----senior unsecured; Long Term Rating; Affirmed; BBB+

Contacts:

Primary Rating Analyst
Paula Bunn,
Associate Director
+1 312 368 3218
Fitch Ratings, Inc.
One North Wacker Drive
Chicago 60606

Secondary Rating Analyst
Jose Ramon Rio,
Associate Director
+56 2 2499 3316

Committee Chairperson
Lucas Aristizabal,
Senior Director
+1 312 368 3260

Media Relations: Elizabeth Fogerty, New York, Tel: +1 212 908 0526, Email:
elizabeth.fogerty@thefitchgroup.com

Additional information is available on www.fitchratings.com

Applicable Criteria

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)
Government-Related Entities Rating Criteria (pub. 13 Nov 2019)

Applicable Model

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)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
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