

## RATING ACTION COMMENTARY

### Fitch Affirms Petroperu's L-T Foreign and Local Currency IDRs at 'BBB+'; Outlook Negative

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Fitch Ratings - Chicago - 16 Dec 2020: Fitch Ratings has affirmed Petroleos del Peru - Petroperu S.A.'s Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) at 'BBB+'. In the addition, Fitch has revised Petroperu's Rating Outlook to Negative from Stable, which mirrors Fitch's recent revision of the Peruvian sovereign Outlook to Negative. Today's rating actions affects USD2 billion of outstanding notes rated 'BBB+'.

On Dec. 15, 2020, Fitch revised Peru's sovereign Outlook to Negative and affirmed its Long-Term Foreign and Local Currency IDRs at 'BBB+'. The Negative Outlook reflects Peru's weakened government balance sheet, deterioration of policy predictability as a result of congressional passage of populist measures in recent months, and Fitch's expectation of continuing challenges to reduce fiscal deficits to levels consistent with debt stabilization.

The weakening of political cohesiveness and institutions in Peru since 2016 could undermine the capacity of the next government to implement wide-ranging fiscal, political, and productivity-enhancing economic reforms. In addition, periodic executive-legislative tensions and political instability cannot be ruled out in the coming years.

As a state-owned company, Petroperu's ratings are equalized with its sovereign's. Petroperu ratings reflect its close linkage with Peru's ratings, due to its strong government ownership and control, and the very strong incentives to support the company as one of the country's largest liquids fuels suppliers.

Government support has been evident through multiple actions. These include 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, the government's approval of a financial guarantee of up to USD1 billion to support the financing of the Talara project, is further evidence of support. The precise mechanism that would activate this guarantee has not yet been committed, pursuant to Law 30130.

Absent implicit and explicit Peruvian government support, Fitch assesses Petroperu's stand-alone credit profile (SCP) as commensurate with the 'b' rating category. Fitch expects the company will conclude the construction of PMRT with no significant delays by the second half of 2021. Additional overrun costs combined with significant delays on PMRT's construction, would be viewed negatively, as a deterioration of the company's SCP, resulting in the downgrade of Petroperu's rating, if the SCP drops to the 'ccc' category.

### KEY RATING DRIVERS

**Government Support:** Petroperu's ratings reflect its close linkage with Peru's ratings, due to strong government ownership and control, and the very strong incentives to support the company, as one of Peru's 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 it receives from the government through a financial guarantee for up to USD1 billion to finance PMRT.

Again, the ratings reflect the Peruvian government's strong incentives to support Petroperu in the event of financial distress. The company 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 fuel nationwide.

**Weak Demand due to Coronavirus:** Extensive lockdowns in the country imply significant reductions in fuel demand, which will likely continue beyond current quarantine restrictions. Social distancing measures combined with the shutdown of large 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 of refining margins. Fitch estimates EBITDA margins will fall to nearly 4% in 2020 and improve to approximately 10% during 2021, as PMRT begins operations and eventual 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 will continue during 2020-2021, while the new Talara refinery is under construction and EBITDA margins improve after expected operations commence in 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 pandemic delays and government mandated social distancing requirements, which have slowed the project. As of November 2020, PMRT has is 92.3% completed. Fitch expects Petroperu will secure the additional funding to complete the project without affecting the company's ratings.

**Regulatory Risk:** Petroperu is exposed to changes in the Peruvian Technical Decree, which is the primary catalyst for PMRT. During 2010, the prohibition of commercializing diesel with more than 50ppm of sulfur 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 more than USD5 billion, primarily for PMRT, for the expansion of the refinery and the inclusion of the desulfurization unit.

**ESG - Governance:** 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, 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%). Fitch has assigned Petroperu an ESG Relevance Score of '4' for Governance Structure because the Peruvian government is its dominant shareholder.

## **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. (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 also reflect the company's strong domestic market position, with 45% 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 \$38/bbl, \$42/bbl, \$47/bbl during 2020, 2021 and 2022, respectively. And long-term prices at \$50/bbl;

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

--Additional debt of approximately USD1.3 billion 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 delays on PMRT's construction that would lower 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 approximately USD3.0 billion, out of which the company has available approximately USD1.4 billion. As of September 2020, Petroperu reported cash on hand of USD154 million and short-term financial debt totaled USD1.262 billion, which Fitch expects will be rolled over.

### 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

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.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means 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. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

ENTITY/DEBT	RATING ACTIONS			PRIOR
			RATING	
Petroleos del Peru - Petroperu S.A.	LT IDR	BBB+	Affirmed	BBB+
	LC LT IDR	BBB+	Affirmed	BBB+
• senior unsecured	LT	BBB+	Affirmed	BBB+