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Petroleos del Peru Petroperu S.A.

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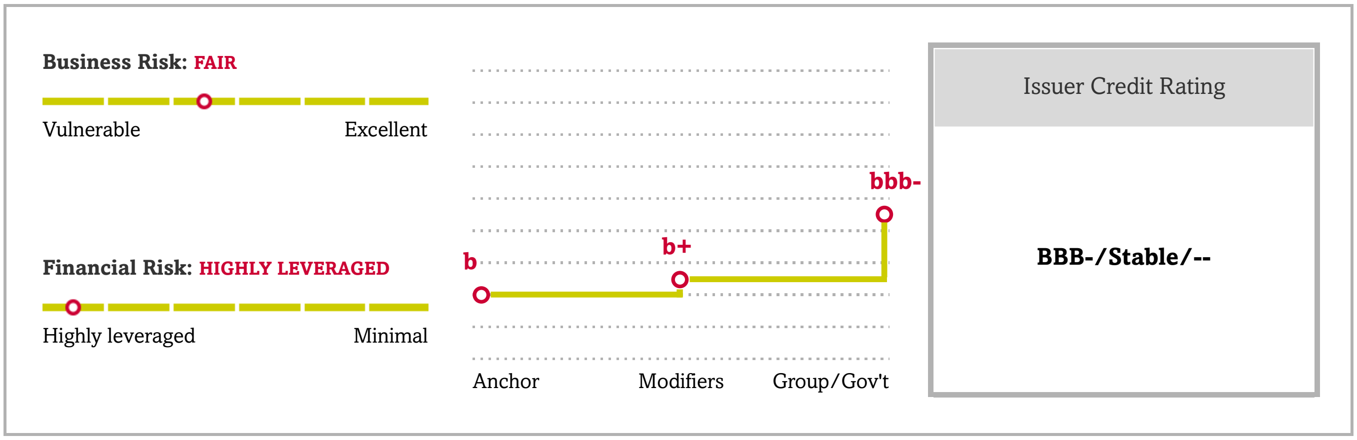


Credit Highlights

Overview

Key Strengths	Key Risks
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 very high leverage, which is sustainable in our view due to the ongoing support from the government and the wide access to the capital markets, thanks to the government ownership.
Some level of vertical integration given that Petroperu operates in the midstream segment by owning the country's sole oil pipeline, which connects all major oil blocks in the northern region of Peru to the country's largest refinery and port.	Inherent volatility in refining margins stemming from factors outside of the company's control such as oil price differentials.
Benefits from ongoing support from the Peruvian government, its shareholder, in the form of tax credits and recognition of certain pension liabilities. The government would also provide extraordinary support to the company in the event of financial distress.	

Petroperu's net debt to EBITDA to peak in 2020 at 16x-18x, gradually decreasing afterwards. The modernization of Petroleos del Peru Petroperu S. A.'s (Petroperu's) Talara refinery, which was initially expected to be completed by 2019, has been delayed because of several disputes with the contractors as well as due to the tendering process delay for the EPC contract of the auxiliary units and complementary works. Therefore, we now expect the ramp-up to occur only in the first half of 2021. Given the project's delay and the refinery's temporary shutdown, Petroperu's leverage in 2020 will be higher than we previously projected. This temporary shutdown will erode the company's operating margins, resulting in an EBITDA of $250 million - $280 million and EBITDA margin in the 5%-6% range, given that Petroperu will mainly have to import the processed products for domestic distribution, obtaining only commercialization profit. We expect a gradual deleveraging starting in 2021, converging to net debt to EBITDA of 8x-10x and EBITDA interest coverage of 2x-3x by 2023.

Given that the government owns the company, which supplies about 50% of the domestic market needs and is a key infrastructure asset for the country, we expect ongoing and extraordinary support from the government in case of financial distress. In our view, Petroperu plays a critical role in the country, because it's the main fuel distributor in Peru and is of significant importance for the government's energy strategy. We believe Petroperu's services can't be easily replaced in the short to medium term because of the difficulty in building new refineries, pipelines, and storage facilities given the amount of investments needed, the environmental issues typically associated with the type of assets, and the construction timeline. Finally, the government has a record of support for Petroperu, which we expect to continue. Examples of support include the transfer of the company's pension liabilities to the government, a capital increase of $325 million in January 2017, and a favorable taxation policy in the Amazonia region.

Outlook: Stable

The stable outlook reflects our expectation that Petroperu will continue to play a very important role in the country's energy and infrastructure policy, while its link to the government remains very strong. Therefore, in our view, there's a very high likelihood of government extraordinary support to the company in case of financial stress, along with ongoing support measures, as seen in the past.

Downside scenario

A downgrade is possible if in our view the likelihood of government support diminishes, while other credit factors remain unchanged, would lead to a downgrade of Petroperu to 'BB+'. That could occur, for example, if our view of the company's role to the government weakens if Petroperu's importance to the Peruvian energy sector diminishes, which we don't envision in the short to medium term. Additionally, we could lower our stand-alone credit profile (SACP) on the company if we believe that its capital structure becomes unsustainable, which could occur if net debt to EBITDA exceeds 20x while EBITDA to interest remains below 1x.

Upside scenario

Given the higher capital investments in the near term and until Talara's overhaul is completed, we view a higher rating as unlikely. In any event, an upgrade would require debt to EBITDA to remain at less than 5x and funds from operations (FFO) to debt to exceed 12%, which we don't expect in the short to medium term. In addition, we could upgrade Petroperu if our view of the extraordinary likelihood of support improves, for example if the company's role or link to the government rises, in our view.

Our Base-Case Scenario

Assumptions

For 2019, we expect EBITDA to increase to $270 million - $290 million, resulting in EBITDA margins of 5.6%-6.0% as a result of our expectations of lower WTI prices than in 2018, which would enable Petroperu to generate higher refining margins than in 2018. Even though our forecast incorporates stable oil prices for 2020, we forecast EBITDA to drop to $250 million - $280 million for that year, given that the Talara refinery will be shut down for several months in 2020 due to its upgrade.

Key Metrics

	2018A	2019E	2020E	2021E
EBITDA (mil. $)	266	270-290	250-280	360-390
EBITDA margin (%)	5.4	5.6-6.0	5.3-5.7	6.0-6.5
Ajusted net debt to EBITDA (x)	12.3	15-17	17-19	12_14
EBITDA interest coverage (x)	1.9	1.3-1.7	1.1-1.5	1.5-1.8

A--Actual. E--Estimate

Base-case projections

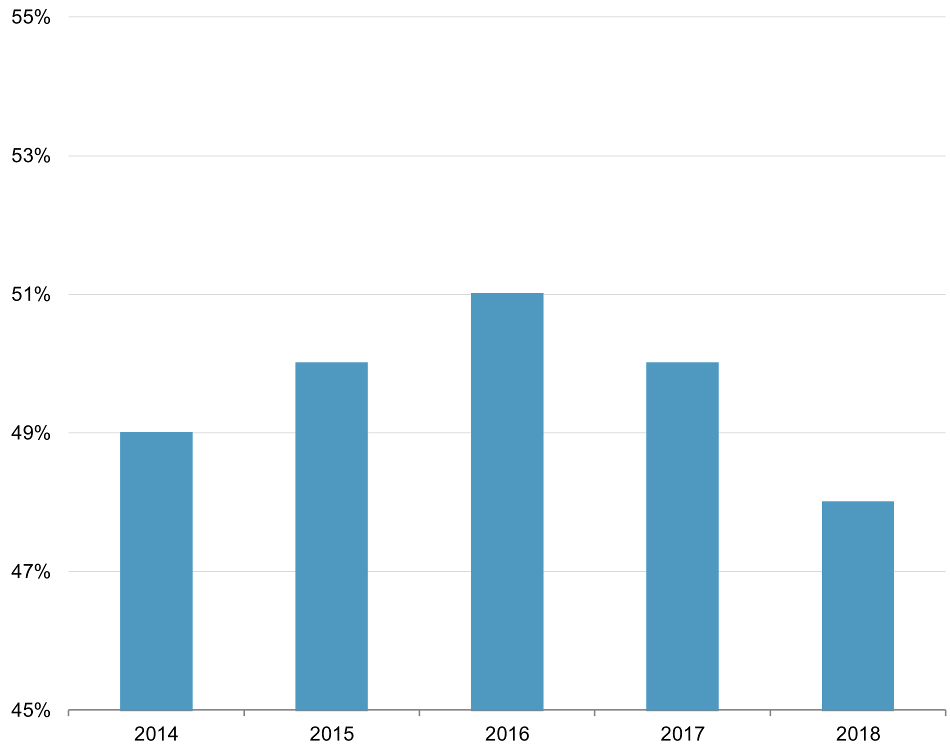
- We're incorporating in our projections macroeconomic variables that we view as relevant for the refining segment, particularly GDP growth that's mainly correlated to energy demand--as seen in the past 10 years—and inflation that affects selling, general, and administrative expenses (SG&A; see "Credit Conditions Latin America: Dovish Fed Eases Short-Term Risks, But Political Challenges Persist", published March 28, 2019). We assume GDP growth in Peru of 4.0-4.1% for the next two years and inflation of 2.2% and 2.1% in 2019 and 2020, respectively.
- Approximately 70,000 barrels per day (bpd) processed, assuming the average utilization level of 75% for 2019, decreasing to around 47,000 bpd for 2020 as a result of the new Talara refinery. Once the refinery is fully operational, we expect the company to process close to 100,000 bpd.
- Fuel price, as well as prices for the purchase of oil and refined products, moving almost in tandem because both correlate with oil prices. In 2019 and 2020, we expect oil prices of $50 per barrel.
- Capital expenditures (capex) of approximately $1.1 billion in 2019 and $750 million in 2020, mostly for the overhaul of the Talara refinery, and around $100 million will be for maintenance purposes.
- New debt of approximately $600 million in 2019 and 2020, which the company will use for the new Talara refinery.
- No dividend payments.

Company Description

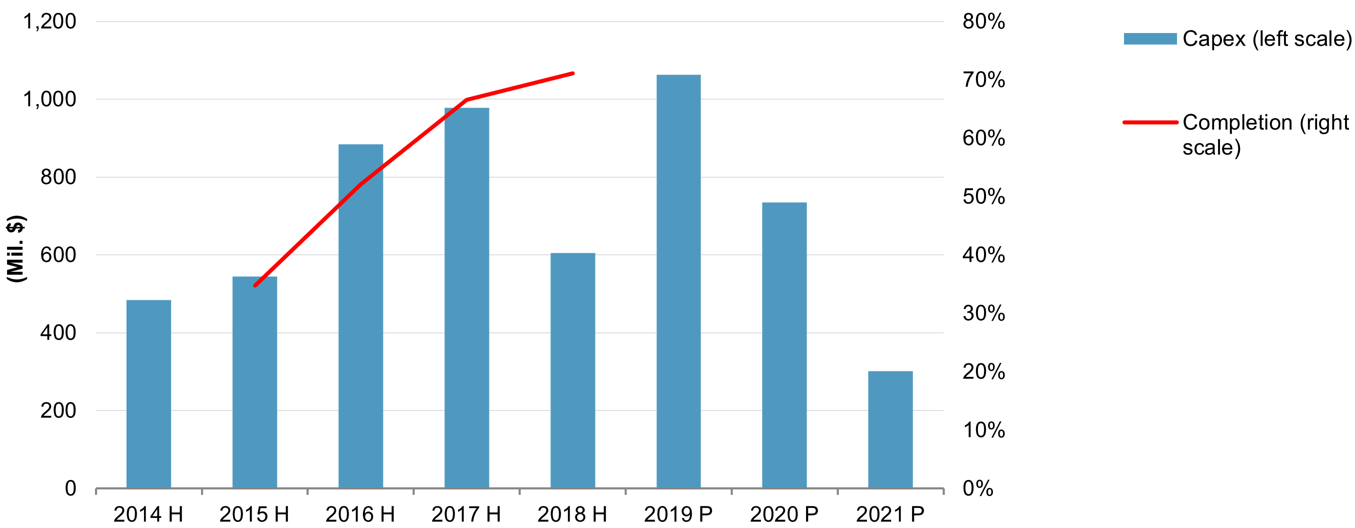
The Republic of Peru (local currency: A-/Stable/A-2) owns 100% of Petroperu. The company is engaged in the transportation, refining, distribution, and marketing of fuels and other petroleum-derived products in Peru. Petroperu currently operates three refineries (Talara, Conchan, and Iquitos) with a total refining capacity of 92.5 thousand barrel per day (kbpd), and leases the Pucallpa refinery to a private entity. The company operates the Nor Peruano and Ramadal North oil pipelines (approximately 1,100 km in length). Nor Peruano is Peru's main transportation pipeline that connects all of the country's major oil blocks to the country's largest refinery and port. Petroperu distributes fuel through ships, tank trucks, and railways, and commercializes it mainly through affiliated retail stations that work exclusively with Petroperu. In this sense, most of the company's revenue and EBITDA come from the refining, marketing, and distribution of oil products in the country.

Petroperu is investing $5 billion for its new Talara refinery, which is expected to increase the plant's refining capacity up to 95 kbpd by 2021 from the current 65 kbpd, reaching a total 122.5 kbpd for all three operating refineries. As of the end of 2018, 71.15% of the construction was completed. Regarding its financing, in addition to two bond issuances in June 2017 for a total of $2 billion, Petroperu took out a $1.3 billion syndicated loan in November 2018. The company is planning an additional debt issuance of approximately $600 million to complete the financing of Talara's new refinery. In order to get the most convenient funding option, Petroperu is evaluating several alternatives to get it done in late 2019 or early 2020. Petroperu expects the refinery to be fully operational by the first half of 2021.

Petroperu's Share Of The Domestic Fuel Market



Petroperu's Capex And The Advance Of The Talara Refinery's Upgrade



H--Historical. P--Projected.

Business Risk: Fair

Through its three operating refineries, the company controls about 50% of the country's refining capacity and is a leading supplier of diesel and gasoline. A subsidiary of Spain-based Repsol S.A. (BBB/Positive/A-2) controls most of the remaining market share in Peru through its refinery, La Pampilla, which is located near Lima. Petroperu also 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 the country's largest refinery and port. In addition, the company has recently obtained the government's authorization to operate block 192. This allows Petroperu to use about 80% domestic oil for its operations, while importing the remainder, resulting in lower transportation, commercialization, and overall all-in feedstock costs than those of its regional peers. Finally, we view the company's distribution network through affiliations with 650 gas stations across the country, which operate under the Petroperu brand as of March 2019, as a rating strength. On the other hand, we believe the company's scale of operations is small--as seen in its total refining capacity of 92.5 kbpd--and its international 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 resulting in lower margins than those of larger international peers, as business-related weaknesses.

Peer comparison

We selected several refining assets that we rate in Latin America as Petroperu's peers. Most of them are government-related entities with a very high likelihood of support from their respective governments, same as for Petroperu. Therefore, they have an important role from an economic and social standpoint in the country of operations, and that they benefit from the absence of--or limited--competition.

Empresa Nacional del Petróleo (ENAP; BBB-/Stable/--) is a Chilean oil and gas (O&G) company with strong presence in the domestic downstream market and some domestic and foreign upstream activities. It represents approximately 40% of Chile's energy supply for transportation and power generation and supplies about 60% of the country's refined product needs. We also view Administracion Nacional de Combustibles Alcohol y Portland (ANCAP; BB+/Stable/--), Uruguay's government-owned O&G company, as another comparable peer. ANCAP maintains exclusive rights for refining, and for crude oil, refined products, and natural gas imports in the country. The company also has a dominant position, but not a monopoly, in the fuel distribution market in Uruguay, enjoying around a 60% market share through its network of 290 service stations.

From a business perspective, we view these two companies as the most comparable, mainly because the three entities have a high importance for their governments as main energy suppliers in the country. A credit strength for Petroperu, unlike ENAP and ANCAP, is its certain level of integration because it owns and operates the country's sole oil pipeline, reducing all-in feedstock costs. In addition, in comparison with ANCAP, Petroperu benefits from fuel prices that are adjusted on a weekly basis, thus incorporating variations in oil price and foreign exchange, mitigating commodity and currency mismatch risks. Moreover, Petroperu's largest refinery has a greater refining capacity than that of ANCAP's. In terms of the financial risk profiles, the three companies are subject to the inherent volatility of refining margins, therefore, their leverage has fluctuated in the past five years, depending on refining cycles.

On a comparable basis, we view that the Peruvian government's ongoing support for Petroperu is a credit strength.

Petroleos del Peru Petroperu S.A. -- Peer Comparison

Industry Sector: Oil Refining & Marketing			
	Petroleos del Peru Petroperu S.A.	Empresa Nacional del Petroleo	Administracion Nacional de Combustibles Alcohol y Portland
Rating as of May 28, 2019	BBB-/Stable/--	BBB-/Stable/--	BB+/Stable/--
	--Fiscal year ended Dec. 31, 2018--		
(Mil. $)			
Revenues	4,965.1	8,350.6	3,061.8
EBITDA	266.4	500.2	395.8
FFO	26.9	270.2	295.7
Interest Expense	139.3	249.1	52.7
Cash Interest Paid	131.1	188.9	31.2
Cash flow from operations	(241.8)	389.4	242.6
Capital expenditures	496.7	571.8	73.3
Free operating cash flow	(738.5)	(182.5)	169.3
Discretionary cash flow	(738.5)	(182.5)	169.3
Cash and short-term investments	1,565.6	653.0	354.6
Debt	3,281.6	4,309.7	849.4
Equity	1,737.3	1,030.8	1,232.2
Adjusted ratios			
EBITDA margin (%)	5.4	6.0	12.9
Return on capital (%)	5.0	(3.5)	14.9
EBITDA interest coverage (x)	1.9	2.0	7.5
FFO cash interest coverage (x)	1.2	2.4	10.5
Debt/EBITDA (x)	12.3	8.6	2.1
FFO/debt (%)	0.8	6.3	34.8
Cash flow from operations/debt (%)	(7.4)	9.0	28.6
Free operating cash flow/debt (%)	(22.5)	(4.2)	19.9
Discretionary cash flow/debt (%)	(22.5)	(4.2)	19.9

Financial Risk: Highly leveraged

We expect Petroperu's adjusted leverage to remain high, with net debt to EBITDA in the 16x-18x range for 2019, increasing to 17x-19x for 2020, and EBITDA interest coverage of 1.3x-1.6x for both years. The highly leveraged capital structure results from the company's $5 billion investment plan. We expect Petroperu to start slowly deleveraging after the peak in 2020 thanks to higher refining volumes and greater capacity utilization at Talara. Last year, Petroperu issued two international bonds with maturities in 2032 and 2047 for an aggregate amount of $2 billion. In addition, it recently obtained a $1.3 billion loan due 2031 from international banks, which Compañia Española de Seguros de Creditos a la Exportacion S.A. guarantees. After taking out this loan, Petroperu was able to structure most of the financing for Talara, and it plans to raise remaining $600 million in 2019 and 2020.

Liquidity: Less than adequate

We continue to assess Petroperu's liquidity as less than adequate mainly because the company's cash uses will be larger than its sources for the next 12 months. Our liquidity assessment incorporates the following factors:

- Well-established, solid relationships with banks, as seen from the disbursement of the syndicated loan.
- A source-to-use ratio below 1x.
- Prudent risk management.
- As of March 31, 2019, Petroperu was in compliance with all covenants under the syndicated loan. We expect the company to remain in compliance with all existing covenants in the upcoming years.

Principal Liquidity Sources	Principal Liquidity Uses
• Cash and liquid investment position: $1.1 billion as of March 2019. • FFO (EBITDA, interest expenses, and taxes) of $90 million - $110 million for the upcoming 12 months.	• Short-term debt maturities of $1.3 billion as of March 2019. • Maintenance and expansionary capex for around $1 billion.

Other Credit Considerations

We adjust the rating upwards by one notch to reflect the relative strengths compared with peers due to the ongoing government support. In this sense, we envision scenarios under which the government can provide an extra tax exemption or recognizes other obligations.

Government Influence

We consider that there's a very high likelihood that the company will benefit from timely and sufficient extraordinary support from its owner, the Peruvian government, in the event of financial distress. This assessment is based on our analysis of the company's very important role because it supplies about 50% of the domestic market's fuel needs, and by owning and operating the Norperuano oil pipeline. We also view the company as having a very strong link to the government, given that the government ownership provides a clear structure of corporate governance, and has a record of business-decision making. In addition, the government is actively involved in key investment decisions and gives authorizations to conduct significant investments and approvals to issue additional debt. The government has a record of support for Petroperu that we expect to continue, which underpins our assessment. The government's latest actions of support include a capital increase of $325 million in January 2017 and a formal government guarantee in place of $1 billion that the company hasn't used yet. Additionally, Petroperu is exempt from paying dividends.

Environmental, Social, and Governance

We view social and environmental factors as more material than governance factors for Petroperu. It is a key infrastructure asset in Peru as the main fuel distributor in the country. Supplying about 50% of the domestic market's needs, it is important for the government's energy strategy. This is one of the pillars of our view of a very high likelihood of extraordinary support from the government that uplifts its rating by 4 notches from its stand-alone credit profile of 'b+'. In regard to environmental factors, the company aims to reduce air pollution by modernizing its Talara refinery. This project should reduce the amount of sulfur in fuels from 1,800 parts per million (ppm) to 50 ppm, which will help reduce toxic emissions by 2021. It's also working to improve the degree of octane in naphthas and to decrease refinery waste. The company is investing $5 billion in the construction of the new refinery, with operations expected to be ramped up in the first half of 2021. We view the company's governance structure as comparable to those of its regional industry peers, such as ENAP or ANCAP. Two of the board's six directors are senior government officials. The government is therefore highly involved in the company's decisions on investment and approval of additional debt incurrence.

Reconciliation

Reconciliation Of Petroleos del Peru Petroperu S.A. Reported Amounts With S&P Global Ratings' Adjusted Amounts (000s PEN)

	--Fiscal year ended Dec. 31, 2017--					
Petroleos del Peru Petroperu S.A. reported amounts						
	Debt	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**	**Capital expenditures**
	10,731,212.0	888,107.0	168,355.0	1,054,346.0	1,625,838.0	3,162,899.0
S&P Global Ratings' adjustments						
Interest expense (reported)	--	--	--	(168,355.0)	--	--
Interest income (reported)	--	--	--	11,041.0	--	--
Current tax expense (reported)	--	--	--	(229,239.0)	--	--
Surplus cash	(2,161,093.0)	--	--	--	--	--
Capitalized interest	--	--	242,314.0	(242,314.0)	(242,314.0)	(242,314.0)
Asset retirement obligations	111,941.3	--	--	--	--	--
Non-operating income (expense)	--	11,041.0	--	--	--	--
Total adjustments	(2,049,151.7)	11,041.0	242,314.0	(628,867.0)	(242,314.0)	(242,314.0)

Reconciliation Of Petroleos del Peru Petroperu S.A. Reported Amounts With S&P Global Ratings' Adjusted Amounts (000s PEN) (cont.)

S&P Global Ratings' adjusted amounts

	Debt	EBIT	Interest expense	Funds from operations	Cash flow from operations	Capital expenditures
	8,682,060.3	899,148.0	410,669.0	425,479.0	1,383,524.0	2,920,585.0

Ratings Score Snapshot

Issuer Credit Rating

BBB-/Stable/--

Business risk: Fair

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

Stand-alone credit profile : b+

- **Likelihood of government support:** Very high (+4 notches from SACP)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	Significant	Aggressive	**Highly leveraged**
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	**b**
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of June 6, 2019)*	
Petroleos del Peru Petroperu S.A.	
Issuer Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-
Issuer Credit Ratings History	
01-Feb-2016	BBB-/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.