Research Update:

Petroleos del Peru Petroperu S.A. 'BBB-' Ratings Affirmed; Outlook Remains Stable

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Rating Action Overview

- Although Peru-based oil refiner Petroperu's credit metrics have worsened beyond our expectations due to delays with the bidding process of its auxiliary units, we believe that the company will be able to continue refinancing its short-term debt maturities, considering its government-related status and solid relationship with banks.
- On Dec. 5, 2019, S&P Global Ratings affirmed its 'BBB-' issuer credit and issue-level ratings on Petroperú.
- The stable outlook reflects our expectations that leverage will peak in 2020 because of the company's demanding investment plan, and from 2021 on it will gradually deleverage as the asset ramps up. It also reflects our views 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.

Rating Action Rationale

The ratings affirmation reflect our view that although the conclusion of Petroleos del Peru Petroperu S.A.'s (Petroperu) investments to expand its refining capacity will take longer than anticipated, postponing the deleverage of its credit metrics, the company keeps benefiting from its strong relationship with the government. In our view, this relationship should allow it to continue refinancing its sizable short-term maturities.

Credit metrics to gradually improve as the refinery posts stronger cash flows. The construction of the new Talara refinery, which Petroperu initially expected to complete this year, will now be completed by the last quarter of 2020 and will start operating in the first quarter of 2021, after several disputes with existing contractors and delays in the tendering process for the auxiliary units and complementary works, which also required insurance renegotiations. As a result, some expenses were postponed to 2020. This, combined with the refinery's temporary shutdown to install the new machinery--which will require Petroperu to import the processed products for domestic distribution, obtaining only commercialization profit--will erode the company's operating margins beyond what we anticipated.

Therefore, we now expect EBITDA close to $200 million-$230 million and EBITDA margins of 4%-5% in 2020, from our previous forecasts of $280 million and 5%-6%. This should translate to debt to EBITDA above 10.0x and EBITDA to interest of 1.0x-2.0x range until at least 2023, but gradually improving once the refinery is fully operational.

Petroperu to continue refinancing short-term maturities. Even in this scenario and with a notable amount of working capital facilities maturing in the next twelve months, we expect the company to continue refinancing its maturities, considering not only its relationship with the government and banks, but also the advancement in the new refinery's construction.

Although we project Petroperu's sources over uses of cash ratio to be below 1x, its short-term debt maturities as of Sept. 30, 2019, related to working capital loans that the company has historically rolled over. In addition, Petroperu's other major use of cash involves completing the construction of the new Talara refinery. Necessary funds to complete the project could either come from a capitalization from the Peruvian government--that could range from $500 million to $1.5 billion and is yet to be defined--or from an alternative debt financing structure. In our view, Petroperu benefits from its sound relationship with banks due to its government ownership.

We believe Peru will keep supporting the company. Given that the government owns the company, which supplies about 50% of the domestic market needs and is a key infrastructure asset for Peru, 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

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. 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 next 12-18 months. Additionally, we could lower our stand-alone credit profile (SACP) on the company if we see a significant worsening in liquidity due to a material deficit in the next 12 months. In that scenario, the SACP would be no higher than 'b-' and result in a downgrade to 'BB', provided that the sovereign's rating remains at the current level. We could also downgrade Petroperu if its capital structure becomes unsustainable, which could occur if after the construction of the new refinery, the company does not deleverage as expected, while EBITDA to interest remains below 1x.

Upside scenario

Given the higher capital investments in the near term and until the new Talara refinery construction 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.

Company Description

Peru (local currency: A-/Stable/A-2; foreign currency: BBB+/Stable/A-2) owns 100% of Petroperu. The company transports, refines, distributes, and markets 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 barrels per day (kbpd). The company operates the Nor Peruano oil pipeline (approximately 1,100 kilometers (km) in length). Nor Peruano oil pipeline 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 comes from refining, marketing, and distributing oil products.

Petroperu is investing close to $5 billion for its new Talara refinery, which we expect to increase the plant's refining capacity by up to 95 kbpd by 2021 from the current 65 kbpd, reaching a total 122.5 kbpd for all three operating refineries. As of September 2019, 81% 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 negotiating a capitalization with the government that could range from $500 million to $1.5 billion to complete the financing, and we expect the government to finalize the amount within the next two months. In case the capital injection does not occur, the company would assess alternatives over the next few months. Petroperu expects the refinery to be fully operational by the second half of 2021, the year in which we anticipate the company to gradually start deleveraging.

Our Base-Case Scenario

Assumptions

- We incorporate 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: Political Challenges Will Prevail in 2020," published Dec. 3, 2019). We assume GDP growth in Peru of 2.8%-3.0% for the next two years and inflation of 2.2% in 2020 and 2.0% in 2021.
- Approximately 23,000 barrels per day (bpd) processed for 2020 as a result of the stoppage in the Talara refinery that we expect to last all 2020. Next year, we expect an increase in purchases of refined products to around 110,000-120,000 bpd from the historic 80,000-90,000

bpd. Once the refinery is fully operational, we expect the company to process close to 100,000 bpd, maintaining utilization rates close to 80%.

- Fuel prices, as well as prices for the purchase of oil and refined products, moving almost in tandem because both correlate to oil prices. In 2020 and 2021, we expect oil prices of $55 per barrel.
- Capital expenditures (capex) of approximately $1 billion in 2020, mostly for the construction of the new Talara refinery, and around $250 million for 2021, of which $100 million will be for maintenance purposes.
- New debt of approximately $860 million in 2019 and 2020, which the company will use for the new Talara refinery. We don't incorporate in our base case a possible capitalization from the Peruvian government.
- No dividend payments.

Key Metrics

Under these assumptions, we expect Petroperú to generate EBITDA of about $200 million-$230 million for 2020 and close to $300 million for 2021. That would lead to net debt to EBITDA above 10x in 2020 and 2021, which we expect to gradually decrease to about 8.0x-10.0x with the ramp up of the new refinery. In addition, we expect EBITDA interest coverage close to 1.0x by 2020 and ranging from 1.2x-1.4x by 2021. Although not included in our base case, we see the possibility of the government injecting capital into the company next year. If a capitalization of about $1 billion occurs, we believe that the company would still have very high leverage, but it would provide some relief to its main credit ratios.

Liquidity

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 $1.3 billion syndicated loan guaranteed by the Spanish export credit agency Compania Española de Seguros de Credito a la Exportacion (CESCE; A-/Stable/A-1) signed on Jan. 31, 2018.
- A source-to-use ratio below 1x.
- Prudent risk management.

As of Sept. 30, 2019, Petroperu was in compliance with all covenants under the syndicated loan. Nevertheless, under our base case we expect the EBITDA interest coverage ratio to be slightly below 1.1x in 2020, breaching an incurrence covenant on the loan provided by CESCE, which does not cause a debt acceleration. In this scenario, we predict that the company could obtain a waiver, as it has already in the past.

Principal liquidity sources:

- Cash balances of $783 million as of Sept. 30, 2019; and
- Funds from operations (FFO) generation ranging from $50 million to $60 million for the next

twelve months.

Primary liquidity uses:

- Short-term debt maturities of $914 million that consist entirely of working capital facilities, which the company has rolled over historically; and
- Capex close to $1 billion that includes all required investments to complete the new refinery.

Issue Ratings--Subordination Risk Analysis

We rate the company's bullet bond issuances of $1 billion due in 2032 and 2047 'BBB-'. All the debt that the company has is issued at the operating level, so we rate the notes at the same level as the issuer credit rating.

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)
- 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:

Local currency: A-/Stable/A-2

Foreign currency: BBB+/Stable/A-2

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

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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, 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, 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

Ratings Affirmed

Petroleos del Peru Petroperu S.A.	
Issuer Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.