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Petroleos del Peru Petroperu S.A.

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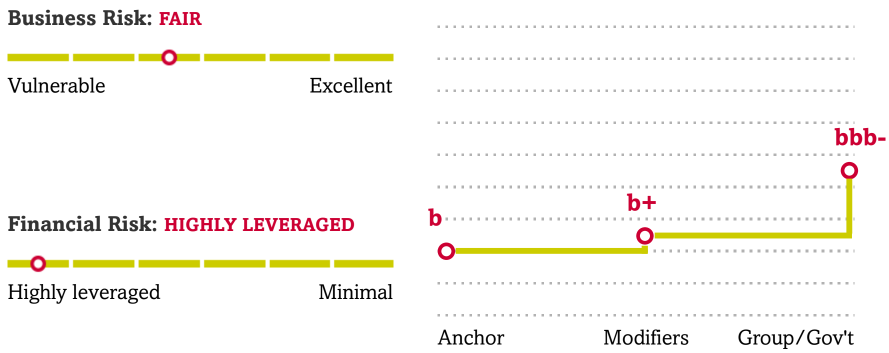

Issuer Credit Rating

BBB-/Stable/--

Credit Highlights

Overview

Key strengths	Key risks
A very high likelihood of government support. We expect such support to continue and we also view extraordinary support as highly likely in case of distress. The recently acted Decree 33/2020 is a demonstration of such support.	The slump in oil prices, the sharply lower domestic fuels consumption, and the suspension of the works in Talara due to the pandemic put further pressure on the company's already highly leveraged capital structure, which is only sustainable -in our view- due to the support from the government.
A wide access to the domestic and international debt and capital markets.	Due to the shutdown of Talara, Petroperu's fuel imports have risen, while it's losing most of its refining revenue.
The company accounts for about 50% of refining capacity and is the leading supplier/importer of refined products in the country.	Inherent volatility in refining margins, stemming from factors outside of the company's control such as oil price differentials.
Some level of vertical integration and ownership of the country's sole oil pipeline connecting all major oil blocks in the northern region of Peru to the country's largest refinery and port.	

Government support remains a key feature of the issuer's credit quality. The government has a track record of providing support to Petroperu, including the transfer of the company's pension liabilities to the government, a capital injection of $325 million in January 2017, a favorable taxation policy on the company's operations in the Amazonia region, and the March 27 enactment of the Emergency Decree 33/2020. Among several initiatives to alleviate the impact of the pandemic on various sectors of the economy, the decree authorizes the public bank, Banco de la Nacion del Peru (not rated), to provide financing at advantageous conditions to certain state-owned companies, including Petroperu. The decree will be in force until Dec. 31, 2020, and the companies can use funds for any operating, financial, or investment needs this year. The decree doesn't set limits to this financial assistance.

Government support for Petroperu stems from its critical role in domestic economy and in the government's energy strategy. The company is the largest refiner and main fuel distributor in Peru. Despite the stoppage of Talara's operations, Petroperu will remain the main importer and distributor of refined fuels because it operates the largest gas station network throughout the country. We view Petroperu's positions in the domestic energy sector as not easily replaceable in the short to medium term because of the difficulty in building new refineries, pipelines, and storage facilities given the amount of necessary investments, the environmental licenses, and the construction timeline. Therefore, and although the government won't inject capital into the company in 2020, we expect Petroperu to continue receiving ongoing and extraordinary support, the latter if necessary.

Petroperu to continue rolling over its short-term revolving credit facilities. Despite the currently tight financing conditions and a sizable amount of working capital facilities maturing in the next 12 months, we expect the company to continue renewing its credit facilities, given its access to a diverse pool of domestic and international banks and financing through the Decree 33/2020.

Although we project Petroperu's cash sources over uses to be below 1x in 2020 mostly because of the maturity of short-term working capital revolving facilities, the company typically rolled them over. As of March 2020, Petroperu's revolving credit facilities totaled $3.1 billion, of which $1.9 billion were undrawn. The other major use of cash is related to the completion of the Talara refinery. The funding for it will come from alternative debt issuances because the government won't inject capital into the company in 2020.

The highly leveraged capital structure is taking a hit from lower oil prices and fuels consumption, and operations suspension at Talara. The refurbishment of the Talara refinery, initially expected to be completed in 2019, is now scheduled to do so in the first quarter of 2021 following disputes with contractors and delays in the tendering process for the auxiliary units and complementary works. As a result, greater-than-expected capex in 2020, combined with the refinery's temporary shutdown, will put pressure erode the company's operating margins

Deleveraging likely to be delayed until late 2021. Under the currently gloomy business conditions, completion of Talara's upgrade is more likely be extended beyond the first or second quarter of 2021. Therefore, we expect deleveraging and improvement in credit metrics to start towards the end of 2021. We now expect EBITDA in the $120 million area and EBITDA margins below 6% in 2020, compared with our previous forecast of $200 million - $220 million and around 5%, respectively. As a result, we expect debt to EBITDA above 20x and EBITDA to interest below 1x in 2020, and gradually improve once the refinery comes back on line in 2021.

Outlook: Stable

The stable outlook reflects our expectation that Petroperu's leverage will peak in 2020, as a result of substantial investments, and to start diminishing in 2021 as Talara ramps up. The stable outlook also reflects our view that Petroperu will continue playing a very important role in Peru's energy and infrastructure policy, while its link with the government remains very strong. In our view, Petroperu's capital structure is only sustainable thanks to the very high likelihood of government extraordinary support in case of financial stress, along with ongoing support measures.

Downside scenario

A downgrade to 'BB+' or below is possible if 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 or if Petroperu's importance to the Peruvian energy sector lessens, which we don't expect in the short to medium term.

Additionally, we could revise downward our stand-alone credit profile (SACP) on the company if liquidity deteriorates over a 12-month horizon. This could occur, for example, if Petroperu's access to credit and capital markets weakens in 2020 which could prevent it from rolling over short-term uncommitted facilities. Under that scenario, the SACP would be no higher than 'b-' and result in a downgrade to 'BB', provided that the sovereign rating remains at the current level. We could also downgrade Petroperu if its capital structure becomes unsustainable, which could occur if after the refinery's renovation the company doesn't start deleveraging as expected, while EBITDA to interest remains below 1x.

Upside scenario

Given the current capital investments and until Talara's overhaul is completed, we view a higher rating in the short term 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 the likelihood of extraordinary support increases, for example, if the company's role to the government--or link to it--rises, in our view.

Our Base-Case Scenario

Assumptions	Key Metrics
• 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 (SG&A) expenses. (Please see	Under these assumptions, we expect EBITDA in the $120 million area in 2020 and around $250 million in 2021. Debt to EBITDA will be above 20x in 2020, which we expect to start gradually decreasing in 2021 as Talara ramps. In addition, we expect EBITDA interest coverage below 1.0x in 2020 and 1.1x-1.5x in

"Economic Recovery From The Covid-19 Pandemic Will Be Uneven Across Latin America", published on April 17, 2020). We forecast Peru's GDP to contract 3.1% in 2020 and grow 5.5% in 2021, and inflation rate of 2.0% and 2.5%, respectively.

- Approximately 19,000 barrels per day (bpd) processed for 2020 due to the stoppage of the Talara refinery in 2020 and the sharp drop in demand for refined products due to the pandemic. Volumes sold to plummet 40% in the second quarter (both for domestic use and exports) and gradually recover through the second half of 2020. Estimated volumes of 115,000-130,000 bpd this year, a decrease of 15%-20% from 144,000 bpd sold in 2019. The volumes sold to recover to around 144,000 bpd, and purchases of oil and refined products of 120,000-130,000 bpd in 2021. We also expect a higher share of refined products than oil in the total purchases until Talara becomes operational. After the latter occurs, bpd processed to reach 95,000, assuming the utilization rate close to 75%.
- Fuels prices, as well as prices for the purchase of oil and refined products, moving almost in tandem because both correlate to oil prices. WTI oil price of $25 per barrel in 2020 and $45 in 2021, according to "S&P Global Ratings Cuts WTI And Brent Crude Oil Price Assumptions Amid Continued Near-Term Pressure", published on March 19, 2020.
- Capex of approximately $1 billion in 2020, mostly for the completion of Talara's refurbishment, and around $700 million in 2021, of which $200 million will be for maintenance purposes.
- New debt of around $1 billion in 2020 to cover the remaining costs of Talara's upgrade.
- No dividend payments.

2021 and 2022. Our view is that these metrics are only sustainable upon the strong support from the government.

Company Description

The Republic of Peru (local currency: A-/Stable/A-2; foreign currency: BBB+/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 owns and operates three refineries (Talara, Conchan, and Iquitos) with a total refining capacity of 92.5 thousand barrel per day (kbpd). The the Pucallpa refinery, which used to be leased from a private entity, is currently under evaluation to continue its operations. The company also owns and operates the Nor Peruano oil pipeline (approximately 1,100 kilometers 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, trucks, and railcars, and commercializes it mainly through affiliated retail stations that work exclusively with Petroperu. Most of the company's revenue and EBITDA come from the refining, marketing, and distribution of oil products in the country.

Petroperu is investing (this is an investment) around $4.7 billion to upgrade Talara, which will increase its refining capacity to 95 kbpd by 2021, from the current 65 kbpd, and total 122.5 kbpd for all three operating refineries. As of the end of 2019, 85.27% of the renovation was completed. Petroperu now expects the refinery to be fully operational in the second half of 2021.

Peer comparison

We selected refining assets that we rate in Latin America as Petroperu's peers. Most of them are government-related entities with a high likelihood of support from their respective governments. Therefore, they have an important role from an economic and social standpoint in the country of operations, and 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 accounts for 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 comparable peer. ANCAP maintains exclusive rights for refining, and for importing crude oil, refined products, and natural gas. The company also has a dominant position, but not a monopoly, in the fuel distribution market in Uruguay, with a market share of around 60% through its network of 290 service stations.

From a business perspective, we view these two companies as Petroperu's closest peers, mainly because the three entities are highly important for their governments key energy suppliers. A credit strength for Petroperu, unlike ENAP and ANCAP, is its 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. 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 comparative credit strength.

Table 1

Petroleos del Peru Petroperu S.A. -- Peer Comparison			
Industry Sector: Oil Refining & Marketing			
	Petroleos del Peru Petroperu S.A.	**Administracion Nacional de Combustibles Alcohol y Portland**	**Empresa Nacional del Petroleo**
Ratings as of April 21, 2020	BBB-/Stable/--	BB+/Stable/--	(BBB-)/(Stable)/--
	--Fiscal year ended Dec. 31, 2019--		
(Mil. $)			
Revenue	4,668.0	3,135.1	7,651.2
EBITDA	334.7	345.4	613.6
Funds from operations (FFO)	123.5	223.1	329.7
Interest expense	181.4	52.7	241.5
Cash interest paid	188.7	39.7	202.5
Cash flow from operations	489.5	427.7	525.2
Capital expenditure	760.5	114.8	403.8
Free operating cash flow (FOCF)	(271.0)	312.9	121.4
Discretionary cash flow (DCF)	(271.0)	312.9	121.4
Cash and short-term investments	381.1	582.4	131.8
Debt	3,814.7	827.3	4,429.9
Equity	1,907.9	1,397.9	1,040.4
Adjusted ratios			
EBITDA margin (%)	7.2	11.0	8.0
Return on capital (%)	5.3	12.1	3.1
EBITDA interest coverage (x)	1.8	6.6	2.5
FFO cash interest coverage (x)	1.7	6.6	2.6
Debt/EBITDA (x)	11.4	2.4	7.2
FFO/debt (%)	3.2	27.0	7.4
Cash flow from operations/debt (%)	12.8	51.7	11.9
FOCF/debt (%)	(7.1)	37.8	2.7
DCF/debt (%)	(7.1)	37.8	2.7

Business Risk: Fair

The company is responsible for 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/Stable/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 (8, 39, 64, 67, 95, 131, and 192) to the country's largest refinery and port. This allows Petroperu to use domestic oil for about 80% of 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 network of 652 gas stations across the country, which operate under the Petroperu brand 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 geographic and asset diversification is narrow. 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 rating weaknesses.

Financial Risk: Highly Leveraged

We expect Petroperu's adjusted leverage to remain very high, with net debt to EBITDA above 20x in 2020 and EBITDA interest coverage below 1x, which will start gradually improving in 2021. The highly leveraged capital structure results mainly from the company's $5 billion investment plan, delays in Talara's renovation, and the pandemic's pernicious impact on domestic demand for refined products. We believe Petroperu's capital structure can only be sustainable thanks to the ongoing and extraordinary support from the government.

We expect Petroperu to start slowly deleveraging after the peak in 2020 once the new Talara refinery ramps-up in 2021 due to higher refining volumes and greater capacity utilization. We also note that under the currently difficult conditions, the company is focusing efforts and initiatives to preserve liquidity and protect its cash flow generation. In 2017, Petroperu issued two international unsecured bonds with maturities in 2032 and 2047 for an aggregate amount of $2 billion. In addition, in 2018 it raised a $1.3 billion ECA-loan due 2031 (99% guaranteed by CESCE). We expect the remaining funding needed for the Talara capex (estimated at $800 million) to be closed during the second and third quarters of 2020.

Reconciliation

Table 3

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

	--Fiscal year ended Dec. 31, 2019--					
Petroleos del Peru Petroperu S.A. reported amounts						
	Debt	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**	**Capital expenditure**
	4,163,739.0	264,983.0	30,466.0	334,726.0	640,435.0	911,386.0
S&P Global Ratings' adjustments						
Cash taxes paid	--	--	--	(22,510.0)	--	--
Cash taxes paid: Other	--	--	--	--	--	--
Cash interest paid	--	--	--	(37,811.0)	--	--
Accessible cash and liquid investments	(381,063.0)	--	--	--	--	--
Capitalized interest	--	--	150,914.0	(150,914.0)	(150,914.0)	(150,914.0)
Asset retirement obligations	32,003.7	--	--	--	--	--
Nonoperating income (expense)	--	19,134.0	--	--	--	--
Total adjustments	(349,059.3)	19,134.0	150,914.0	(211,235.0)	(150,914.0)	(150,914.0)

Table 3

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

S&P Global Ratings' adjusted amounts

	Debt	EBIT	Interest expense	Funds from operations	Cash flow from operations	Capital expenditure
	3,814,679.7	284,117.0	181,380.0	123,491.0	489,521.0	760,472.0

Liquidity: Less Than Adequate

We maintain our assessment of Petroperu's liquidity as less than adequate, mainly because the company's cash sources to uses will be below 1x for the next 12 months. Our liquidity assessment also incorporates the company's well-established, solid relationships with banks. As of March 2020, and in addition to the long-term funding for Talara's upgrade, Petroperu had $3.1 billion in short-term uncommitted credit facilities, of which $1.9 billion were undrawn.

As of Dec. 31, 2019, Petroperu was in compliance with all covenants under the syndicated loan from CESCE. Our base-case scenario assumes the EBITDA interest coverage ratio of below 1x in 2020. The covenants exclude the interest on the debt for Talara's upgrade, we assume the company will comply with them. However, given the currently extreme volatile conditions, our base-case assumptions may not materialize.

Principal Liquidity Sources	Principal Liquidity Uses
• Cash balances of $376 million as of Dec. 31, 2019; and • FFO after working capital changes of around $200 million for the next 12 months.	• Short-term debt maturities of $1 billion that consist of working capital facilities, which the company is in the process of rolling over; and • Capex close to $1 billion that includes all required investments for the refinery's renovation.

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 extraordinary support to Petroperu in case of financial distress.

Government Influence

In our view, there's a very high likelihood that the company will benefit from timely and sufficient extraordinary support from the government in the event of financial distress. This assessment is based on our analysis of the company's very important role in the Peru's energy matrix. We also view the company as having a very strong link to the government. The latter is actively involved in key investment decisions and gives authorizations to conduct significant investments and approvals to raise debt. In the past, the government's injected $325 million in capital in January 2017, the approved the law that provided $1 billion in guarantee to support financing of the refinery's upgrade, and enacted the Decree 033/2020 in response to the pandemic, allowing Banco de la Nación del Peru to provide financial assistance in 2020 to Petroperu and other state-owned companies to meet their financial commitments, if needed.

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: 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

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 2, 2020)*

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.