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Research Update:

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

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Overview

- We expect Peru-based oil refiner Petroperu to continue posting very high leverage in light of its sizable investment plan to upgrade its main refinery, Talara, that should be finalized by 2020.
- We're affirming our 'BBB-' long-term corporate credit and issue ratings on Petroperu.
- The stable outlook reflects our expectation 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

On Feb. 23, 2018, S&P Global Ratings affirmed its 'BBB-' long-term corporate credit rating and issue-level ratings on Petroleos del Peru Petroperu S.A. (Petroperu). We also kept the company's 'b+' stand-alone credit profile (SACP) unchanged. The outlook on the corporate credit rating remains stable.

Rationale

The ratings on Petroperu continue to reflect our opinion that there's a very high likelihood that its owner, Peru (foreign currency: BBB+/Stable/A-2; local currency: A-/Stable/A-2) would provide timely and sufficient extraordinary support to the company in the event of financial distress. This reflects our assessment of the company's:

- Very important role for Peru. Petroperu is a leader in the refining and marketing of oil products in Peru, supplying about 50% of the domestic market's needs, and is a key infrastructure asset for the country. Moreover, Petroperu is the only distribution company in Peru that serves all of the country's departments and is of significant importance for the government's energy strategy. We believe that 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.
- Very strong link to the Peruvian government. The government owns Petroperu, provides a clear structure of corporate governance, and has a record of business-decision making. Two out of six of the company's board directors are senior government officials, and the government is actively involved in key investment decisions. In addition, the government gives

authorizations to conduct significant investments and approval 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 \$315 million in January 2017. Additionally, Petroperu is exempt from paying dividends.

The 'b+' SACP assessment continues to reflect Petroperu's strong competitive position as a leading oil refiner in the country that also has some integration to the midstream and distribution segments. We also include in our analysis the ongoing support that Petroperu receives from the government--in the form of tax credits and recognition of certain pension liabilities, for example--as a comparable rating strength in relation to its privately owned peers. Petroperu's small scale of operations, the inherent volatility in its margins, and its highly leveraged capital structure partially offset these strengths.

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 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, 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 the company to use about 80% domestic oil, while importing the remaining 20%, which translates into lower transportation, commercialization, and overall all-in feedstock costs. Finally, we view the company's distribution network through affiliations with 674 gas stations across the country, which operate under the Petroperu flag, as a rating strength. On the other hand, we think that Petroperu's scale of operations is small--as seen in its total refining capacity of 94,500 barrels per day (bpd)--and its geographic and asset diversification is limited. Moreover, we consider the cyclicity of the company's profitability (typical for the refining industry), and the lack of economies of scale and operating flexibility that lead to lower margins than those of larger international peers, as business-related weaknesses.

We continue to expect that Petroperu's adjusted leverage will remain high, with net debt to EBITDA near 9x and EBITDA interest coverage of 2x. The highly leveraged capital structure results from the company's \$4.4 billion investment plan primarily devoted to modernizing the Talara refinery. The project should allow Petroperu to increase its refinery capacity to 124,500 bpd and its market share in Peru to 55%. Additionally, we expect Petroperu to decrease its operating and processing costs and to start producing the low-sulfur diesel Euro 6, which Peru will require by 2020. As of Dec. 31, 2017, the Talara project was 66.57% complete. We don't envision deleveraging in the near or medium term, not until the completion of Talara's upgrade.

Last year, Petroperu issued international bonds with maturities in 2032 and

2047 for an aggregate amount of \$2 billion. In addition, it recently signed a facility agreement with international banks, guaranteed by the Spanish Compañía Española de Seguros de Creditos a la Exportacion S.A. (CECE; local currency: BBB+/Positive/A-2), for \$1.3 billion with final maturity in 2031. With the closing of the mentioned loan, Petroperu was able to structure most of the financing for Talara in the long term, which we view as a positive for credit.

Our base-case scenario includes the following assumptions in 2018 and 2019:

- 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&As) (see, "Favorable Conditions In Latin America Should Remain, But Elections Loom," published Nov. 30, 2017). We assume GDP growth in Peru of 3.5% and 3.8% and inflation of 2.8% and 2.6% in 2018 and 2019, respectively.
- Approximately 70,000 bpd processed, assuming average utilization levels of 75%.
- 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 2018 and 2019, we expect oil prices of \$55 per barrel.
- EBITDA generation approaching \$400 million, which represents a margin of approximately 8%.
- Capital expenditures (capex) of approximately \$1.1 billion in 2018, \$740 million in 2019, and \$590 million in 2020, mostly for modernizing the Talara refinery.
- New debt of approximately \$2 billion in the next two years, including the recently signed facility agreement with international banks.
- No dividend payments.

Liquidity

We continue to assess Petroperu's liquidity as less than adequate mainly because the company's cash uses are larger than its sources for the next 12 months. However, we acknowledge Petroperu's well-established relationship with banks due to its government ownership. Moreover, in the next few months, we expect Petroperu's liquidity to improve because the company will use most of the proceeds from the recently signed loan to cancel short-term debt. A condition precedent for disbursement of the loan is the preliminary report to be issued by the General Controller of Peru that the company obtained on Feb. 22, 2018.

Petroperu's current debt does not have financial covenants.

Principal liquidity sources:

- Cash and cash equivalents of \$636 million as of Dec. 31, 2017;
- Highly liquid investments at international banks for \$276 million, and
- Funds from operations (FFO) approaching \$180 million in the next 12 months.

Principal liquidity uses:

- Short-term debt maturities of \$1.2 billion as of Dec. 31, 2017;
- Total capex of approximately \$1.1 billion, most of which corresponds to the modernization of Talara and to maintenance capex of \$100 million; and
- Marginal working capital outflows.

Outlook

The stable outlook reflects our expectation 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. That would translate to a very high likelihood of extraordinary support from the government to Petroperu in case of financial stress, but also to ongoing measures, like the government has already done through tax reductions and its recognition of the company's liabilities, for example.

Downside scenario

A downgrade is possible if we revise our view of the likelihood of government support to high from very high. In addition, if the company's liquidity significantly deteriorates, due to a significant deficit projected for a 12-month horizon, we could also downgrade the company. This could occur if Talara's upgrade requires substantially higher extra funds or if cash flows from operations deteriorate. Under that scenario, we could revise our liquidity assessment to weak, which would result in an SACP of no higher than 'b-' and a downgrade to 'BB', provided that the sovereign's rating remains at the current level.

Upside scenario

Given Petroperu's higher capital investment over the near term, and until it completes Talara's modernization, we view a rating raise as unlikely in the next 24 months. In any event, a higher rating would require debt to EBITDA to remain below 5x and FFO to debt to surpass 12%. We could also upgrade Petroperu if our view of the extraordinary likelihood of support improves, for example, if we think that Petroperu's role has become critical or its government link strengthens to integral.

Ratings Score Snapshot

Corporate 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: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- 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

Ratings List

Ratings Affirmed

Petroleos del Peru Petroperu S.A.

Corporate 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 the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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