

Research Update:

Peru LNG Ratings Lowered To 'B' From 'BB+' On Significant Gas Price Pressure And Volatile Cash Flows; Outlook Stable

March 16, 2020

Rating Action Overview

- Amid more volatile and record-low gas prices, we expect Peru-based natural gas liquefaction company Peru LNG S.R.L.'s (PLNG) leverage to remain at very high levels until at least 2022. We revised our base-case scenario and now expect net debt to EBITDA to peak at about 9x-10x in 2020 and close to 7.5x in 2021 versus our previous expectations of 4.0x-4.5x for 2020 and below 4.0x by 2021.
- Although our ratings already incorporate certain exposure to commodity prices, we see lower contractual protection under the current scenario of particularly low gas prices, exacerbating cash flow volatility.
- We continue to view PLNG's liquidity positively--as of Dec. 31, 2019, PLNG had cash balances of \$140 million and marginal interest payments of almost \$50 million on its \$940 million bond due 2030, accounting for all of its debt.
- PLNG has initiatives that could minimize unplanned stoppages and cash flow volatility, including investments that raise availability during rough weather conditions, the renegotiation of the commercial strategy with the off-taker, and a hedging plan to reduce commodity exposure. Although we view these as positive, we do not expect the effects to materialize before 2021.
- As a result, on March 16, 2020, S&P Global Ratings lowered its issuer credit and issue-level ratings on PLNG to 'B' from 'BB+'.
- The outlook is stable, reflecting our expectations of even higher leverage in the next 18 months, albeit with adequate liquidity, as well as our view that PLNG will continue to rely on favorable weather conditions to prevent port closures and depend on gas price volatility.

PRIMARY CREDIT ANALYST

Juan Barbosa
Buenos Aires
(54) 114-891-2108
juan.barbosa
@spglobal.com

SECONDARY CONTACT

Cecilia L Fullone
Buenos Aires
(54) 11-4891-2170
cecilia.fullone
@spglobal.com

Rating Action Rationale

Sustained underperformance is beneath our deleveraging expectations, although we view the company's liquidity position positively. The downgrade reflects PLNG's still very-high leverage, pushing its previously expected deleveraging into 2022. The weaker operating and financial performance are related to recurrent unplanned stoppages and dependence upon natural gas prices for both Henry Hub (HH) and non-Henry Hub markers, which have traded at very low levels in the past few months. Our updated base-case scenario includes revised HH gas prices of \$2.00 per million British Thermal Units (mmBTU) in 2020 and \$2.25 per mmBTU in 2021 (versus \$2.5 per mmBTU and \$2.75 per mmBTU, respectively) and average non-HH markers of \$4 per mmBTU and \$5 per mmBTU for the next two projected years, respectively--lower than we previously expected (\$6.3 per mmBTU and \$7 per mmBTU, respectively). Gas prices have continued to decline this year due to the oversupply in the U.S. and demand concerns related with the coronavirus. We now anticipate EBITDA of about \$80 million-\$90 million for 2020, rising to \$110 million-\$120 million (down from our previous expectation of \$170 million for both years), leading to net debt to EBITDA of 9x-10x in 2020 and near 7.5x for 2021, which compares negatively to our previous estimates of 4.0x-4.5x for 2020 and below 4.0x by 2021.

On the other hand, we view PLNG's liquidity positively--as of Dec. 31, 2019, PLNG had cash balances of \$140 million and marginal interest payments of almost \$50 million on its \$940 million bond due 2030, accounting for all of its debt, while having to face low capital investments of about \$20 million-\$30 million for the next two years and discretionary dividend payments.

Cash flow volatility is greater than we anticipated because contracts have not fully protected against commodity risk in a low-price environment. We expect low gas prices in 2020-2021 and the delivery of almost all cargoes to non-HH destinations to continue to affect margins and cash flow generation.

PLNG maintains a take or pay agreement with Shell International Trading Middle East (SITME, a wholly owned subsidiary of

[Royal Dutch Shell PLC](#)

; AA-/Stable/A-1). PLNG's supply is fully guaranteed until 2028 by separate agreements signed with the Block 56 and Block 88 of the Camisea consortium, which, in turn, comprises Pluspetrol (not rated),

[Hunt Oil Co.](#)

(B+/CW Negative/--),

[SK Innovation Co. Ltd.](#)

(BBB/Negative/--), Tecpetrol (not rated),

[Repsol S.A.](#)

(BBB/Positive/A-2), and Sonatrach (not rated). Although PLNG's revenues and costs are linked by a formula reflecting ultimate cargo destination, PLNG is exposed to LNG price volatility, which worsens under low gas prices.

In 2019, we saw volatility in volumes caused by unanticipated production stoppages arising from bad weather conditions; we don't expect such conditions in 2020 or 2021, but if those conditions do occur this year, results could be even weaker than we have anticipated. Overall, we anticipate more volatile cash flow generation under the current context, which we view as negative from a credit perspective.

To reduce cash-flow volatility, management is implementing a series of initiatives related to port availability, pricing, and cash flow protection, though the positive effect of these actions will occur after late-2021. To mitigate the causes of lower production--mainly related to rough sea conditions in second-quarter 2019 caused a 46-day port shutdown (lowering quarterly EBITDA generation to below \$4 million from a normal threshold of \$50 million), PLNG approved a capital expenditure (capex) plan to boost operating windows of the port and gain operational efficiencies in the liquefaction process. The most important project is the implementation of a mooring system that will provide ships greater stability and enable the loading of liquid natural gas (LNG) tanks under bad weather conditions, with a maximum cost of about \$25 million to be disbursed in 2020-2021. The other project in the pipeline is a refrigerant ethane recovery facility that will optimize the overall liquefying process; it will need investments of \$8 million. We expect PLNG to complete the mooring system project by second quarter 2021, while the ethane recovery facility is expected to be implemented in late 2020.

PLNG has stated that it is in negotiations with the off-taker to review its commercial strategy to increase the company's profitability, but we do not expect this to take place before 2021.

PLNG is trying to get approval from shareholders to implement a hedging strategy to buy put options on the HH marker for three to nine months to protect against price decreases. We believe that if implemented, this will help lower cash flow volatility when natural gas prices are low, though at a cost.

Although we view these initiatives as positive from a credit standpoint since they lower volume, price, and revenue volatility and, so, will make cash flows more predictable. This may not be evident until 2021 at the earliest, with the completion of the mooring system. We will monitor the results of these initiatives, especially after 2021, once in place.

Outlook

The stable outlook reflects our views that even though we expect PLNG's net debt to EBITDA to peak in 2020 at 9.0x-10.0x, it will deleverage to close to 7.5x by 2021, while continued to be pressured by stagnant gas prices, while it produces about 210-215 thermal BTUs per year. We believe the impact of various initiatives in development will reduce cash flow volatility, though not until 2021, leaving the company vulnerable to unplanned port closures and price volatility in the meantime.

Downside scenario

We could lower the ratings in the next 12 months if we see higher volatility in the company's profitability arising from, for example, further unplanned stoppages or continued commodity price decreases. If our leverage expectations remain above 8x, and the company's liquidity starts to deteriorate, we could view the capital structure as unsustainable.

Upside scenario

In the next 12 months, we could raise our ratings if we perceive reduced volatility in the company's cash flows, allowing PLNG to return to net debt to EBITDA levels below 5.0x, which could occur by a successful renegotiation of the off-take agreement with Shell that could mitigate the effect of adjustments that hurt cash flows, particularly in low price environments.

Company Description

PLNG operates a 4.45 million metric tons per year liquefaction plant, a marine terminal, and a 408 kilometer pipeline that transports natural gas from Camisea, one of the most important natural gas reserves in Latin America. PLNG is a strategic asset for Peru not only because it consumes/monetizes about 50% of the gas produced in Camisea (the royalties of which are important for the national economy), but also because it supports Peru's gas consumption.

Our Base-Case Scenario

We incorporate the following assumptions into our base-case scenario for 2020-2021:

- Macroeconomic variables including U.S. inflation of 1.8% in 2019 and 2.4% in 2020, and inflation in Peru of 2.2% in 2020 and 2% in 2021 (see "Political Challenges Will Prevail In 2020," published Dec. 3, 2019, on RatingsDirect).
- Average HH prices of about \$2.0 in 2020 and \$2.25 per mmBTU in 2021, and non-HH prices of \$4.0-\$5.0 for 2020 and 2021 (see "Unrestrained Supply Swamps Oil Outlook: S&P Global Ratings Revises Oil & Gas Assumptions," March 9, 2020).
- Volumes delivered to SITME of about 215 trillion BTU and close to 210 BTU for 2020.
- A plant processing factor of 92%--in line with the historical record.
- Gas transportation services and compression services adjusted by U.S. inflation.
- Capex of about \$15 million in 2020 and \$35 million in 2021 related to the ethane recovery, the mooring system projects, and planned maintenance in 2021.
- Interest payments of about \$50 million stemming from the \$940 million bond and no increase in debt.
- No dividend payments in 2020 and \$25 million in 2021, depending on management's cash distribution policy; if leverage improves, we expect dividend payments to increase.

Under these assumptions, we expect PLNG to generate EBITDA of about \$80 million-\$90 million in 2020 and \$110 million-\$120 million in 2021. That would lead to net debt to EBITDA above 9x in 2020 and near 7.5x in 2021. We also expect free operating cash flow to net debt to be negative in 2020 and range between 6% and 10% in 2021.

Liquidity

We assess the company's liquidity as adequate. Although in the next 12 months we continue to expect the company's sources of cash to more than double its uses, PLNG's standing in credit markets has not been as established as we expected, shown by the bond's significant price drop in the past month.

Our assessment of PLNG's liquidity also incorporates its ability to absorb high-impact, low-probability events without refinancing, considering it has no short-term debt maturities and no acceleration covenants under its financial debt. In our view, PLNG has a sound relationship with banks, as shown by the full availability under its sole bank facility consisting of a committed \$75 million working capital facility from Banco de Credito del Peru that comes due in March 2021.

Principal liquidity sources:

- Cash balances of \$140 million as of Dec. 31, 2019;
- Funds from operations of \$30 million-\$50 million in the next 12 months; and
- An undrawn committed credit facility of \$75 million from Banco de Credito del Peru maturing in March 2021 (we will monitor the renewal of the committed facility in second- or third-quarter 2020).

Primary liquidity uses:

- No short-term principal maturities; and
- Working capital outflows and capex near \$50 million.

Issue Ratings--Subordination Risk Analysis

We rate PLNG's \$940 million amortizable notes due 2030 'B'. This is the only debt that the company has outstanding at the operating level, so we rate the notes at the same level as the issuer credit rating.

Ratings Score Snapshot

Issuer credit rating: B/Stable/--

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Low
- 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: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: neutral

Sovereign rating:

- Foreign currency: BBB+/Stable/A-2
- Local currency: A-/Stable/A-2

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
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Midstream Energy Industry, Dec. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded

	To	From
Peru LNG S.R.L.		
Senior Unsecured	B	BB+

Downgraded; CreditWatch/Outlook Action

	To	From
Peru LNG S.R.L.		
Issuer Credit Rating	B/Stable/--	BB+/Negative/--

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