

Research Update:

Peru LNG S.R.L. Downgraded To 'B-' From 'B' On Sustained Weak Performance And Slower Deleveraging; Outlook Negative

October 23, 2020

Rating Action Overview

- The rating action is aligned with our downside scenario published in March 2020 and reflects Peru-based natural gas liquefaction company Peru LNG S.R.L.'s (PLNG) weaker results than we expected in the first half of 2020. We also expect still weak results and a highly leveraged balance sheet in the next 12 months, further delaying the anticipated deleveraging. These interim 2020 results were due to continued low gas prices and further port disruptions due to adverse weather conditions. The slow advancement on the initiatives to improve profitability and cash flow generation, in particular the negotiations for better terms in the off-taker contract, also affected results, in our view.
- On Oct. 23, 2020, S&P Global Ratings downgraded PLNG to 'B-' from 'B'. The outlook is negative.
- The negative outlook captures the increased downside risks and the likelihood of a downgrade in the next 12 months if we continue to expect very high leverage (illustrated by net debt to EBITDA above 8x).

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Rating Action Rationale

Weaker-than-expected performance in first half of 2020 decelerates the forecast pace of

deleveraging. Our ratings reflect PLNG's very high leverage, subdued cash flow generation, and what we now see as a more gradual deleveraging path well into 2022. Although our revised base case incorporates the recovery of natural gas prices from record-low levels in 2020, the recovery pace now results in a more gradual deleveraging than we originally forecasted. The following table summarizes price assumptions in our previous and new base case.

Non HH gas prices (average)	2020	2021	2022
Previous	3.9	5.0	5.6
New	3.3	4.9	5.3

HH gas prices (S&P deck)	2020	2021	2022
Previous	2.00	2.25	2.50
New (including \$2.75 in Q4)	2.19	2.75	2.50

Record low gas prices for both Henry Hub (HH) and non-HH markers, particularly during the second quarter, continue to weaken revenues and EBITDA for 2020 compared to our previous base case. To a lesser extent, new unplanned weather-related stoppages during the second quarter, when loading operations were interrupted for 47 non-consecutive days, also hampered PLNG's performance.

In addition, we've seen most LNG cargoes sent to non-HH destinations because prices are higher, so the potential benefits from higher HH prices in 2021 may end up eroded by the contractual clause that caps 67% of PLNG's revenues to HH prices, while the off-taker has flexibility to deliver to the market of its choice (the Manzanillo adjustment). We incorporate most cargoes sent to non-HH destinations in our base case.

We now expect EBITDA of \$45 million-\$50 million in 2020 (versus \$80 million-\$90 million in our previous base case) and about \$100 million in 2021. This would lead to debt to EBITDA close to 18.0x in 2020 (compared to 9.0x-10.0x in our previous forecast), recovering to about 8.5x in 2021 and 6.0x in 2022. This deleveraging path is slower than the one resulting from our previous forecast of near 7.5x in 2021. PLNG's very high leverage this year and the uncertain prospects for a strong recovery in the next 12 months compare negatively to other issuers in the oil and gas industry in the 'B' category.

Other management measures to increase profitability and cash-flow predictability are ongoing, yet not advancing as quickly as we expected. In early 2020, PLNG began conversations with the off-taker to review the contract in place and to mitigate some features that have been hurting PLNG's profitability for the past four years. Despite the ongoing conversations, the advances so far have not been as fast as we expected, presumably affected by the pandemic. In addition, the visibility about the exact content of these negotiations and the timing for a final agreement remains low. We view this initiative as relevant for PLNG, because the negative impact to revenues from the clause under review (about \$370 million since 2016 up until June 2020) represents 39% of the \$940 million bond outstanding.

PLNG is also working on implementing a hedging strategy. While the company is focusing on getting the final approval from shareholders to implement options on HH natural gas prices, the documentation is still under discussion with the potential hedging providers. We maintain our view that if successfully implemented, this would help lower cash flow volatility, though at a cost.

Liquidity remains a strength in the short term, but is uncertain in the long term. We continue to view PLNG's liquidity position as adequate in the next 12 months, with sources over uses above 2x. This is mainly due to the company's robust cash balance of \$163 million as of June 30, 2020. However, in our view over the medium to long term, PLNG's cash generation mostly depends on how commodity gas prices evolve (therefore outside the company's control) and the renegotiation of the agreement with the off-taker. Absent a successful strategy to stabilize and make revenues more predictable, PLNG will likely face challenges to build up cash to serve the bond amortizations from 2024 on.

From a qualitative standpoint, we're also monitoring PLNG's relationship with banks, considering that it still has to renew the committed facility with Banco de Crédito del Perú (BCP, BBB+/Negative/A-2) due in March 2021. This facility has been in place for many years now,

although we now think there could be challenges to renew it under the current business conditions.

Capital expenditures (capex) plan still in place for 2020 and 2021, with positive effects

expected by 2022. To mitigate the causes of lower production related to rough sea conditions in second-quarter 2019 and 2020, PLNG has embarked on a capex plan to increase the port's operating windows and gain operational efficiencies in the liquefaction process. Capex includes implementing a mooring system to provide ships with greater stability during adverse weather conditions and a refrigerant ethane recovery facility that would optimize the overall liquefying process. The budget for the former is about \$25 million, to be disbursed in 2020-2021, and for the latter is around \$8 million. We expect PLNG to complete the mooring system in 2021, although not before the rough weather season that typically occurs annually in the second quarter. Thus, we expect full contribution from this project only in 2022, similar to the ethane recovery facility, which has suffered delays due to the pandemic and due to a review of the portfolio of projects in 2020 in order to optimize costs.

Outlook

The negative outlook incorporates the likelihood of a downgrade in the next 12 months if our expectations of leverage continue to be very high (illustrated by a net debt-to-EBITDA ratio above 8x).

Downside scenario

We could lower the ratings in the next 12 months if we see further erosion in the company's profitability, EBITDA, or cash flow generation, further delaying the deleveraging path or preventing the company from building up cash to serve debt amortizations from 2024 onwards. For example, this could result from continued commodity price pressure if prices in our base case don't materialize in 2021, further delays or cost overruns in executing the capex initiatives, or if the negotiations on the off-taker agreement aren't completed by June 2021.

Upside scenario

Although it appears increasingly unlikely, 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 close to 5.0x. This could occur, for example, if PLNG successfully renegotiates the off-taker agreement that could mitigate the effect of adjustments that hurt cash flows, particularly during low gas prices. We could also revise our outlook to stable if we perceive a firmer price recovery in the next 6-12 months, resulting in faster-than-expected deleveraging.

Our Base-Case Scenario

Assumptions

- Macroeconomic variables including U.S. inflation of 1.4% in 2020, 1.9% in 2021, and 1.4% in 202, and inflation in Peru of 1.8% in 2020, 2.0% in 2021, and 2.2% in 2022.
- Average HH prices of about \$2.20 in 2020 (including the expectation of \$2.75 for the rest of

2020), \$2.75 per million British thermal unit (mmBTU) in 2021, and \$2.50 thereafter. For non-HH prices, we assume \$3.00-\$3.50 for 2020, about \$5.00 in 2021, and \$5.00-\$5.50 in 2022 (see "S&P Global Ratings Revises Oil And Natural Gas Price Assumptions," Sept. 16, 2020).

- Volumes delivered to SITME revised downward in 2020 from 215 TBTUs to about 205 TBTUs, up to about 210 BTU for 2021 and 230TBTUs in 2022 assuming PLNG fully implements the mooring system. We assume a plant processing factor of 92%.
- Most deliveries to non HH destinations in the foreseeable future, as long as the off-taker contract is not amended.
- Gas transportation services and compression services adjusted by U.S. inflation.
- Capex of about \$15 million in 2020 and \$35 million in 2021 mainly related to the ethane recovery project, the mooring system project, and other minor 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 down to \$15 million from \$25 million in 2021 in our previous base case. We note 2021 potential dividends are under review because the company has complete discretion about dividend payments. If prices recover and leverage improves, we expect dividend payments to increase.

Key metrics

Under these assumptions, we expect PLNG to generate EBITDA of \$45 million-\$50 million in 2020 (versus \$80 million-\$90 million in our previous base case) and around \$100 million in 2021. That would lead to net debt to EBITDA of about 18.0x in 2020 (compared to 9.0x-10.0x in our previous forecast), recovering to about 8.5x in 2021 and 6.0x in 2022. This deleverage is now lower than the one resulting from our previous forecast of near 7.5x in 2021. We also expect EBITDA to interest slightly below 1x in 2020 and recovering to more historical levels between 2.0x and 2.5x from 2021 on.

Liquidity

We continue to assess the company's liquidity as adequate. Although in the next 12 months from June 2020 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 and solid as we expected, as illustrated by the bond's significant price drop.

Our assessment of PLNG's liquidity also incorporates its ability to absorb high-impact, low-probability events without refinancing. We view this pandemic as a demonstration of such an event, because the company has no short-term debt maturities and no acceleration covenants under its financial debt.

We also incorporate the fact that PLNG has not yet renewed the \$75 million, three-year committed facility from BCP due in March 2021, as we initially expected. Depending on the terms and conditions of the renewal, which the company expects before year-end, we could downwardly revise our liquidity assessment.

Potential Liquidity Sources:

- Cash balances of \$163 million as of June 2020;
- Funds from operations (FFO) generation ranging between \$20 million to \$30 million for the next twelve months; and
- We no longer consider the undrawn committed credit facility for \$75 million from BCP because it comes due within 12 months and the renewal would only be discussed at the end of the fourth quarter.

Potential Liquidity Uses:

- No short-term principal maturities; and
- Working capital outflows and capex between \$50 million to \$60 million.

Ratings Score Snapshot

Issuer credit rating: B-/Negative/--

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: Negative (-1 notch)

SACP: b-

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: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Downgraded

	To	From
Peru LNG S.R.L.		
Senior Unsecured	B-	B

Downgraded; CreditWatch/Outlook Action

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

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