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Research Update:

Peru LNG S.R.L. Downgraded To 'BB+' From 'BBB-' On Slower-Than-Expected Deleveraging; Outlook Negative

Primary Credit Analyst:

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

Secondary Contact:

Candela Macchi, Buenos Aires (54)-11-4891-2110; candela.macchi@spglobal.com

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Rating Action Overview

- Because of unanticipated production stoppages and lower gas prices that were exacerbated during the second quarter of the year, we now expect Peru LNG S.R.L. (PLNG or the company) to deleverage significantly slower than what we originally anticipated. We revised our base-case scenario in this new context, and we now consider a net debt to EBITDA of about 8.0x by end of 2019 and between 4.0x-4.5x for 2020, versus the previously expected 4.0x and 3.0x, respectively.
- The company will take specific initiatives that would help minimize unplanned stoppages and consequently, cash flow volatility, including investments at the port that will allow it to increase availability levels, but we expect the effect to become more relevant after 2021, once initiatives are completed.
- On Nov. 26, 2019, S&P Global Ratings lowered its issuer credit and issue-level ratings on PLNG to 'BB+' from 'BBB-'. We're also removing the ratings from CreditWatch with negative implications and assigning a negative outlook.
- The negative outlook on PLNG reflects the possibility of a further downgrade in the next six to 12 months if the company continues facing unplanned stoppages or a further decrease in prices hurts cash flow generation. More precisely, if the company does not deleverage in line with our projections, resulting in net debt to EBITDA consistently above 4.5x, we could revise the ratings.

Rating Action Rationale

Several unexpected operational events amid low prices have postponed the expected deleverage.

The downgrade of PLNG reflects our view that with its weaker-than-expected results in 2018 and the first semester of 2019, and our updated base case, the company will deleverage more slowly than we previously expected. Our updated base case includes EBITDA generation of \$100 million for 2019 and about \$170 million for 2020, resulting in debt to EBITDA of 8.0x and between 4.0x-4.5x, respectively.

Given several unexpected events that included leaks in Transportadora de Gas

del Peru's (TGP; BBB+/Stable) pipeline and rough weather conditions that caused a 45 day closure of the terminal's port in the second quarter of 2019, the company was forced to decrease the volumes it processed. These events, along with low natural gas prices for Henry Hub and non-Henry Hub markers of about \$2.3 and \$4 per million BTU, respectively, significantly affected Peru LNG's operating results. As a result, we now expect EBITDA generation of about \$100 million for 2019, increasing to \$160 million-\$180 million for 2020, which would represent debt to EBITDA of 8.0x this year and 4.0x-4.5x by 2020. That compares unfavorably with our previous expectations of \$200 million in EBITDA and net debt to EBITDA of 4.0x and 3.0x in 2019 and 2020, respectively.

To reduce cash flow volatility, management is looking forward to implement a capex plan to mitigate port shutdowns and ensure volumes processed. In order to mitigate the causes of lower production levels, mainly related to rough sea conditions that in this year's second quarter caused a 46 day port shutdown (lowering quarterly EBITDA generation to below \$4 million from a normal threshold of \$50 million), the company decided to make additional investments to increase the operating windows of the port and gain operational efficiencies in the liquefaction process. The most important project relates to implementing a mooring system that will provide ships greater stability and enable the loading of LNG tanks amid bad weather conditions, with a maximum cost of approximately \$30 million that the company expects to disburse throughout 2020 and 2021. The other project in pipeline is a refrigerant ethane recovery facility that will optimize the overall liquefying process and will need investments of \$8 million. We expect PLNG to complete both projects by late 2021. Although we view these initiatives as positive from a credit standpoint, since they will stabilize operating volumes, the effects will only be perceived from 2022 onwards, exposing the company to some volatility until then. In addition, PLNG is working to get approval from shareholders to implement a hedging strategy to buy put options on the Henry Hub Marker for a three to nine month period to protect against price decreases. We believe that if implemented, it will help decrease the cash flow volatility we see when natural gas prices are low.

Despite volatile profitability, we believe that the management's strategy will increase cash flow stability, while we consider the company's solid competitive position in Peru and its contracted business model. Although the company's volatile profitability has been higher than what we previously expected, we believe that the actions management has in the pipeline to reduce volume and price volatility will make the company's cash flows more predictable. Nevertheless, we will continue to monitor the results of the abovementioned initiatives, especially after 2021, once they are completed.

Additionally, we continue to believe that the company's competitive position is supported by significant barriers to entry for potential competitors, considering a 40-year investment agreement with the Peruvian government signed in 2006 that provides certain guarantees related to taxes, import duties, and foreign exchange matters. In addition, PLNG benefits from volumes through 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+) until 2028. PLNG's gas supply is fully guaranteed until 2028 by separate agreements signed with the Block 56 and Block 88 of the Camisea consortium (which, in turn, is composed of 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]).

Outlook

The negative outlook reflects our view that in the next six to 12 months, we could further lower the ratings if the company's financial metrics does not improve as expected, for example, if net debt to EBITDA remains consistently above 4.5x. In addition, we could lower the ratings if we perceive a still high level of volatility in cash flow generation that challenges the existing business risk profile.

Downside scenario

We could downgrade PLNG in the next six to 12 months if recurring unplanned plant stoppages of over 45 days occur, pushing the company to process below 200 Tbtus per year, or if profitability continues to erode, dragged down by lower prices. In our view, this could translate to EBITDA generation below \$150 million, all else being equal, and to net debt to EBITDA of above 4.5x.

Finally, we could further lower the ratings if we continue to perceive significant volatility in the company's cash flow generation and profitability, challenging the existing satisfactory business risk profile.

Upside scenario

If the company's credit metrics improve, with net debt to EBITDA consistently below 4.0x for the next two years, we could revise the outlook back to stable. This scenario could occur if we see lower volatility in its operations and the company is able to process volumes above 205 Tbtus per year, resulting in EBITDA above \$180 million, while maintaining low capital investments and marginal dividend distributions. Even though unlikely in the short term, we could raise the ratings to 'BBB-' if we see that the company has mitigated volume and price volatility, and is able to process over 220 Tbtus, while generating EBITDA above \$200 million.

Company Description

PLNG operates a 4.45 million metric tons per annum liquefaction plant, a marine terminal, and a 408 kilometer (km) 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 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 2019 and 2020:

- Macroeconomic variables relevant for our analysis include U.S. and Peruvian inflation, which jointly form the basis for the adjustment of certain costs. We expect inflation in the U.S. to be 1.8% in 2019 and 2.4% in 2020, while inflation in Peru would be 2.3% in 2019 and 2020 (please see "Americas Economic Snapshots: Trade Conflict Escalates, Once Again," published Aug. 30, 2019).
- Average Henry Hub prices of about \$2.3 and \$2.5 per million British thermal units (BTU) for 2019 and 2020, respectively, and non-Henry Hub prices of \$6.0-\$6.5 for 2020 and 2021.
- Volumes delivered to SITME will be about 210 trillion BTU for 2019 and close to 215 BTU for 2020 (67% delivered at Henry Hub destinations).
- Plant processing factor of 92%, in line with the historical track record.
- Gas transportation services and compression services adjusted by U.S. inflation.
- Capital expenditures (capex) of about \$10 million in 2019 and \$20 million-\$25 million in 2020 related to the ethane recovery and the mooring system projects.
- Interest payments of about \$50 million, resulting from the \$940 million bond and no increase in debt.
- No dividend payments in 2019 and 2020. However, it depends on management's cash distribution policy.

Under these assumptions, we expect PLNG to generate EBITDA of about \$100 million for 2019 and \$160 million-\$180 million for 2020. That would lead to net debt to EBITDA of about 8x in 2019 and 4.0x-4.5x by the end of 2020. In addition, we expect free operating cash flow (FOCF) to net debt ranging from 5%-10%.

PLNG's shareholders include four sponsors with strong expertise in the energy industry: Hunt Oil (50%), SK Innovation (20%), Shell (20%), and Marubeni Corporation (10%; BBB/Positive/--). No single member controls the company; rather, all the shareholders review the critical corporate decisions, such as dividend payments, debt payments, and asset sales.

Liquidity

We continue to assess PLNG's liquidity as strong even under a more adverse scenario because the company has an accessible capex plan, no debt amortizations, and discretion on its dividend distributions. Considering this,

we still expect its liquidity sources to exceed uses by at least 1.5x in the next 12 months and to be above 1.0x for the next 24 months, allowing the company to withstand substantially adverse market circumstances. We also expect sources to exceed uses even if EBITDA were to decline by 30%.

Our assessment of the company's liquidity also incorporates its likely ability to absorb high impact, low probability events without refinancing, considering it has no short-term debt maturities, and taking into account that it has well-established relationships with banks (indicated by the fully committed \$75 million working capital facility from Banco de Credito del Peru). Finally, the existing bond does not have acceleration covenants.

Principal liquidity sources:

- Cash balances of \$70 million as of Sept. 30, 2019;
- Funds from operations (FFO) generation ranging from \$100 million to \$110 million for the next twelve months; and
- Undrawn committed credit facility for \$75 million from Banco de Credito del Peru.

Primary liquidity uses:

- No short-term principal maturities; and
- Working capital outflows and capex close to \$45 million.

Issue Ratings--Subordination Risk Analysis

We rate the company's \$940 million amortizable notes due 2030 'BBB-'. This is the sole debt the company has and it is at the operating level, so we rate the notes at the same level as the issuer credit rating.

Ratings Score Snapshot

Issuer credit rating: BB+/Negative/--

Business risk: Satisfactory

- Country risk: Moderately high
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bb

Modifiers:

- Diversification/Portfolio effect: Neutral (No impact)
- Capital structure: Neutral (No impact)
- Liquidity: Strong (No impact)
- Financial policy: Neutral (No impact)
- Management and governance: Fair (No impact)
- Comparable rating analysis: Positive (+1 notch)

Group credit profile: N/A

Entity status within group: N/A

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; CreditWatch/Outlook Action

	To	From
Peru LNG S.R.L. Issuer Credit Rating	BB+/Negative/--	BBB-/Watch Neg/--
Peru LNG S.R.L. Senior Unsecured	BB+	BBB-/Watch Neg

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