Fitch Ratings 2020 Outlook: Latin American Energy (Oil & Gas)

Downward Rating Trajectory

Fitch's Sector Outlook: Stable

The stable sector outlook reflects Fitch Ratings' expectation of moderately level global hydrocarbon prices in the long term, although with potentially high volatility in the short term. Fitch assumes Brent and West Texas Intermediate (WTI) could trend toward USD57.50 and USD55.00 a barrel, respectively, in the long term. The Latin American oil and gas industry is dominated by state-owned national oil companies (NOCs), with the ratings for many NOCs relying on linkage to the sovereign.

Rating Outlook: Negative

The rating trajectory for Latin American oil and gas companies remains negative as a result of macroeconomic challenges in the region and some issuer-specific expected credit deterioration. Five issuers, or approximately 36% of oil and gas ratings in the region, have a Negative Outlook, while only two issuers are on Positive Outlook and the balance with Stable Outlooks. Two out of the five oil and gas issuers with a negative trajectory are located in Argentina (CC), which is partially driving this trend.

Government Related Entities Dominated the Sector

Latin American oil and gas issuers are predominantly government-related entities (GREs), representing approximately 43% of issuers and the bulk of outstanding FX denominated debt from oil and gas companies in the region. GREs' ratings are primarily underpinned by these issuers' high strategic importance for the countries where they operate, resulting in very high incentives for the countries' governments to financially support these issuers.

Petroleo Brasileiro S.A. (Petrobras; BB–/Stable), Ecopetrol S.A. (BBB/Negative) and YPF S.A. (CCC) have Standalone Credit Profiles (SCP) the same, or higher, than the actual ratings. SCPs for Petroleos Mexicanos (PEMEX; BB+/Negative), Empresa Nacional del Petroleo (A/Stable) and Petroleos del Peru S.A. (Petroperu; BBB+/Stable) are significantly below the final rating.

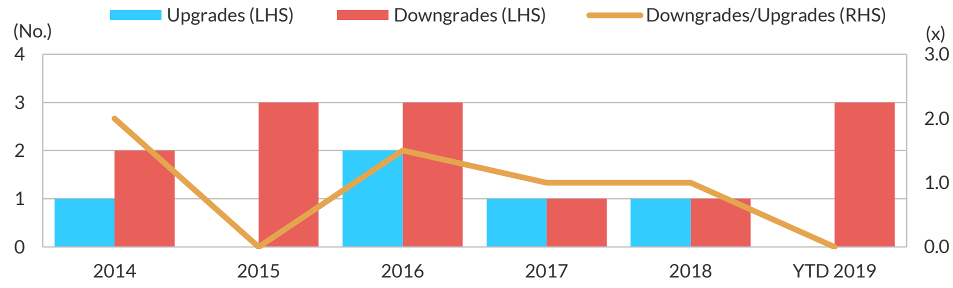
What to Watch

- PEMEX: Neutral to positive FCF. While investing enough in exploration and production (E&P) to stabilize production and replenish 100% of proved (1P) reserves may stabilize the rating, the opposite may be negative.
- Petrobras: Downstream divestitures' effects on cash flow and deleveraging targets.
- Ecopetrol: Accretive reserve replacement and acquisitions is cementing the investment-grade rating.
- YPF: Ability to pass through Argentine peso fuel price volatility is critical for cash flow generation.
- Independents: Acquisitions and divestitures can shape credit qualities.

Lucas Aristizabal, Senior Director

"Fitch forecasts a marginally negative trajectory for Latin American oil and gas ratings to continue in 2020 as 36% of issuers have a Negative Outlook. Rating upgrades will be limited due to credit-specific traits, rather than industry-wide dynamics, as only two companies are on Positive Outlook. PEMEX and Ecopetrol are the only national oil companies on Negative Outlook and could be affected by sovereign downgrades, while YPF is currently rated 'CCC'."

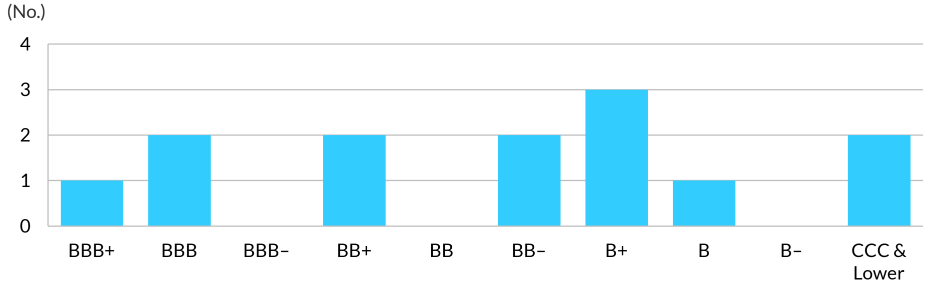
Latin American Energy Downgrades and Upgrades: International Scale



Source: Fitch Ratings.

Latin American Energy Ratings Distribution: International Scale

(As of November 2019)



Source: Fitch Ratings.

PEMEX's 1P Reserves Replacement Ratio

After PEMEX's two rating downgrades in 2019 to 'BBB–' from 'BBB+' in January and 'BB+' from 'BBB–' in June, the Outlook remains Negative as the issuer continues to underinvest in its E&P business and taxes remain elevated. PEMEX's ratings could stabilize as a result of neutral to positive FCF, while investing enough to stabilize production and replenish 100% of 1P reserves. Fitch does not expect the company to replenish reserves produced during 2019, given the continued underinvesting in its upstream business. PEMEX completed 15 exploratory wells, as of September 2019, short of the company's projected 47 exploration wells for the year. Reserve additions in 2019 will mostly be derived from revisions to previous estimates.

Petrobras Downstream Divestitures

Although Petrobras' intention to divest a portion of its downstream infrastructure in Brazil (BB–/Stable) is credit neutral, this action may lower political interference risk but at a price. The company's cash flow generation will likely be negatively affected and divestiture prices will likely incorporate political interference risk.

Although, downstream EBITDA was trending downward in the past three years, during the first nine months of 2019, EBITDA represented 14% of Petrobras' reported EBITDA, or USD3.4 billion out of nine-months of EBITDA of USD23.8 billion from 33% in 2017.

Ecopetrol Reserves Incorporation

Fitch expects Ecopetrol's reserves and reserve life to continue to improve as a result of ongoing E&P capex, a recent joint venture with Occidental Petroleum Corp. (BBB+/Stable) in U.S. unconventional oil and a recent 30% acquisition in Gato do Mato, Brazil. 1P reserves of 1.7 billion barrels of oil equivalent (boe) gives Ecopetrol a reserve life of 7.2 years as of 2018. Ecopetrol reported reserve additions of 307.0 million boe in 2018, of which 120.5 million boe were due to price revision and the balance from improvements, extension and discoveries.

YPF's Downstream Pricing Policy

The Argentine government has a history of significant interference in the oil and gas sector, as the nation set regulations related to investment levels in the oil and gas sector and domestic price reference points. The Argentine government, through Decree 566/19, froze crude oil, gasoline and diesel prices for 90 days, in August 2019, which is estimated to have negatively affected YPF's cash flows by USD120 million per month.

Macroeconomic Headwinds and Political Intervention

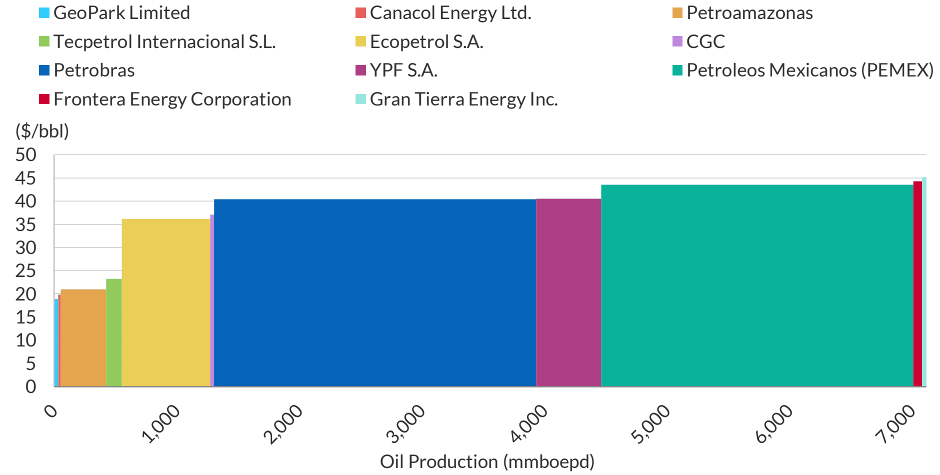
The region's oil and gas companies, particularly NOCs, remain exposed to macroeconomic headwinds and increasing political intervention that could affect credit quality. Political risk could be exacerbated by international hydrocarbon prices volatility, currency depreciation and challenging macroeconomic environments. This could, at times, prevent downstream or integrated companies from passing through fuel costs to end users in a timely manner, affecting working capital requirements and potentially profitability. This was primarily evident in Argentina this year, as exchange rate volatility and government driven gasoline pricing policies negatively affected cash flow generation.

Fitch Latin American National Oil Companies

	FC IDR	LC IDR	National Scale	SCP
Empresa Nacional del Petroleo (ENAP)	A	N.A.	AAA(cl)	b+
Ecopetrol S.A.	BBB	BBB	AAA(col)	bbb
Petroleos del Peru S.A. (Petroperu)	BBB+	A–	N.A.	b
Petroleos Mexicanos (PEMEX)	BB+	BB+	AA(mex)	ccc
Petroleo Brasileiro S.A. (Petrobras)	BB–	BB–	AA(bra)	bb+
YPF S.A.	CCC	CCC	N.A.	bb

IDR – Issuer Default Rating. FC – Foreign currency. LC – Local currency. SCP – Standalone Credit Profile.
N.A. – Not applicable.
Source: Fitch Ratings.

Latin American Oil & Gas Full-Cycle Cost Curve



Petroamazonas – Empresa Publica de Exploracion y Explotacion de Hidrocarburos Petroamazonas EP. CGC – Compania General de Combustibles S.A. Petrobras – Petroleo Brasileiro S.A. (Petrobras). Bbl – Barrel. Mmboepd – Millions of barrels of oil equivalent per day. Note: Figures are estimated by Fitch.
Source: Fitch Ratings.

Credit Metric Trends

Leverage Trend: Falling

Overall, Latin American oil and gas companies are reducing leverage, on aggregate, primarily driven by debt reductions made by Petrobras and Ecopetrol. This is somewhat offset by PEMEX. In the future, median leverage is expected to remain relatively flat to moderately declining, as companies reach a steady state in capital structure.

Cash Flow Generation: Neutral

Fitch expects Latin American oil and gas companies' median FCF to be neutral in the future as a result of increasing capital investments, growing dividends and level hydrocarbon prices. As some companies approach deleveraging targets, we expect an increase in dividend payments and a potential increase in capex, while maintaining neutral FCF. This could be primarily the case for Ecopetrol and Petrobras.

Liquidity Position: Manageable

Liquidity across the board is adequate, supported by comfortable amortization profiles, strong cash on hand and access to capital markets. Issuers need these factors to remain stable in order to withstand potential price pressures in the oil and gas market. Petrobras and Ecopetrol stand out among the region's NOCs as having strong liquidity positions and manageable amortization profiles. Although, PEMEX benefits somewhat from this year's liability management operations, cash on hand remains extremely low and PEMEX is in a difficult position to face price pressures. YPF's adequate liquidity position may erode as a result of price controls affecting cash flow generation, while Petroperu waits for capex funding to complete the Talara refinery expansion.

Lower Prices Will Limit Profitability

We expect profitability, measured as the difference between the realized crude oil prices and half-cycle costs, to decline in 2019 and through 2020, as oil prices decline due to a well-supplied global oil market amid subdued demand growth. Profitability improved by 50% in 2018 to $40.25 per barrel (bbl) for rated entities. Marginal producers' full-cycle costs are assumed to drive oil prices downward in the long term. Fitch's price assumptions for Brent and WTI for 2020 are $62.50/bbl and $57.50/bbl, respectively.

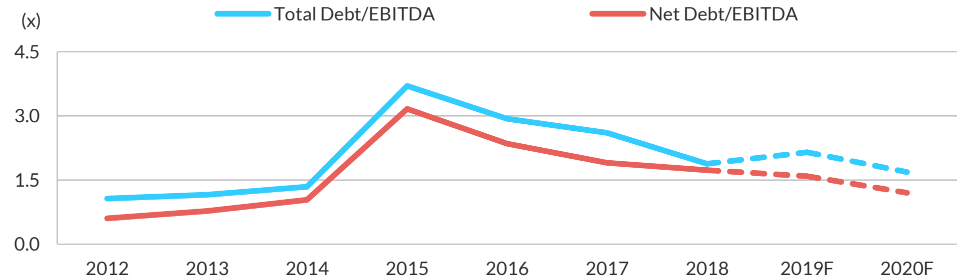
Sector Fundamentals

Half-Cycle Costs to Remain Low

Half-cycle costs for Latin American oil and gas companies, as calculated by Fitch, were slightly higher in 2018, at 3%, after an increase of 11% in 2017. This marginal increase is due to higher lifting and selling, general and administrative costs, partially offset by interest expenses. This trend is negligible, compared with the recovery of global oil prices of 27.6% yoy in 2018.

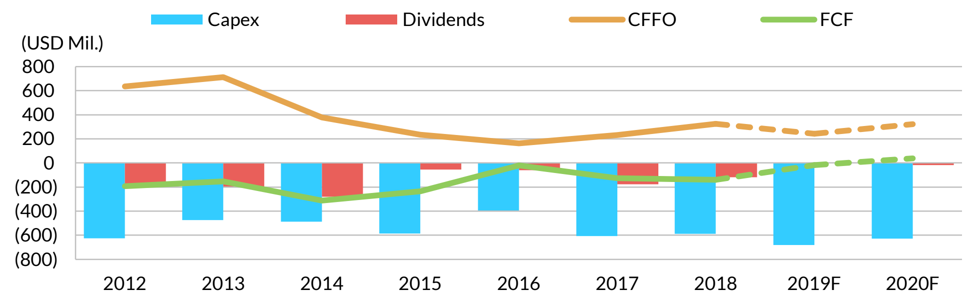
Half-cycle, or periodic costs, remained below market prices for both integrated and independent issuers. Weighted average liquids realization prices during 2018 stood at approximately $73.20/bbl, compared with $60.20/bbl in 2017. Half-cycle costs were about $22.50/boe in 2018 from $21.80/boe in 2017. Fitch views these production cost increases similar to other global peers.

Median Leverage



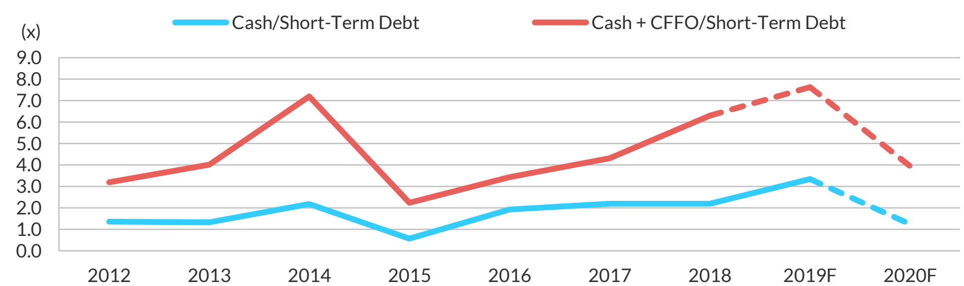
F – Forecast.
Source: Fitch Ratings, Fitch Solutions.

Median Cash Flow



CFFO – Cash flow from operations. F – Forecast.
Source: Fitch Ratings, Fitch Solutions.

Median Liquidity



CFFO – Cash flow from operations. F – Forecast.
Source: Fitch Ratings, Fitch Solutions.

Marginally Declining Production

Fitch expects Latin American oil and gas production to be stable to marginally declining in the short to medium term, as production declines in Mexico (BBB/Stable) and Venezuela marginally offset production increases in Brazil. Colombia's (BBB/Negative) oil and gas production is expected to be relatively stable, while Argentina might find it challenging to increase output. Fitch's Latin American-rated portfolio reported a production decline of 4%, while NOCs' production declined by 368 million barrels of oil equivalent per day (mmboepd) and independent oil producers reported production growth of 54mmboepd in 2018.

Beneficial Vertical Integration

All vertically integrated oil and gas companies in Latin America, which are primarily NOCs, benefited from vertical integration during 2018. Still, crack spreads, the difference between refined products and crude oil prices, were lower by 26% yoy, due to increases in crude oil prices coupled with currency depreciation throughout the region. The benefits of being vertically integrated were best exemplified by Petrobras' ability to command robust domestic product prices in 2018, although prices were not as strong as in 2017. Prices for PEMEX were below after-tax prices, due to the higher than average government take, although to a lesser extent than in 2017.

Size Limits Small Independents

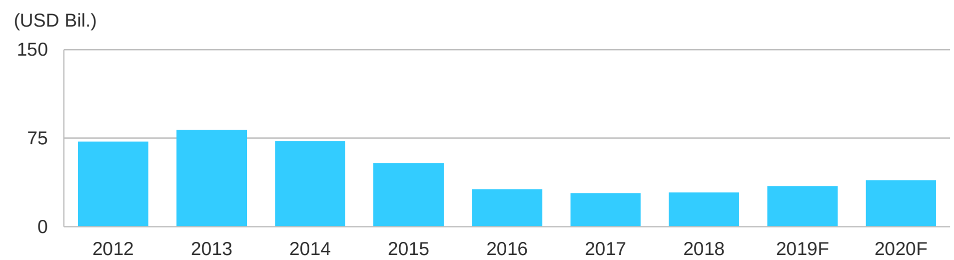
Many Latin American independent oil and gas companies' ratings are limited due to a relatively small scale, low diversification and aggressive growth strategies. Oil and gas companies with production below 75,000 barrels of oil equivalent per day are perceived as having operational and business risks commensurate with the 'B' rating category. Some predominantly gas producers mitigate this risk with sound long-term contractual structures at fixed prices, which increase cash flow stability and predictably, resulting in 'BB' ratings.

Fitch Corporate Oil and Gas Price Assumptions

	2019	2020	2021	Long Term
Base Case				
Brent (USD/bbl)	65.00	62.50	60.00	57.50
WTI (USD/bbl)	57.50	57.50	55.00	55.00
Henry Hub (USD/mcf)	2.75	2.75	2.75	2.75
NBP (USD/mcf)	4.75	5.50	6.00	6.50
Stress Case				
Brent (USD/bbl)	55.00	45.00	47.50	50.00
WTI (USD/bbl)	50.00	42.50	45.00	47.50
Henry Hub (USD/mcf)	2.25	2.00	2.25	2.50
NBP (USD/mcf)	4.50	3.50	3.75	4.00

Bbl – Barrel. WTI – West Texas Intermediate. Mcf – Thousand cubic feet. NBP – National Balancing Point.
Source: Fitch Ratings.

Latin American Energy Aggregate Capex



F – Forecast.
Source: Fitch Ratings. Fitch Solutions.

Outlooks and Related Research

2020 Outlooks
Global Economic Outlook (September 2019)
Latin American Oil & Gas Netback Peer Comparison (August 2019)

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