**Quick Pitch: Short PlusPetrol Peru 6.240% Senior Notes due 2036 (CUSIP: 72941KAA4).**

Evaluation performed on 12/10/2024 using the offering memorandum for both issues and current market information. See attached excel file for further financial statement analysis and credit rating scorecard

**Quick Thesis:**

Short this credit in favor of Hunt Oil Company of Peru L.L.C. 8.55% Senior Notes due 2033 (CUSIP: 445640AC9), the largest minority financial investor in the Camisea field consortium with similar investment size. Both have nearly identical income statements and although Pluspetrol is the operator of this oilfield and Hunt oil has slightly higher financial leverage, I do not believe that justifies a 60 bps spread.

**Analysis:**

**Investment Catalysts & Valuation**

•**What are the key investment catalysts for your BUY-SELL. (credit fundamental, valuation, catalysts, others)**

I have a sell opinion on this credit.

Buy

* Large proven reserves, can sustainably extract well into the future
* Strong domestic GDP growth of 3.1% in 2024 and 2.7% in 2025 after a mild recession in 2023. Should lead to increase in domestic demand for pluspetrol camisea
* Despite being a callable bond in callable territory, the investment banking fees for the debt issuance and the 30bp penalty for calling the bonds means that this bond will not get called.

Sell

* The two entities pay out an unsustainably high amount of their earnings in dividends. In 2022 and 2023, pluspetrol LOTE 56 paid out more than its annual net income in dividends, even selling off equipment in 2023 to pay out a dividend. I believe that this debt raise is primarily used to pay out a dividend, benefitting equity holders at the expense of debt holders and maintaining a higher debt/EBITDA ratio moving forward as opposed to the ratios presented in the prospectus.
* Forecasts for Brent oil prices look to decrease over the next two years, having an outsized impact on operating margins as seen in the hit to margins between 2022-2023, which largely stems from the asset-intensive nature of an oil extraction operation
* This US denominated bond issuance has an embedded American call option. With a forecasted drop in the US yield curve over the course of the next year, this is likely to lead the bond into callable territory. This almost entirely caps our upside while giving us increased exposure to the downside. As of this weekend, it appears that the bond is currently in callable territory.
* Although not as important for a private firm, they skipped a dividend payout in 2024 Q1 and then proceeded to continue making massive dividend payments
* As discussed, I do not believe that it makes sense to give up so .6% yield as compared to Hunt’s outstanding debt when they have the same source of cash flows.

•**What are catalysts that could drive movements in the credit spreads?**

* A drop in global oil prices due to weakening demand amongst large economies could drop the Brent price. Both direct and indirect costs on the balance sheet have a beta less than one to revenues as shown by the drop in margins from 2022 to 2023.
* Heightened political uncertainty is a risk according to the world bank and could affect the fiscal credibility of the nation and/ or could lead the government to renegotiate/ further regulate the consortium.

•**What are the primary risk factors that we should monitor?**

* Pluspetrol Camisea is confined to this oil field and its contract with the peruvian government
* The consortium has downstream risks in that there are only two pipelines owned by TPG to transport the extracted oil. If one or both of those become impaired it becomes a serious risk to the firm. As stated on page 36, this narrow dependency is a vulnerability, resulting in the consortium to cease operations for 18 days due to the TPG pipeline system not being operational.
* international oil prices and demand

•**Who are the comparable issuers, and how does this issuer compare in terms of fundamentals and operations?**

* Compares favorably to “Hunt Oil Company of Peru L.L.C, Sucursal del Perú”, the second largest stakeholder in the Camisea consortium and the only other entity to issue debt at its Peruvian subsidiary level. Pluspetrol had lower financial leverage and lower operational risk (as pluspetrol operates the camisea fields). Given this and its slightly higher share of production, I am confident in pluspetrol’s $500m debt issuance being rated a BBB+ while Hunt’s debt issuance is a BBB. However, as of 12/10/2024, the implied yield on this debt issuance is 5.93% to Hunt’s 6.5%. Given this, I think it is hard to justify giving up significant yield in purchasing the pluspetrol’s debt instead of Hunt’s given the same source of cash flows and same operational risks at the subsidiary level.

•**How would you assess the value of this issuer based on benchmark issuances?**

* There are two benchmark issuances that I think we can use to assess this issuance, the US treasury yield curve and the J.P. Morgan Emerging Markets Bond Index (EMBI). I would use the US treasury YC because this debt issuance is in USD, and I would use the EMBI because it will show us how the bond is performing relative to other emerging market US-denominated debt. We should evaluate the spread to these two benchmarks at the 12y maturity, but the 10y can be used for a quick analysis.

**Credit Fundamental & Financial Factors**

•**What are the key macroeconomic and microeconomic factors that drive the firm’s cash flow generation?**

Macro

* Global oil prices and domestic demand almost entirely drive the firm’s revenue when determining that side of the cash flows

Micro

* Apart from the exclusive processed NG contract from blocks 56 & 57 to Peru LNG, the customer base is expansive and cannot impose meaningful pricing power on pluspetrol.
* The contract with the Peruvian government that pays out a royalty (and makes up the majority of cost of sales) is the largest driver of cash flows outside of international demand.
* Capital investments don't appear to be a significant expense, routinely taking up less than 3.5% of revenues and inline with management's statement that they are a mature operation where future capex is predictable and will be used to maintain the Camisea operation’s current extractions capabilities
* The high operational leverage of oil companies more broadly means that they perform poorly when there is a drop in revenues.

•**How sensitive or volatile is the firm's cash flow generation in response to these key drivers?**

* Highly sensitive. On the income statements we can see that year-over-year, the cost of sales and operating expenses have a low beta to the drop in revenue. This is to be expected given the operational leverage and asset-intensive nature of oil production.

•**Describe the firm’s credit fundamentals, including the balance sheet, cash flow strength, and key metrics such as leverage, margins, and coverage ratios?**

* The firm currently has low leverage for the oil & gas industry relative to the field’s proven reserves and daily production
* The cashflow strength is strong, with a solid demand base in Peru and low expenses in cash flows from investing. However, the cash flows from financing activities (reflecting the dividend payout) show that most of the firm’s earnings are being extracted from the subsidiary
* The balance sheet is healthy, although not exceptionally strong largely due to the high dividend payments. The debt/equity ratio of 1.3x is well within industry norms.

•**What are the trends from the firm’s most recent earnings, and are there any notable anomalies or developments?**

* One thing I did notice is that the firm applied all of the depreciation and amortization expense to the cost of sales. I would assume that not all of the depreciable assets are direct costs tied to the volume of oil produced, and so I believe that this should probably be divided into two entries to accurately depict the nature of the depreciation

•**Who are the comparable companies, and how do they differ or align in terms of key fundamentals?**

* Hunt’s Peruvian subsidiary is the most obvious comparable company, which has higher existing leverage than Pluspetrol and is not operating the oilfield. The comparison between this debt issuance and Hunt oil CUSIP: 445640AC9 has been made throughout this pitch
* I would have liked to compare pluspetrol’s Peruvian performance with its oil exploration and production efforts in Bolivia, Colombia, Venezuela, and Angola but unfortunately ran out of time. Pluspetrol’s shale operation in Argentina is not comparable as Shale fields typically have shorter lifespans. Additionally, I would have liked to compare Pluspetrol’s Peruvian operation to another large South American oil producer such as Petrobras.

•**Describe key metrics: covenants**

* No new debt can be acquired that is senior to this bond
* Sale and leasebacks are not allowed, as it's a way to get around the restrictions on debt raising
* CO-Issuers must provide bondholders with quarterly financial statements reviewed by an auditor
* Default is defined as: Failure to pay principal or interest, breach of covenants, bankruptcy, default on other debt exceeding $40 million, or government expropriation of assets.
* Limits to fundamental structural changes in the company unless bondholders interests are safeguarded

**Credit Opinion**

•**Provide credit opinion on this issue and explain in detail the key factors that led to your conclusion.**

* My Credit opinion for this bond is somewhere between a BBB and BBB+, and largely aligns with Fitch’s rating that I obtained using Moody's industry credit rating scorecard. I got a score at the high end of BBB for the issuer, and given that this debt would be the most senior obligation, I think it is fair to move the debt issue to a BBB+.

•**What are the potential catalysts that could influence the direction of credit spread movements?**

* A continued increase in the firm’s financial leverage would likely increase credit spreads. Current debt/ EBITDA is around 1 based on the 2023 year-end financial statements. Financial debt is expected to expand from $337 million to at least $500 million with the new debt issuance, pushing the debt/ EBITDA ratio closer to 1.5.
* A further deterioration in margins from 2022 as a result of low global oil prices

•**What catalysts and risks have you factored into your credit opinion?**

* Using the credit rating scorecard and existing credit rating for the Hunt’s Peru subsidiary, I knew that my credit opinion was to be anchored by the scorecard and has to be at least as good, if not better than Hunt’s due to lower leverage and operational control over the oilfield
* The positive contributions to the credit rating came from the LFCR, as this is a mature company that is not currently engaged in any exploration efforts. Additionally, the amount of leverage the company currently has relative to the proven reserves and daily production numbers is considered quite conservative in the industry
* The largest negative contribution to the credit rating was the amount of retained cash relative to the current amount of debt. Given that this is a mature company looking to diversify its exposures at the parent company level, this isn't a large concern and the .5% weighting it is given is reasonable.

•**What risks could challenge or alter your current view?**

* The potential for significant deterioration of the leverage ratios found in the credit rating scorecard as a result of lower oil prices. Additionally, this would lead to a further deterioration in the margins as we have seen occur when there is a drop in revenue. The callable nature of the proposed debt issue hedges them well against changes in benchmark yields and as of 2024 has placed them in a strong position to refinance their debt at lower rates as their outstanding debt is currently in callable territory.

•**In your opinion, how is the market currently perceiving this credit?**

* The market is currently viewing this credit favorably as opposed to Hunt’s debt of a similar size. THe debt from Hunt has seen its OAS spread widen relative to Pluspetrol over the past few months.

**Business Description**

**•What are the firm’s primary business operations, and state in terms of product mix, geographical regions, and countries of operation?**

* Geographically constrained to the Camisea oilfield in Peru

**•What are the main factors driving the firm’s cash flow generation?**

* the production and sale of NGL and Processed NG and the agreement it has with the peru regulatory body for permits and royalties

**•If applicable, how do regulatory bodies and ownership structures impact the company’s operations?**

* The parent company’s interests are well aligned with the subsidiaries as this is pluspetrol’s largest investments.
* Decisions are made at the level of the consortium
* The government has a significant impact on the firm’s operations, as all of the firm’s revenue comes from the contractual agreement the consortium has with perupetro. The company claims it has an incredibly stable relationship with the government, and to date it does. However, the country has the potential for some political instability in the future according to the world bank. This does not appear to be a large concern, but shouldn't be excluded from consideration when discussing risks.
  + The government and the camisea consortium have long term contractual agreements with a very low likelihood of being impacted under the current legislative framework.
  + The government demands royalties for all of the production from the consortium, which is the firm’s largest expense and regularly makes up between 45-55% of the cost of sales over the observed time period. Some of the royalties demanded on sales are a fixed percentage (specifically most domestic NG sales). However, oil exports have variable royalties demanded by the government that increase when the price of oil increases and vice versa.

**•Are there any additional factors or insights that help clarify how the business functions?**

**•Describe firm's history if relevant (i.e. strategic acquisitions or divestments)**

* The parent company’s largest investment is in the Camisea operation. It has engaged in the acquisition of other energy assets, specifically in Argentina and Uruguay. These assets are in shale and renewable energy sources, diversifying the parent company’s investment portfolio away from its high concentration on the Camisea oilfield appear to be the use case of the extracted retained earnings.

**Sector / Industry / Business Environment**

•**What are the key factors that are unique to this industry or sector?**

* Cannot change the composition of its revenue significantly due to limits on re-injection of undesirable oil products. In short, pluspetrol cannot easily shift to selling more NGL or processed NG if one of those products has better margins.
* Like many other commodities production businesses, pluspetrol is largely a price taker with little pricing power of its own. Its revenues have large macro dependencies on global demand and supply shocks from the OPEC cartel.
* Although not unique to oil, the oil & gas industry typically has among the highest friction with environmental regulation and activism. While it does not appear that pluspetrol is directly vulnerable to further environmental regulation, it is vulnerable to activists interrupting production, and this has occurred a few times since they began their Peru operation.

•**Can you describe the current phase of the industry cycle, and how would you assess where the industry stands today?**

* This industry is definitely in the late expansion stage, as over the last four years, the industry’s capital expenditures have increased by 53%, while its net profit has risen by nearly 16% and forecasted brent prices are expected to continue to moderate from their post-pandemic highs

•**What are the major threats facing the industry?**

* Global Conflicts
* The Middle East and Russia are some of the world’s largest oil exporters and currently find themselves in conflicts which have contributed to short term supply shocks in Brent oil prices over the past few years.
* With the Houthi rebels playing agitator in the red seat, to the Israel-Gaza conflict, the Middle East has very real geopolitical risks that could impact the oil industry., There are risks that the largest oil-exporting nation (Saudi Arabia) could be drawn into a wider regional conflict. Developments over the past few weeks have been positive on this front.
* Climate change and renewable energy sources are a longer term risk

•**If applicable, what regulatory challenges or developments should we be aware of?**

* There do not appear to be any direct regulatory threats or changes to Pluspetrol Camisea’s business in the short or long term (10+ years) as outlined in the management discussion.