

**RATING ACTION COMMENTARY**

# Fitch Downgrades Tupras to 'B+'; Outlook Negative

Mon 26 Oct, 2020 - 12:43 PM ET

Fitch Ratings - Warsaw - 26 Oct 2020: Fitch Ratings has downgraded Turkiye Petrol Rafinerileri A.S.'s (Tupras) Long-Term Issuer Default Rating (IDR) to 'B+' from 'BB-'. The Outlook is Negative. Fitch has also downgraded the senior unsecured rating to 'B+' from 'BB-'.

The downgrade reflects cash flow generation that is weaker than we previously forecast and high leverage, due to historically low refining margins caused by demand loss for fuels amid the coronavirus pandemic. The Negative Outlook reflects uncertainties related to the rebalancing of the fuel market in the next 12-18 months, which may cause additional rating pressure for Tupras.

Despite the short-term challenges, Tupras has a leading position in the Turkish market, with significant growth potential. We believe Tupras, with its complex refining assets, is firmly placed to benefit from a recovery in refining margins once the pandemic subsides. The adequate liquidity further supports the rating.

**KEY RATING DRIVERS**

Revised Down Expectations: Tupras recently revised its expectation for its net refining

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**Low EBITDA:** Tupras reported negative EBITDA of TRY0.8 billion in 1H20 (down from TRY2.3 billion in 1H19) on low demand and capacity utilisation as it was forced to suspend production at its Izmir refinery in May and June 2020. We expect weak results in 3Q20 due to a still challenging macro environment as European refining margins remained negative throughout the quarter. We assume Tupras's 2020 EBITDA (pre-current cost of supply adjustment) to decrease 80% yoy.

**High Leverage:** The difficult operating environment will push funds from operations (FFO) net leverage to 17.3x in 2020, up from 4.0x in 2019, according to our forecasts. We also assume leverage to remain elevated in 2021 as EBITDA remains depressed, before swift deleveraging from 2022, albeit subject to market conditions. High leverage in 2020 increases the risk of Tupras breaching its covenants on residuum upgrading project loans. Should this happen, we would expect banks to grant Tupras waivers due to the temporary nature of the breach.

**Weak Demand:** Recovery in European oil demand is progressing slowly. The US Energy Information Agency (EIA) expects oil consumption to remain 11% lower yoy in 3Q20 despite a strong quarterly increase by 2mmb/d following a re-opening of economies. Overall, EIA forecasts European oil demand to be 12% lower yoy in 2020 and 5% lower in 2021. While quarterly consumption is expected to grow in 2021, we do not see demand returning to pre-pandemic levels. The coronavirus pandemic in Europe remains challenging, amplifying downside risks.

**Turkish Lira Depreciation:** Refiners are usually able to manage foreign-exchange risk as oil supplies are denominated in US dollars while product prices, albeit sold in local currency, are driven by international US dollar-denominated benchmarks. Nevertheless, due to the exceptionally high volatility of the Turkish lira in 2020, Tupras reported foreign-exchange losses in other operating and financial items of TRY1.4 billion for 1H20. Although the majority was unrealised (TRY1 billion), the volatility in exchange rate provides a downside risk to our forecasts.

Foreign exchange denominated debt accounted for 93% of total debt at end-June 2020, while 39% of cash balances was denominated in foreign currencies.

**Global Refining Capacity Additions:** OPEC expects global distillation capacity additions of between 1.2 million and 1.4 million barrels per day (mmb/d) annually in 2020-2022 from existing projects, mainly in the Middle East and in Asia. The additional barrels of oil

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cash-generative until 2019 and maintained gross debt in recent years due to a fairly generous dividend policy following completion of the residuum upgrading project in 2015. We believe Tupras is well placed to benefit from improved market conditions, but the timing of the latter is uncertain given the pandemic.

**High Complexity, Low Integration:** Tupras maintains a leading position in the Turkish oil refining market and operates some of the most complex set of refineries in EMEA. Tupras remains focused on refining and has little integration across the value chain compared with MOL Hungarian Oil and Gas Company (MOL) and Polski Koncern Naftowy ORLEN S.A. (PKN), which are diversified into upstream, petrochemicals and retail. Tupras's 40% stake in Opet, Turkey's second-largest fuel retailer, only partly mitigates this lack of integration, which increases Tupras's earnings volatility through the cycle.

## DERIVATION SUMMARY

Tupras's closest EMEA peers are PKN (BBB-/Stable) and MOL (BBB-/Stable). PKN's 689 kbb/d downstream capacity exceeds Tupras's 585 kbb/d. Moreover, PKN benefits from an integrated petrochemical segment, a large retail network and some exposure to upstream. MOL's downstream capacity (417 kbb/d) is smaller than Tupras's, but the company's credit profile is stronger due to an integrated business profile with a 100 kbb/d of upstream production that provides countercyclical cash flows.

Unlike MOL and PKN, Tupras operates in a deficit fuel market, while the coastal location of its two principal refineries allows it to actively manage crude feedstock supplies. Tupras's leverage is much higher than that of MOL and PKN, but the company has lower capital intensity than its peers, as well as a lack of diversification.

## KEY ASSUMPTIONS

- Base-case Brent at USD41/bbl in 2020, USD45/bbl in 2021, USD50/bbl in 2022, and USD53/bbl thereafter

- Weaker revenue for 2020-2021 following volume loss and lower oil price

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- No dividend in 2020-2022

#### Key Recovery Rating Assumptions:

Our recovery analysis is based on a liquidation value approach, which yields a higher value than a going concern approach. It assumes Tupras will be liquidated in a bankruptcy rather than reorganised.

The liquidation estimate reflects Fitch's view of the value of balance-sheet assets that can be realised in a sale or liquidation conducted during a bankruptcy or insolvency proceedings and distributed to creditors.

-Fitch has applied a 100% discount to cash held

-Fitch has applied a 25% discount to account receivables

-Fitch has applied a 25% discount to inventory, lower than the usual 50% discount as we consider commodities to be more readily marketable

-Fitch has applied a 50% discount to net property, plant and equipment

All loans and bonds are unsecured and rank pari passu.

After deduction of 10% for administrative claims, our waterfall analysis generated a ranked recovery in the RR4 band, indicating a 'B+' instrument rating. The waterfall analysis output percentage on current metrics and assumptions was 50%.

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#### **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- The Outlook is Negative, therefore positive rating action is unlikely in the short term. However, FFO net leverage below 5.0x would lead to the Outlook being revised to Stable.

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Factors that could, individually or collectively, lead to negative rating action/downgrade:

- FFO net leverage consistently above 5.0x
- Worsening liquidity
- Consistently negative free cash flow (FCF)
- Slower-than-expected recovery of refining margins and fuel market due to the continued impact of the pandemic

### **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

### **LIQUIDITY AND DEBT STRUCTURE**

As of end-June 2020 Tupras reported cash and cash equivalents of TRY16.2 billion (net of restricted cash), which covered short-term debt of TRY14.6 billion, adjusted for factoring of TRY3.9 billion. Combined with Tupras's debt maturity profile over the next 24 months, the company's liquidity is therefore contingent on continued access to domestic banks. This is not uncommon among Turkish corporates but exposes Tupras to systemic liquidity risk, which is further exacerbated by the weak financial standing of the Turkish banking sector.

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Tupras maintains large deposits with related-party bank Yapi ve Kredi Bankasi (B+/Negative). These deposits amounted to TRY4.6 billion at end-June 2020, up from TRY2 billion in 2019 and TRY2.4 billion in 2018. We understand from management that the increase is in line with a higher reliance on bank funding to improve liquidity and Tupras has full access to its deposits in Yapi ve Kredi Bankasi as well as other Turkish banks.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY/DEBT	RATING		RECOVERY	PRIOR
Turkiye Petrol Rafinerileri A.S. (Tupras)	LT IDR	B+ Rating Outlook Negative	D o w n g r a d e	BB- Rating Outlook Negative

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## APPLICABLE CRITERIA

[Corporates Notching and Recovery Ratings Criteria \(pub. 14 Oct 2019\) \(including rating assumption sensitivity\)](#)

[Corporate Rating Criteria \(pub. 01 May 2020\) \(including rating assumption sensitivity\)](#)

[National Scale Rating Criteria \(pub. 08 Jun 2020\)](#)

[Sector Navigators - Addendum to the Corporate Rating Criteria \(pub. 26 Jun 2020\)](#)

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## Corporate Monitoring &amp; Forecasting Model (COMFORT Model), v7.9.0 (1)

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