FitchRatings

Fitch Downgrades Tupras to 'BB-'; Outlook Negative

Fitch Ratings - Warsaw - 19 July 2019:

Fitch Ratings has downgraded Turkiye Petrol Rafinerileri A.S.'s (Tupras) Long-Term Issuer Default Rating (IDR) to 'BB-' from 'BB+' following a similar action on the Turkish sovereign ratings (see "Fitch Downgrades Turkey to 'BB-'; Outlook Negative" dated 12 July, 2019). The Outlook is Negative, in line with that on Turkey's sovereign IDR (BB-/Negative).

Key Rating Drivers

FX Risk Managed: Tupras's debt and costs are predominantly in US dollars, while the majority of sales (86%) are denominated in Turkish lira. The resulting FX risks are mitigated by the natural hedge presented by the company's US dollar-linked inventories for crude oil and oil products and by the company's hedging programme with several major domestic and international banks for commodity prices and crack spreads. Any negative effects of Tupras's leverage ratios should be temporary and are most likely to occur if there is significant lira weakening around the year-end. To further mitigate the effects of FX volatility Tupras maintains ample liquidity in US dollar and euro-denominated deposits.

Business Fundamentals Support Profitability: Tupras's operations benefit from the company's leadership position in an under-supplied, growing Turkish refined product market, combined with the company's ability to access and process cheaper, heavier and sour crudes from a number of suppliers. These advantages translated into a 2018 reported net refining margin of USD9.3/bbl, double the Mediterranean complex margin, despite sharply higher oil price and lira volatility. The company generated TRY5.6 billion of Fitch-adjusted funds from operations (FFO) in the same year, up 7% yoy.

Rating in Line with Country Ceiling: Domestic operations and a policy of holding cash in Turkish banks cap the rating at Turkey's Country Ceiling (BB-), in line with our Corporates Exceeding the Country Ceiling Rating Criteria. Sovereign credit factors, such as a weaker lira, lower growth and weaker domestic demand have had a limited impact on Tupras's results so far. A material, prolonged economic slowdown could have negative consequences on industrial activity and depress demand for two of Tupras's major products - jet fuel and diesel. However, demand for middle distillates continues to grow, up 10.5% for jet fuel and 3.5% for diesel in 2018.

IMO 2020: Tupras is well-positioned to benefit from the introduction of the IMO 2020 regulation, which will limit the sulphur content in marine fuels to 0.5%, from 3.5% currently. We believe the reduction will happen at the point of production, rather than consumption, with ship owners switching to compliant fuels, rather than installing scrubbers. This should drive up prices and margins for compliant fuels, such as marine gasoil, at least in the medium term, and will benefit complex refiners that have the capacity to produce them, such as Tupras, which has a high middle distillate yield (52% in 2018) and low fuel oil output (7% in 2018).

STAR Commissioning Rating Neutral: Construction of the STAR refinery, operated by competitor SOCAR (State Oil Company of the Azerbaijan Republic, BB+/Stable) was completed in October 2018, with a full ramp-up expected by mid-2019. We believe the commissioning will be rating-neutral for Tupras with no material impact on the company's results forecast. The Turkish market for diesel, Tupras's key product, will remain in deficit, so average realised product prices should not be adversely affected.

Moreover, Tupras will remain in a relatively stronger competitive position given its wider geographical footprint, with its four refineries located in different regions of the country, and a more developed transportation, storage and import infrastructure than SOCAR.

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 vertical integration compared with MOL and PKN, which are diversified into upstream, petrochemicals and retail. Tupras's 40% stake in Opet, Turkey's second-largest fuel retailer partly mitigates this lack of integration, which increases Tupras's earnings volatility through the cycle.

National Scale Recalibrated: Fitch is recalibrating its Turkish National Rating scale. This is to better reflect the changes in the relative creditworthiness among Turkish issuers that have taken place since the downgrade of the country's long-term sovereign ratings to 'BB-' on 12 July 2019. The recalibration may result in rating actions on some issuers with Turkish national scale ratings, including those of Tupras, after the recalibration exercise is finalised, expected by early August. Further details are provided in "Fitch Ratings: Recalibration of Turkish National Rating Scale" dated 16 July 2019.

Derivation Summary

Tupras's closest EMEA peers are Polski Koncern Naftowy ORLEN S.A. (PKN, BBB-/Stable) and MOL Hungarian Oil and Gas Company (BBB-/Stable). PKN's 689 mbbl/d downstream capacity exceeds Tupras's (564 mbbl/d), and the gap is expected to widen to around 350 mbbl/d should PKN's planned acquisition of Grupa LOTOS S.A. (Lotos) go ahead. Moreover, PKN benefits from an integrated petrochemical segment, a large retail network and some exposure to upstream activities.

MOL's downstream capacity (417 mbbl/d) is smaller than Tupras's, but the company's credit profile is stronger due to an integrated business profile with a 100 mbbl/d of upstream production that provides countercyclical cash flows. Unlikely MOL and PKN, Tupras operates in a deficit fuels market, while the coastal location of its two principal refineries allows it to actively manage crude feedstock supplies. The combination of these factors contributes to higher and more stable downstream margins. Tupras's leverage is higher than that of MOL and PKN due to high historical and projected dividends, but the company has lower capital intensity than its peers.

Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer

- USD/TRY FX of 5.9 in 2019, 6 in 2020, 6.1 in 2021 and 6.3 thereafter

- Benchmark refining margin of USD4/bbl in 2019, rising to 4.5/bbl in 2020 and remaining stable thereafter

- Capital intensity of around 1.6% over the next four years

- Dividend payout ratio of 90% of net IFRS profits

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- Positive rating action on Tupras would be conditional on similar action on Turkey sovereign rating and/or a corresponding stronger assessment of Turkey's Country Ceiling

- FFO-adjusted net leverage consistently below 3.5x

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO-adjusted net leverage consistently above 4.0x

- Consistently negative FCF

- Substantially higher capex or dividends leading to higher-than-expected leverage

- A downgrade of Turkey's sovereign rating and a corresponding weaker assessment of Turkey's Country Ceiling, or a worsening operating environment in the country

Liquidity and Debt Structure

As of end-2018 reported cash and cash equivalents of TRY4.6 billion (net of restricted cash) covered short-term debt of TRY4.1 billion. However, Tupras's liquidity appears weaker when short-term maturities are adjusted for TRY2.3 billion of factoring, which brings the total short-term debt to TRY6.4 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 the company to systemic liquidity risk. Positively, we project positive FCF generation over the next four years, which combined with the company's track record of access to domestic and international banks, should ensure successful continued refinancing.

Tupras maintains large deposits with related-party bank Yapi ve Kredi Bankasi. These deposits amounted to TRY2.4 billion (52% of total) in 2018 and TRY4.9 billion (65% of total) in 2017.

Summary of Financial Adjustments

TRY2.3 billion of factoring has been added to short-term debt and trade receivables. Operating cash flow has been reduced by the year-on-year increase in factoring, while financing cash flow has been increased by the corresponding amount.

A multiple of 5x was used to capitalise operating leases.

TRY2.2 billion of working capital outflow in 2018, related to other receivables/payables, has been taken out of operating cash flow and treated as non-recurring. These relate to amounts the company has not received as of end-2018, but expects to receive in 2019.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Turkiye Petrol Rafinerileri A.S. (Tupras)	LT IDR BB- ⊖ Downgrade		BB+ ⊖
	LC LT IDR BB- ⊖ Downgrade		BB+ ⊖
senior unsecured	LT BB- Downgrade		BB+

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Applicable Criteria

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Non-Financial Corporates Exceeding the Country Ceiling Criteria (pub. 17 Jan 2019)
Corporate Rating Criteria (pub. 19 Feb 2019)

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