MOODY'S INVESTORS SERVICE

Credit Opinion: Empresa Nacional del Petroleo

Global Credit Research - 04 Dec 2013

Santiago, Chile

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured	Baa3

Contacts

Analyst	Phone
Gretchen French/New York City	212.553.3798
Steven Wood/New York City	212.553.0591

Opinion

Rating Drivers

> High level of implicit government support

> Elevated financial leverage

> Strong market position and good operational and business diversification

> Capital intensive sector, with reliance on imports and exposure to cyclical and volatile commodity prices

Corporate Profile

Empresa Nacional del Petróleo (ENAP) is an integrated petroleum company 100% owned by the Chilean state. ENAP is primarily involved in refining and wholesale petroleum product distribution and exploration and production. The company owns three refineries in Chile, two of which are large-scale refineries, with a total crude distillation capacity of approximately 229,000 barrels per day. The company also has upstream operations in Chile, Argentina, Ecuador and Egypt, with estimated total proved reserves of about 122 million barrels of oil equivalent at June, 2013. With total assets of roughly US$6.2 billion at September 30, 2013, ENAP is the second largest state owned company in Chile. Chile's energy industry has been deregulated since 1978, but ENAP remains the only refiner in the country.

Rating Rationale

Since ENAP is 100% owned by the Chilean state, we consider ENAP a government-related issuer (GRI) under Moody's methodology for such entities. ENAP's Baa3 rating combines: (i) ENAP's underlying baseline credit assessment, and (ii) the willingness and ability of the government of Chile to provide credit support to ENAP in a distress situation.

We rank ENAP's underlying baseline credit assessment at b2. The baseline credit assessment considers the company's high financial leverage profile, weak free cash flow generation, exposure to volatile and cyclical commodity prices, dependence on crude oil and natural gas imports and high refinancing needs. However, the baseline credit assessment is supported by ENAP's dominant market position within Chile, the company's good operational and business diversity, the high quality of its refined products, and its relatively strong refinery reliability records.

The government of Chile's ability to provide support to ENAP is measured by its Aa3 local currency rating and stable outlook, weakened only somewhat by the medium dependence of the government and the company on credit factors that could eventually cause stress on both simultaneously. While ENAP accounts for only a small part of the government's revenue base and the credit profiles of the government and ENAP have been diverging in recent years, the medium default dependence reflects the fairly high correlation between ENAP's credit profile and Chilean economic trends, as ENAP derives the majority of its revenues domestically.

We consider the government's willingness to support the company as high. The high support considers ENAP's strategic importance to the Chilean economy, being the only refiner in the country and the role it served during past energy crises to ensure refined product supply through imports. The high support also considers ENAP's 100% ownership by the state. We also consider the Chilean government's historically moderately interventionist approach. The government is involved in ENAP's budget approval and other policy-related processes. We believe that the market impact for the government in the event of a default by ENAP would be highly negative; however, we note the government does not guarantee ENAP's debt.

DETAILED RATING CONSIDERATIONS

STRONG DOMESTIC MARKET POSITION AND GOOD OPERATIONAL AND BUSINESS DIVERSIFICATION

ENAP not only has a dominant market position within Chile, supplying about 65% (via its own refinery production) of the country's petroleum product requirements, but its refinery reliability has consistently remained high and its refined product output is also of high quality, consisting of about 71% diesel and gasoline and only 10% of lower value fuel oil. In addition, the company's transportation network and Chile's relatively stringent environmental requirements create high barriers to entry. ENAP has completed the lion's share of the investments required to meet Chile's existing stringent fuel quality standards.

Relative to its underlying baseline credit assessment, ENAP also exhibits good operational and business diversity. The company has total refining (crude distillation) capacity of approximately 229,000 barrels per day, with two refineries having crude distillation capacity each in excess of 100,000 barrels per day. The company also has a modest degree of downstream integration, reflecting an substantial logistics network. Following the sale of its interests in Primax Peru and Primax Ecuador, the company will no longer have any retail exposure.

In addition, the upstream business is a partial natural hedge to ENAP's refining operations, although only a fraction of its upstream production actually flows through its own refineries. ENAP has suffered over the years from flat to declining production and reserves despite significant capital investments. However, oil production has been growing modestly since 2011 (up 30% in the second quarter of 2013 as compared to 2011 levels), driven by growth in Egypt, Argentina and Ecuador.

However, total oil and gas production levels remain modest, particularly compared to the crude distillation capacity of ENAP's refineries. As of the second quarter of 2013, oil and gas production was only about 52,300 barrels of oil equivalent per day (boe/d), 67% of which was oil production. This level of production is comparable to B1 rated E&P companies in North America. As such, ENAP continues to rely heavily on imports from third parties to meet its crude and natural gas requirements. The company's local upstream operations currently supply only about 2% of its crude requirements. Management remains focused on maintaining high domestic and international upstream investment levels in order to reduce ENAP's dependence on crude oil imports from third parties and finding and developing domestic natural gas reserves to help offset the lack of natural gas imports from Argentina. Areas of investment are Chile (tight gas exploration in the Magallanes region), Argentina, Ecuador and Egypt. However, ENAP's investments in international exploration and production do subject the company to political risks.

ENAP does benefit from its equity interest in a liquefied natural gas (LNG) regasification plant in Chile, which started operations in January 2011. ENAP holds a 20% stake in the regasification facility, GNL Quintero S.A., and a 33% stake in the commercial and marketing company, GNL Chile S.A. Through is participation in this venture, ENAP has been able to secure natural gas for its refinery needs and sell additional gas in the domestic market in Chile.

CAPITAL INTENSIVE SECTOR, WITH RELIANCE ON IMPORTS AND EXPOSURE TO CYCLICAL AND VOLATILE COMMODITY PRICES

ENAP's earnings and cash flow are subject to the volatility and cyclicality that are inherent to both refining margins and oil and natural gas prices. Furthermore, ENAP is reliant on crude oil and natural gas imports for its refineries, and both its upstream and downstream sectors are highly capital intensive. The company also faces the threat of increased competitive pressures from refined product imports from US refiners and global refining capacity additions.

ENAP's fundamental earnings performance in 2013 has significantly improved from 2012 levels, with EBITDA in the first nine months of 2013 reaching over $550 million, as compared to around $5 million in 2012.

The EBITDA improvement in 2013 has been driven by lower LNG import costs, commercial sales of LNG in Chile at favorable prices, cost reimbursements from the government for below market natural gas sales, and the full earnings impact from the company's new alkylation unit at its Aconcagua refinery. In addition, the company has increased its focus on inventory management in order to lower working capital needs and improved its hedging strategy.

In addition, over the last couple of years, ENAP's management has continued to focus on optimizing refinery utilization levels, and under normal operating conditions, has been willing to give up market share in order to preserve profitability.

Looking forward to 2014, ENAP's management continues to focus on operational efficiencies to further improve the company's profitability levels. In particular, management is in discussions with government authorities to lower ENAP's foreign crude oil import duty costs from certain African countries, which will expand its crude oil supply options, and adjust domestic diesel fuel specification requirements. However, these two initiatives have not yet been finalized.

STRONG MARKET POSITION IN CHILE, BUT ROLE AS GUARANTOR OF ENERGY SUPPLY CAN PRESSURE PROFITABILITY

ENAP benefits from its sole refiner position in Chile, a transparent, market-based domestic pricing mechanism based on import parity (US Gulf Coast prices plus transportation costs and insurance), and a relatively favorable outlook for refined product demand in Chile in 2014, supported by our GDP growth assumption of around 4%.

However, ENAP, as a state owned entity, has served as a guarantor of energy supply in Chile during certain periods. During the 2008 energy crisis, which stemmed from restrictions on natural gas exports from Argentina, ENAP responded by substantially increasing imports of diesel from the US Gulf Coast in order to meet demand. In addition, as a result of damage to its two main refineries from the massive earthquake that occurred in Chile in February of 2010, ENAP increased its imports of refined products. During these crises, the company sold the imported refined products with a small or null associated margin or in certain cases at a loss, as under Chile's import parity pricing formula some of ENAP's financing costs and additional storage costs were unable to be passed through to end-users.

LEVERAGE PROFILE IMPROVED, BUT REMAINS HIGH

ENAP has successfully improved its financial leverage profile in 2013 through higher earnings generation and debt reduction from asset sales. However, the company's debt burden and financial leverage profile remain high for its Baa3 investment-grade rating, particularly in the context of its exposure to the import-dependent Chilean refining sector.

At September 30, 2013, the company had about $4.3 billion of total adjusted debt, which included an adjustment for Petropower and debt allocation for ENAP's interest in GNL Quintero. Pro-forma for the expected after-tax proceeds from the sale of its stake in Primax Peru and Primax Ecuador, ENAP's debt/EBITDA for the last twelve months ending September 30, 2013 was about 7x. This represents a considerable improvement from debt/EBITDA of 104x in 2012.

We project debt/EBITDA coming in at just over 6x for the full year of 2013 and rising to about 8x for 2014, based on our assumptions of modestly weaker EBITDA generation. We have not assumed any debt reduction in 2014. Free cash flow generation is expected to be limited, with capital spending expected to rise to over $300 million in 2014 from around $280 million in 2013.

Management's long-term financial leverage target of debt/EBITDA of 2.5x is conservative, but we believe that it could be a number of years before ENAP demonstrates a more conservative leverage profile.

HIGH LEVEL OF GOVERNMENT SUPPORT

ENAP's rating reflects strong implicit support from the Chilean government and the strategic importance of ENAP to Chile's energy security.

Historically, this implicit support has been tempered somewhat by a relatively high tax and dividend burden. As a state-owned entity, ENAP has historically paid a 40% special tax on income and on dividends received from subsidiaries, in addition to the 20% income tax normally paid by private Chilean companies. In addition, the company has historically distributed a substantial portion (based on a return on equity threshold) of its annual net income to the government in the form of dividends.

We recognize that the government has made some concessions with respect to the flexibility of the dividend payout and taxes. Over the past several years the government has waived its right to collect dividends from ENAP, enabling the company to capitalize retained earnings and increase its equity, and tax payments to the government have been small.

Moreover, the government provided a $250 million capital injection to ENAP in 2008, representing the first time the state made a direct capital infusion into the company.

While we view these actions as indicative of high government support, they have had only a modest impact on the standalone credit profile of ENAP. In addition, there appears to be an unwillingness at this time to inject additional capital into ENAP that would support significant debt reduction.

FOREIGN EXCHANGE RISK PARTIALLY MITIGATED

Because a substantial portion of ENAP's operating expenses (including import costs) and its debt is denominated in foreign currency, devaluations of the Chilean peso could adversely affect its performance and increase its financing costs. However, the weekly indexation of all of the company's revenues from refined products to US currency through the import parity pricing mechanism offsets nearly all of the negative effects of a devaluation on its financial position. In addition, the company also has currency hedging programs in place to help mitigate foreign exchange risk.

Liquidity Profile

ENAP's liquidity is supported by the benefits associated with its ownership by the Chilean state. The company faces high refinancing risk due to its reliance on short-term debt, with short term debt coming due of over $780 million through year-end 2014. While ENAP has a history of operating with a high proportion of short-term debt in its capital structure and has successfully rolled maturities, the constant need to access the debt capital markets is a concern. Additionally, as fairly typical for corporate entities in the region, ENAP does not have committed lines of revolving credit due to their high cost and its good market access. These concerns, however, are partially tempered by steady support from a diversified group of domestic and international banks and ENAP's ability to raise debt even during the 2009 global credit crisis, with a strong local market in Chile. In addition, the company's bank loans are currently not subject to financial covenants.

We believe ENAP's cash flows will remain subject to the volatility and cyclicality of commodity prices, which during periods of high prices can result in substantial working capital needs. We expect the company's capital spending program will increase to over $300 million in 2014. We note that ENAP's capital spending program has a high level of flexibility, largely oriented towards its upstream segment and with downstream regulatory spending requirements complete.

Rating Outlook

Our stable rating outlook assumes that ENAP continues to focus on reducing debt balances over the medium term and that Chilean implicit government support of ENAP remains high.

What Could Change the Rating - Down

If ENAP is unable to continue its modestly deleveraging trend, its baseline credit assessment could be lowered, resulting in a downgrade of its Baa3 foreign currency rating. If there are indications of reduced implicit government support for ENAP, its Baa3 foreign currency rating could be downgraded.

What Could Change the Rating - Up

While a rating upgrade is unlikely over the near-term, a significantly improved sustainable financial leverage profile, with debt/EBITDA approaching 5x, more supportive of the cyclicality and volatility of the refining sector could have positive rating implications over the medium term.

Other Considerations

GRID INDICATED RATING

Under Moody's Global Independent Refining and Marketing rating methodology, ENAP maps to a B1 grid indicated rating based on the last three years of financial data ending September 30, 2013 and a Ba3 indicated rating based on Moody's one-year forward view, in line with ENAP's underlying b2 baseline credit assessment. We primarily analyze ENAP's baseline credit assessment within a peer group of independent refining and marketing companies, as this segment accounts of most of the company's capital employed and earnings. However, we also recognize that the company's upstream operations provide a degree of operational integration and diversification benefits to the consolidated entity. ENAP's final rating outcome of Baa3, primarily reflects the high level of implied government support from the Aa3 rated government of Chile.

Rating Factors

Empresa Nacional del Petroleo
600021280

Independent Refining and Marketing [1][2]	**LTM9/30/2013**	[3]**Moody's 12-18 Month Forward View**
Factor 1: Size and Scale (35%)	**Score**	**Score**
a) Crude Distillation Capacity (mbbls/day)	B	B
b) Complexity Barrels (mbbls)	Ba	Ba
c) Number of Large-Scale Refineries	Ba	Ba
Factor 2: Refinery Profitability (15%)		
a) EBIT / Total Throughputs Barrels (3 Year Average) ($/bbl)	B	Ba
Factor 3: Financial Flexibility (35%)		
a) Debt / Complexity Barrels ($/bbl)	Caa	Caa
b) EBIT (3 Year Average) / Interest Expense	Caa	B
c) RCF (3 Year Average) / Debt	B	B
Factor 4: Institutional Framework and Operating Environment (15%)		
a) Insitutional Framework and Operating Environment	A	A
Rating:		
a) Weighted Average Factor Result	B1	Ba3
b) Actual Rating Assigned	Baa3	

Government-Related Issuer	
a) Baseline Credit Assessment	b2
b) Government Local Currency Rating	Aa3
c) Default Dependence	Moderate
d) Support	High
Final Rating Outcome	Baa3

[1] All ratios are calculated using Moody's Standard Adjustments. [2] Based on financial data as of 9/30/2013; Source: Moody's Financial Metrics. [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

MOODY'S
INVESTORS SERVICE