FITCH AFFIRMS TUPRAS AT 'BB+', NEGATIVE OUTLOOK

Fitch Ratings-Warsaw/London-18 April 2019: Fitch Ratings has affirmed Turkiye Petrol Rafinerileri A.S.'s (Tupras) Long-Term Issuer Default Rating (IDR) at 'BB+' with a Negative Outlook. The Negative Outlook mirrors that on Turkey's sovereign IDR (BB/Negative). The full list of ratings is at the end of this commentary.

The rating affirmation reflects Fitch's view that Tupras will maintain a sound credit profile as a result of the high complexity of its refining asset base, its advantageous geographic position, which allows access to cheaper, heavier and sour crudes, and the company's leadership in the Turkish market. We forecast moderate leverage over 2019-2021 for the 'BB+' rating and expect the company to generate positive free cash flow despite ongoing lira volatility in the short term and a generous dividend policy.

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 group's US dollar-linked inventories for crude oil and oil products and by its hedging programme with several major domestic and international banks for its 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 its leadership position in an undersupplied, 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), up 7% yoy.

Iran Payables Temporarily Increase Gross Debt: Overall operating cash flow for the year was weaker than 2017, due to a large working capital outflow in the last quarter, related to Tupras repaying all of its outstanding Iran-related payables, prior to the re-introduction of US sanctions in early November. Together with a TRY3.4 billion dividend pay-out, this increased gross debt and drove Fitch-calculated FFO adjusted net leverage to 2.5x at year-end. Tupras has good access to a variety of crude oil sources and the lack of supplies from Iran will not have an impact on the company's operations. We also expect that the working capital outflow will be gradually reversed in 2019.

Projected Leverage Within Guidance: The impact of the weaker lira and rising oil prices on fuel prices for consumers has partly been absorbed by the state since May, via a reduction in the special consumption tax (SCT) on fuel products. Even if these measures become difficult to sustain, given their impact on government tax revenue, and are eventually scaled back, we expect demand for fuel products, which is fairly inelastic, to remain solid.

The introduction of the International Maritime Organisation (IMO) 2020 regulation, and its forecast positive effect on margins, and declining crude prices under our price deck should support Tupras's profitability and lead to positive FCF generation after dividends over the rating horizon.

This in turn would drive gradual deleveraging from the 2.5x FFO adjusted net leverage peak at end-2018 to 1.9x by 2021.

Rating Above the Sovereign: We rate Tupras above Turkey, but cap the rating at the sovereign ceiling (BB+) in line with our Corporates Exceeding the Country Ceiling Rating Criteria largely due to domestic operations and a policy of holding cash in Turkish banks. 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, the 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 had 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 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 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.

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 (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. MOL's downstream capacity (417 mbbl/d) is smaller than Tupras, 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.

We rate Tupras above Turkey, but cap the rating at the sovereign ceiling (BB+) due to its mainly domestic operations and cash held in Turkey.

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
- Crude prices of USD65/bbl in 2019, USD62.5/bbl in 2020, USD60/bbl in 2021 and USD57.5/bbl thereafter
- Capital intensity of around 1.6% over the rating horizon
- 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 (BB/Negative) and a corresponding higher assessment of Turkey's country ceiling, which currently constrains Tupras' rating

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- FFO-adjusted net leverage consistently above 2.5x and FFO fixed charge cover well below 5x
- Consistently negative FCF
- Substantially higher capex or dividends leading to higher-than-expected leverage
- A downgrade of Turkey's sovereign rating and a corresponding lower assessment of Turkey's country ceiling, or a worsening operating environment in the country

LIQUIDITY

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' 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 situation 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 free cash flow generation over the rating horizon, 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 (BB-/Negative). These deposits amounted to TRY2.4 billion (52% of total) in 2018 and TRY4.9 billion (65% of total) in 2017.

FULL LIST OF RATING ACTIONS

Turkiye Petrol Rafinerileri A.S. (Tupras)
- Long-Term Foreign-Currency IDR affirmed at 'BB+', Negative Outlook
- Long-Term Local-Currency IDR affirmed at 'BB+', Negative Outlook
- National Long-Term Rating affirmed at 'AA+(tur)', Stable Outlook
- Foreign-currency senior unsecured rating affirmed at 'BB+'

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Summary of Financial Statement 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.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Criteria (pub. 19 Feb 2019)
https://www.fitchratings.com/site/re/10062582
Non-Financial Corporates Exceeding the Country Ceiling Criteria (pub. 17 Jan 2019)
https://www.fitchratings.com/site/re/10059284