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Research Update:

Ecopetrol S.A. 'BBB' Ratings Affirmed, Outlook Remains Negative

Primary Credit Analyst:
Marcela Duenas, Mexico City (52) 55-5081-4437; marcela.duenas@spglobal.com

Secondary Contact:
Fabiola Ortiz, Mexico City (52) 55-5081-4449; fabiola.ortiz@spglobal.com

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Overview

- Ecopetrol's credit measures will remain weak in 2016 as a result of a sharp drop in capital spending and moderate production decline in 2016.
- We're affirming our ratings on Colombia-based oil and gas company, including our 'BBB' long-term corporate credit rating. The company's stand-alone credit profile (SACP) remains at 'bb'.
- The negative outlook on Ecopetrol reflects the negative outlook on the Republic of Colombia. It also reflects the risks related to oil price volatility, which could further affect the company's credit metrics and pressure its liquidity. Additionally, if Ecopetrol's oil production is significantly lower than we expect as a result of lower capital spending during 2016, a downgrade is possible.

Rating Action

On June 28, 2016, S&P Global Ratings affirmed its 'BBB' long-term corporate credit rating on Ecopetrol S.A. At the same time, we affirmed our 'BBB' rating on its senior unsecured debt. The company's SACP remains at 'bb'. The outlook remains negative.

Rationale

The affirmation reflects our view that Ecopetrol's credit measures, including debt to EBITDA, free operating cash flow (FOCF) to debt, and discretionary cash flow (DCF) to debt, will remain weak in 2016. However, the company has achieved higher operating efficiencies than we expected due to its austerity plan, cost-cutting measures across all of its business segments, and its focus on profitable barrels, resulting in EBITDA margins above 35%. Additionally, during the first half of 2016, Ecopetrol continued with the divestment of its share interest in Empresa de Energía de Bogotá S.A.E.S.P. (EEB; BBB-/Negative/--) and Interconexión Eléctrica S.A.E.S.P. (ISA; BBB/Negative/--) from which it obtained about $242 million, which improved its operating cash flow.

We continue to assess a very high likelihood that the Colombian government will provide timely and sufficient extraordinary support if the company is under financial distress. In accordance with our criteria, we base our rating approach on our view that Ecopetrol plays a very important role in Colombia, given its position as the largest company in the country, has a significant presence in Colombia's oil and gas sector, acts as the main supplier of oil-derived products in the domestic market, and has very strong link with the government. The latter is based on the government's controlling ownership and strategic oversight, despite the company's independent management team.

Our view of Ecopetrol's business risk profile reflects the company's leading position in Colombia's oil and gas industry, low production costs of about $6.7 dollars per barrel during the 12 months ended March 31, 2016, and a large reserve base. As of the first quarter of 2016, the company's production reached 737 million barrels equivalent per day (mboed), compared with 773 mboed during the same period of last year. This was mainly due to a natural decline, a lower activity, and the decision to temporarily close some fields given their low generated profitability. Given the current oil prices and the company's focus on value (profitable barrels) over volume, we estimate a further decline in production to 715 mboed in 2016, despite the higher production due to the concession reversal for the Rubiales and Cusiana fields during the year. Moreover, we expect that the completion of major projects in the midstream segment (P135, which increases Ecopetrol's transportation capacity by 135 bpd) and in the downstream segment (the expansion and modernization of the Cartagena refinery) to mitigate the impact of currently lower oil prices.

We assess Ecopetrol's financial risk profile as aggressive. We estimate that the company's recent announcement of lower capital spending and production levels will result in a debt to EBITDA of 3.0x-3.5x, funds from operations (FFO) to debt of 20%-25%, and DCF to debt below 5%. On the other hand, given that Ecopetrol will continue to divest its nonstrategic assets and the shareholders' decision to forego a dividend distribution in 2016, we believe that the company will generate DCF and diminish the need for additional debt for the year.

Our base-case scenario assumes the following:

- Production levels at approximately 715 mboed in 2016, a 6% decline as a result of lower capital spending. For 2017, we estimate 718 mboed, given a slight recovery in oil prices and higher estimated capex.
- Average realized sale price of $30 per barrel of oil equivalent (boe) in 2016 and $35 per boe in 2017. Our average realized sale price ultimately depends on our price assumption for Brent crude oil at $40 per oil barrel (bbl) for 2016 and $45 per bbl in 2017 minus a $10 per barrel, given the current spread between Brent and Colombian crude export basket prices.
- EBITDA of $4.6 billion in 2016 as a result of greater operating efficiencies, resulting in an EBITDA margin at about 36%.
- Working capital needs of about $1 billion during the next two years.
- Annual investments of about $3 billion in 2016 to finish the refinery's expansion and modernization, and into the exploration and production (E&P) segment. For 2017, we estimate $3.3 billion mainly for the E&P segment.
- No dividends expected in 2016 and 2017.

These assumptions result in the following credit measures:

- Adjusted net debt to EBITDA of about 3.4x in 2016 and 3.15x in 2017;

- Adjusted FFO to debt at above 20% for the next two years; and
- DCF to debt below 3%.

Liquidity

We assess Ecopetrol's liquidity as adequate, which reflects our expectations that the company's sources of liquidity will exceed its uses by more than 1.2x in the next 12 months, and that net sources and uses of liquidity will remain positive even if EBITDA were to decline by 15%.

Our liquidity analysis also incorporates qualitative factors, including our view that the company has the capacity to withstand high-impact, low-probability events based on its sound banking relationships and satisfactory access to capital markets, as seen in its recent $500 million add-on to its senior secured notes due 2023. We expect Ecopetrol to retain its very ample access to banks and debt capital markets, given its close relationship with the government.

Principal Liquidity Sources:
- Cash balances of about $2.5 billion as of March 31, 2016;
- Cash FFO of $4.2 billion in 2016;
- Proceeds from $500 million of bonds issued in June 2016; and
- About $242 million of proceeds from the announced asset sales during the first half of 2016, but excluding proceeds from potential divestitures in our liquidity analysis.

Principal Liquidity Uses:
- Debt maturities of about $1.7 billion as of March 31, 2016;
- Working capital outflows of $965 million; and
- Capex, excluding downstream investments, of $2 billion.

Outlook

The negative outlook on Ecopetrol reflects the outlook on the Republic of Colombia. It also reflects the risks related to oil price volatility, which could further affect the company's credit metrics and pressure its liquidity assessment. Additionally, if Ecopetrol's oil production is significantly lower than we expect as a result of lower capital spending during 2016, a downgrade is possible.

Downside scenario

We could lower the ratings on Ecopetrol if we were to lower the sovereign ratings on Colombia, or if the company generates lower-than-expected cash flow, which could result in a revision of our liquidity assessment to less than adequate or increase the company's debt leverage to above 5x, leading to a revision of the company's financial risk profile to highly leveraged. Liquidity could weaken if the Brent oil price remains below $30/bbl in 2016 and its recovery in 2017 is slower than expected.

Upside scenario

We could revise the outlook on Ecopetrol to stable if we were to take the same rating action on the sovereign rating on Colombia, while the company's performance is in line with our expectations and it maintains an adequate liquidity position.

Ratings Score Snapshot

Corporate Credit Rating
Global Scale: BBB/Negative/--

Business risk: Satisfactory
- Country risk: Moderately High
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: bb

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)
- Stand-alone credit profile: bb

Likelihood of government support: Very high

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors: For The Oil And Gas Exploration And Production Industry, Dec. 12, 2013
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios and Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate

Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April, 15, 2008

Ratings List

Ratings Affirmed

Ecopetrol S.A.	
Corporate Credit Rating	BBB/Negative/--
Senior Unsecured	BBB