RATING ACTION COMMENTARY

Fitch Affirms Ecopetrol's Foreign and Local Currency IDRs at 'BB+'; Outlook Stable

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Fitch Ratings - New York - 23 Nov 2021: Fitch Ratings has affirmed Ecopetrol S.A.'s Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) at 'BB+'. The Rating Outlook for the IDRs is Stable. Fitch has also affirmed the company's National Long- and Short-Term ratings at 'AAA(col)'/'F1+(col)'. The Rating Outlook for the National Long-Term rating is Stable.

Ecopetrol's ratings reflect the close linkage with the Republic of Colombia (Foreign and Local Currency IDRs BB+/Stable), which currently owns 88.5% of the company. Ecopetrol's ratings also reflect the company's strategic importance for the country, as well as its ability to maintain a solid financial profile.

KEY RATING DRIVERS

Linkage to Sovereign: Ecopetrol's ratings reflect the strong linkage between the credit profile of the Republic of Colombia, which owns 88.5% of the company's total capital. The ratings also reflect the very strong incentives of the Colombian government to support Ecopetrol in the event of financial distress, given the company's strategic importance to the country, as it supplies virtually all liquid fuel demand in Colombia, and owns 100% of the country's refining capacity. The company relies on the receipt of funds from the Colombian government, through its stabilization fund Fondo de Estabilizacion de Precios de los Combustibles (FEPC), to offset the difference from selling fuel in the local market at lower prices versus the export market.

Integration with ISA is Credit Neutral: The acquisition of the 51.4% stake in ISA is a credit neutral event, as a majority of Ecopetrol's consolidated EBITDA is generated from their energy business. For example, on a deconsolidated basis, ISA's dividends in 2022 adjusted to Ecopetrol's ownership, are expected to represent 2.7% of Fitch's projected Ecopetrol EBITDA for 2022. Thus, currently, the ISA acquisition is not expected to impact its leverage metrics over the rated horizon.

Fitch estimates that consolidated pro forma gross leverage, defined as total debt to EBITDA, will change modestly. On a proforma basis, Ecopetrol's consolidated gross leverage when including ISA will go from 1.7x to 1.9x in 2021 and 2.1x to 2.3x in 2022F. On a net debt basis, 2021 is estimated to be 1.6x from 1.3x and 2022 will be 2.0x compared to 1.7x. Consolidated EBITDA margin is expected to improve to an average of 45% over the rated horizon, and free cash flow is expected to be positive from 2022 onward, absent any unexpected capex.

Strong Financial Profile: Ecopetrol's 'bbb' SCP reflects the company's strong financial profile. Fitch calculated gross leverage as measured by total debt to EBITDA increased to 2.9x in 2020 from approximately 1.2x at YE 2019. Fitch expects deconsolidated leverage, which does not include ISA's debt, but does include the incremental debt at Ecopetrol to finance the acquisition, will be below 2.5x over the rating horizon.

The flat leverage profile over the rating horizon is supported by strong Brent prices. The strong financial profile is supported by the strong coverage ratios. Fitch expects Ecopetrol's interest coverage as measured by EBITDA to interest expense to average approximately 6.5x over the next three years.

Neutral to Positive FCF Expected: Fitch expects Ecopetrol's FCF to be neutral to marginally positive going forward, subject to revisions to investment and dividends plans. Fitch's base case assumption includes the company having an average annual capex budget of approximately USD5.0 billion over the next three years, and that it will pay 60% of previous year's net income in line with its 40% to 60% dividend policy. This, coupled with Fitch's price assumptions for Brent crude oil price of USD63/bbl in 2021, USD55/bbl in 2022, and USD53/bbl in the long term, would result in positive FCF over the next three years.

Stable Operating Metrics: After production cuts of 4% implemented in 2020, and subsequent 6% reduction in reserves resulting from lower global hydrocarbon prices, Ecopetrol's operating metrics are expected to recover going forward to levels in line with those reported in 2019.

Fitch assumes total hydrocarbons production to be 680 thousand barrels of oil equivalent per day (boe/d) in 2021 before starting to recover to historical levels over the next three years. The company's proved reserve (1P) of 1,770 million boe gave the company a reserve life of 7.5 years as of 2020.

Ecopetrol's leverage, as measured by total debt/proved reserves (not including ISA's debt), improved to USD7.5/boe as of YE 2020 from USD10/boe in 2016 due to the decrease in debt. Fitch's calculated implied pretax break-even crude oil price for Ecopetrol has remained relatively stable over the past three years at approximately USD38/bbl.

DERIVATION SUMMARY

Ecopetrol's rating linkage to the Colombian sovereign ratings is in line with the linkage present for most national oil and gas companies (NOCs) in the region; including Petroleos Mexicanos (Pemex; BB-/Stable), Petroleo Brasileiro S.A. (Petrobras; BB-/Negative), Petroperu S.A. (BBB/Stable) and Empresa Nacional del Petroleo (A-/Stable).

In most cases in the region, NOCs are of significant strategic importance for energy supply to the countries where they operate, as is the case in Mexico, Colombia and Brazil. NOCs can also serve as a proxy for federal government funding as in Mexico, and have strong legal ties to governments through their majority ownership, strong control, and governmental budgetary approvals.

Ecopetrol's SCP is commensurate with a 'bbb' rating, which is in line with that of Petrobras at 'bbb' given Petrobras' recent significant debt reduction. Excluding IFRS16 leases, Ecopetrol's leverage as of in year-end 2020 was 2.9x. Ecopetrol's credit profile is materially higher than that of Pemex 'ccc-' SCP as a result of Ecopetrol's deleveraging capital structure versus Pemex increasing leverage trajectory. Ecopetrol will continue reporting a stable production, which Fitch expects to stabilize between 690,000-700,000boe/d. These production trajectories further support the notching differential between the two companies' SCP.