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INVESTMENT & SOVEREIGN RESEARCH STRATEGY *Friday March-22-2019.*

PETROBRAS ANNOUNCES NEW BOND & CASH TENDER OFFERINGS

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THE NEW OFFERS

Petròleo Brasileiro S.A. – Petrobras has announced that it's wholly owned subsidiary, Petrobras Global Finance (PGF), has commenced two new offerings. The first offering is; (A) a new series of US-dollar denominated, senior unsecured global notes and (B) an add-on to its senior unsecured 5.75% global notes due 2029. Petrobras has noted that it will unconditionally and irrevocably guarantee the notes.

The second offering is a cash tender offer to repurchase certain, including the widely held 4.375% 2023 global notes, of its outstanding US and Euro denominated notes. Essentially, Petrobras intends to use the net proceeds from the bond issuance to finance tender/cash offers on several bonds due between 2021 and 2025, i.e. refinance existing debt. The excess financing will be used for general corporate purposes

The cash tender on the 2023 notes will expire at 5:00 PM, New York time, on March 18, 2019. The tender offers are being made subject to certain terms and conditions set forth in the "offer to purchase" including the generation of net proceeds to PGF of at least US$2.0 billion.

COMPANY OVERVIEW

Petrobras was founded on October 3, 1953 and is headquartered in Rio de Janeiro, Brazil. The company is publicly held and operates on an integrated basis, specializing in the oil, natural gas and the broader energy industry. Petrobras operates through the following segments;

exploration and production, refining, marketing, transportation, petrochemicals, oil product distribution, natural gas, electricity, chemical-gas and biofuel segments.

The company has a market capitalization in excess of US$100 billion with the Brazilian government owning 50.3% of the voting capital and 28.7% of the total capital. By law, the federal government must hold at least a majority of Petrobras' voting stock. Petrobras has net proven reserves of 12.0 billion barrels of oil equivalent (bnboe) and has total oil and gas production of approximately 2.6 million boe (MMboe).

Going forward Petrobras' strategy is to focus on divestment, debt reduction (synonymous with the strategy discussed here) and its core activity of exploration and production (E&P). The company has a five-year (2019 to 2023) capital expenditure plan totalling US$84.1 billion, with 82% of the total directed to E&P.

RATING ON THE DEBT

Both S&P and FITCH rate the senior unsecured debt issued by PGF as "BB-/Stable". The rating is the same as the rating given to the parent Petrobras based on the guarantee of the debt. The parent company (Petrobras) also has limited secured debt collateralized by real assets and generates significant earnings. This mitigates the risk of low recovery (subordination). The priority debt ratio is also far less than 50%.

It is important to note that based on S&P rating methodology….. the priority debt ratio is used to determine if there is a significant proportion of total consolidated debt issued by the issuer's subsidiaries. If subsidiary debt is significant, we believe that lenders to the issuer of the debt to be rated could be meaningfully structurally subordinated if the group's income-generating assets are located in subsidiary operating companies, rather than at the level of the issuer of the debt to be rated.

ANALYSIS OF PETROBRAS

In our last piece on Petrobras dated April-9-2018, we rated the debt as underweight. At that time there were lingering concerns and uncertainty around the SEC (Securities and Exchange Commission) bribery investigations, corruption charges and the resulting consequences for the company. Petrobras was also climbing out of a resignation by its auditors and consequent refusal to sanction its financial statements.

Poor corporate governance was also an issue as its controlling stakeholder, the Brazilian government, was accused of facilitating corruption. Brazilian construction firm Odebrecht SA and affiliated petrochemical company Braskem SA had pleaded guilty in a US court to violating American foreign bribery laws as part of a more than $3B deal resolving a sweeping corruption probe of Brazil's state oil company. The plea not only hit the company's bottom line but could have opened the door to more investigations and future payments.

At the time, April-2018, we had not placed on outright sell on the entity because we were of the view that its importance to Brazil and its integration in the society meant that strong and robust government intervention to address its debt and corporate governance issues were likely.

Petrobras' rating is constrained by the sovereign credit rating on Brazil. The government has strong ownership and control due to the company's strategic importance to the country. Petrobras also has a dominant market share in the supply of liquid fuels in Brazil combined with its large hydrocarbon production footprint. This exposes the company to government intervention via pricing policies, investment strategies and budgetary changes / adjustments. Petrobras is also the largest supplier of liquid fuels in Brazil.

IMPROVEMENTS

Petrobras' position as a standalone credit improved significantly in 2018. The proceeds from higher oil prices combined with asset sales was used to reduce debt by US$25 billion or approximately 23%. Based on year-end (YE) 2018 numbers, the company's leverage as measured by net debt/EBITDA has declined from 5.1X as at YE 2015 to 2.2X as at the latest financials.

As at YE 2018 Petrobras reported EBITDA of US$31 billion, a 48% increase, from the US$24 billion reported over the last three financial years. Total debt also declined by 33% to US$84 billion as at YE 2018 from a high of US$126 billion as at YE 2015. The company's free cash flow is also estimated at a healthy US$8 billion. These improvements in cash flow and debt help to support the improved outlook for the company.

On the negative side, production was flat, coming in at 2.6 million boe/d, slightly lower than the figure recorded for 2017. The flat outturn was due in part to asset sales and production depletions. Despite the flat production, the company invested enough in its upstream business (exploration & production) to maintain reserves. Petrobras has proven reserves of 9.6 billion boe which equates to a reserve life of about 11 years.

Petrobras is in the enviable position of benefitting from the indirect support of the Brazilian government during periods of distress. The company has received liquidity support from government controlled financial institutions, regulations have been adjusted to improve its cash flow and beneficial pricing policies have been facilitated by the government. Given the controlling stake owned by the government, Petrobras was also allowed to reduce dividend payments thereby increasing retained earnings and boosting capital. Reductions in downstream investments (marketing and distribution) and asset sales have also aided the company's capital structure and its stand-alone credit profile.

The general view is that as Petrobras approaches its ideal capital structure of 1.5X net debt to adjusted EBITDA, it will modestly increase its dividend payments. We view this ongoing improvement in capital structure as a positive for investors and are of the view that capital gains are likely to accrue to bondholders as a result.

COMPARISON

A comparison between Petrobras and other state controlled oil companies shows that Petrobras is doing comparatively well (***Figure 1***). Its EBITDA margin is healthy, return on capital needs improvement, funds from operations (FFO) to interest coverage is healthy and cash flow to debt is also relatively healthy.

Figure 1

Petroleo Brasileiro S.A. - Petrobras -- Peer Comparison

Industry Sector: Integrated Oil & Gas				
--Fiscal year ended Dec. 31, 2017--	Petroleo Brasileiro S.A. - Petrobras (Brazil)	Petroleos Mexicanos (Mexico)	Ecopetrol S.A. (Colombia)	YPF S.A. (Argentina)
Local currency rating as of Aug. 20, 2018	BB-/Stable/--	A-/Stable/--	BBB-/Stable/--	B+/Stable/--
(Mil. $ - S&P Adjusted)				
Revenues	85,626.2	71,428.7	55,954.2	13,434.7
EBITDA	38,612.7	27,511.5	24,647.2	3,881.7
Funds from operations (FFO)	24,249.1	(2,686.4)	15,609.2	2,788.7
Net income from continuing operations	(134.6)	(14,359.3)	7,178.5	655.8
Cash flow from operations	24,741.1	(4,427.8)	14,807.9	3,163.0
Capital expenditures	13,163.8	4,696.7	5,965.6	3,168.2
Free operating cash flow	11,577.3	(9,124.5)	8,842.3	(5.2)
Discretionary cash flow	11,414.9	(9,124.5)	7,337.7	(43.2)
Cash and short-term investments	24,366.6	5,003.1	7,849.1	2,214.6
Debt	165,381.3	147,065.5	44,627.6	12,292.9
Equity	81,546.2	(76,510.1)	50,152.4	8,105.8
Adjusted ratios				
EBITDA margin (%)	45.0	38.5	44.0	28.7
Return on capital (%)	7.9	14.8	17.0	5.1
EBITDA interest coverage (x)	2.6	2.5	7.8	3.8
FFO cash interest coverage (X)	5.8	1.5	7.0	4.0
Debt/EBITDA (x)	4.3	5.3	1.8	3.2
FFO/debt (%)	14.6	(1.8)	35.0	22.5
Cash flow from operations/debt (%)	14.9	(3.0)	33.2	25.6
Free operating cash flow/debt (%)	7.0	(6.2)	19.8	(0.2)
Discretionary cash flow/debt (%)	6.9	(6.2)	16.4	(0.5)

Source: Standard & Poor's

RISK FACTORS

The primary risk facing Petrobras stems from government intervention or poor policy choices in the firm's management. The manipulation of diesel and energy prices to the final customer is also another risk. Independent committees and a robust governance structure are needed to insulate the company from political interference.

A devaluation of the Brazilian real and consequent increase in fuel prices does pose a risk. The government may intervene to reduce gas and fuel prices to the populous. This would negatively impact the stand alone credit rating and reduce Petrobras' cash flow generation. In 2018 the government intervened to fix and subsidize diesel and fuel prices due to social and political pressures. This move was a potential risk and exposed Petrobras' cash flow to government subsidies until the end of the program.

OUTLOOK

Going forward the company is projected to increase production by about 10% in 2019 and 5% annually between 2020 and 2022. This forecast is driven by eight new production systems scheduled to begin operations in 2018-19. Gasoline and diesel prices are expected to remain aligned to international prices with the prudent operation of the company resisting government pricing distortions and supporting market friendly strategies.

Asset sales are projected to come in at US$18 billion between 2018 and 2019. The cash is projected to be used to continue to pay down debt. Going forward there are no projections for additional/increased cash outlays as corruption and tax disputes were expected to have been completely settled.

Capital expenditure, which is vital to energy companies, especially upstream spending, is projected to come in at US$15 to US17 billion per annum. The spending is to focus on **pre-salt oil fields** which by definition is oil of good quality but found in reserves that are in deep-sea areas and under thick layers of salt, requiring large-scale investment to extract. The pre-salt discoveries also represent very large reserves with the potential to almost double the proven oil reserves of Brazil.

ANALYST'S OPINION

Petrobras has undergone significant improvement over the past three years. The government controlled energy company has received liquidity support from state controlled financial institutions and has even been allowed to implement beneficial pricing policies. The company's debt has declined, its cash flow has improved, its rating from both FITCH and S&P has been upgraded and the general health of the company has improved. The strategy going forward and corporate governance improvements have also indicated that, at least for now, the company outlook is positive.

STRATEGIC POSITIONING / RECOMMENDATION

As a result of the improved performance we are also improving our recommendation on Petrobras **from UNDERWEIGHT TO MARKETWEIGHT**. Our view is that maintaining exposure to Petrobras' debt at this time could lead to capital gains/price appreciation as the company continues to improve the health of its balance sheet. We are quick however to note that Political risk is the company's Achilles heel.

Source: Fitch Ratings, S&P Global / Capitaliq, Moodys.com, Bloomberg,

APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

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