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Brazil's Petrobras faces worsening short-term credit outlook due to possible political interventions

by Vivane Raj & Lee Wei Qi

- **NUS-CRI Forward PD shows that Petrobras faces a deteriorating credit outlook in the near term, which can be partially attributed to the firm's change in leadership amidst the backdrop of a weakening Brazilian Real (BRL)**
- **Efforts to deleverage and raise liquidity are set to unwind if domestic oil prices are suppressed, which is more probable under the new leadership**

Petróleo Brasileiro SA (Petrobras), the leading Brazil domiciled petroleum firm, has undergone a change in leadership from Robert Branco to Joaquim Silva[1] as of 19 Feb 2021. This shift has led to investors' confidence taking a nosedive despite the ongoing oil price rally emboldened by the COVID-19 vaccine rollout and economic recovery. Under Silva, the direction of Petrobras is now more likely to be influenced by political agendas that are in favour of government intervention, which could include suppressing prices on oil below international levels. This might undo the work done to deleverage and increase profit margins. The deterioration of short term credit outlook is reflected in the NUS-CRI Forward 1-Year PD (Forward PD[2]) where an over 50bps increment was recorded.

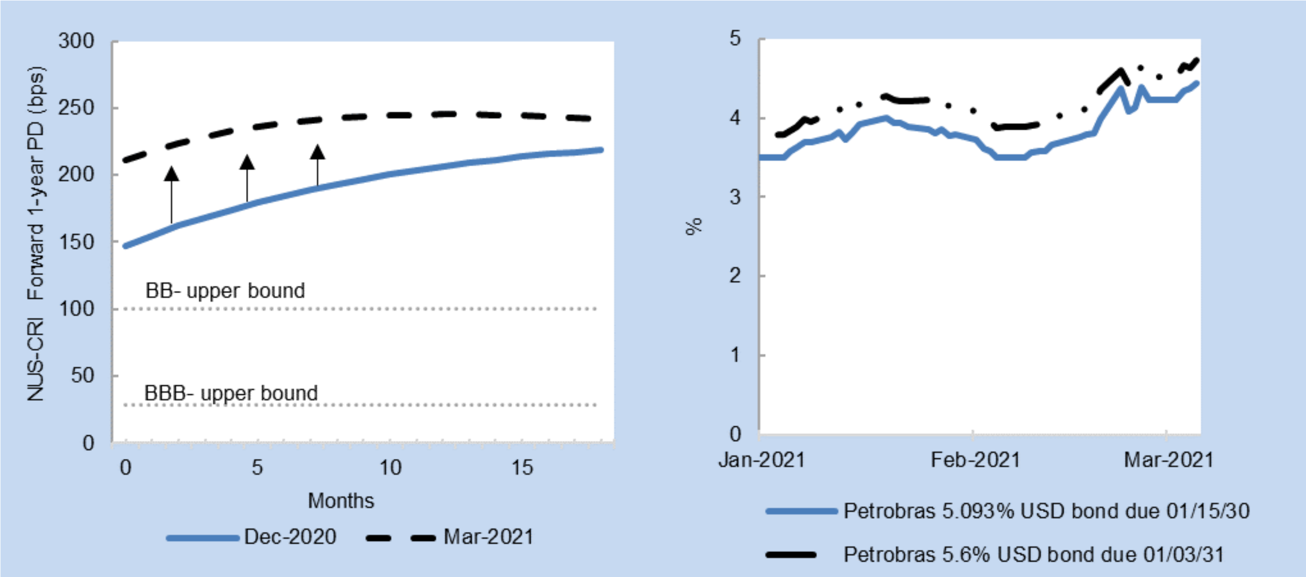

Figure 1a (LHS): NUS-CRI Forward 1-Year PD for Petrobras based on data feed as of Dec 2020 and Mar 2021 with reference to PDiR2.0[3] bounds. Figure 1b (RHS): Mid yield to maturity across Jan to Mar 2021 for several selected bonds issued by Petrobras. *Source: NUS-CRI, Bloomberg*

[1] Joaquim Silva was a former Brazillian Army General who is affiliated with the Bolsonaro administration.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

Figure 1a has shown that the projected Forward PD term structure for Petrobras as of Mar 2021 is relatively elevated when compared to that of Dec 2020. Given Silva's new leadership and the corporation's majority state-owned status, it is more probable that prices will be set below the competitive market equilibrium. This is concerning as stakeholders have previously seen what happened to Petrobras when fuel was sold at a discount relative to their international counterparts. Spanning from 2011 to 2014, when Petrobras's prices were sub-optimally set, the firm sustained billions of dollars in losses. The strain on the firm's top line caused corresponding pressure on liquidity. This resulted in Petrobras becoming increasingly geared as they took on more debt to remain operationally viable. As such, the prospects of an impending cut in oil prices under Silva's directive led to a recent sell-off of the firm's debts where the bonds, documented in Figure 1b, recorded around 95bps increase in mid yield to maturity.

From the onset of 2011, the firm was unable to completely meet the fuel demand from Brazil's population. As such, they had to import fuel from the international markets. However, in the government's bid to control headline inflation, Petrobras was forced to sell oil at a loss. Over time, this compounded to an accumulated loss of over USD 40bn from 2011 to 2014. Recognising the unsustainable financial conditions, the company then made strides to improve its credit profile. The measures included adjusting the fuel pricing to incrementally converge with that of the international market.

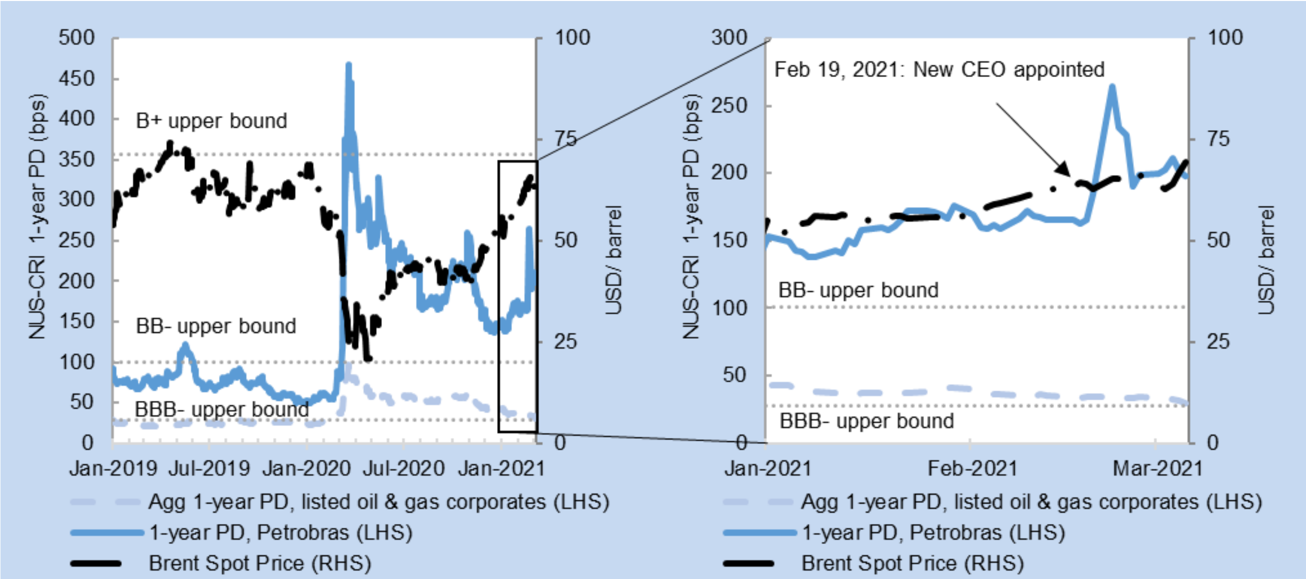

Figure 2a (LHS): NUS-CRI 1-Year PD for Petrobras, Agg PD for listed oil and gas corporates with reference to PDiR2.0 and spot price for Brent crude from Jan 2019 to Mar 2021. Figure 2b (RHS): Corresponding data for Jan 2021 to Mar 2021. *Source: NUS-CRI, Bloomberg*

By re-adjusting to prices dictated by the free market, Petrobras became more competitive in the international markets. This increased its profit margins from -0.16% in 2017 to 13.28% in 2019. The company also made strong attempts to reduce leverage via internal cash flow generation. Overall, there has been a steady growth in the company's Free Cash Flow, which grew from USD 13.8bn in 2017 to USD 23.4bn in 2020. Moreover, Debt-to-EBITDA levels fell from 5.88 to 2.51 during the same period. In tandem, the NUS-CRI 1-year PD for the firm tapered down to 52bps in Dec 2019 (see Figure 2a) from the peak of over 300bps in Jan 2016.

Under Branco's stewardship from Jan 2019 to the end of 2020, the firm also had to navigate the headwinds that came with the COVID-19 pandemic. Due to the series of lockdowns and supply chain disruptions, global demand for oil plummeted. With dampened oil prices, the Agg PD for listed oil and gas corporates, similarly for Petrobras, surged to a high. Amidst worsening commodity prices, Branco sought to mitigate the impact of the pandemic by slashing costs and raising liquidity. Moreover, Petrobras was set to undertake significant divestments through the sales of its non-core assets such as refineries. Cumulatively, the sale of 9 refineries was supposed to avail over USD 10bn in cash.

Today, upon the global recovery from the pandemic-induced economic downturn, oil prices have recovered substantially with Brent Crude, the international benchmark, crossing over USD 70/barrel. By relieving top line pressures, the Agg PD for listed oil and gas corporations globally fell from 42.8bps to 30bps in just this year alone. However, it seems that Petrobras is unable to enjoy the revived optimism as the work done to match international pricing stands to be unwound should domestic prices be suppressed. Diverging from the general downtrend of the industry's Agg PD, Petrobras's recorded PD has increased from 152bps to 197bps in the same time period.

The worsening credit profile is further exacerbated by a depreciating real (BRL) which is Petrobras's functional currency. The BRL is the worst performing currency amongst major economies so far in 2021. In 2020, BRL lost around 30% of its value against the USD. Should prices be suppressed, the firm may not have the price setting flexibility to adjust for further depreciation in BRL against the USD. Petrobras can stand to lose more due to the widening spread between the relatively expensive USD denominated fuel imports and suppressed domestic prices in BRL. As of Mar 2021, around 87% of its debts are issued in foreign currencies. With USD denominated issuances accounting for over 80% of the outstanding debt by Petrobras, the depreciation of the BRL against the USD poses a significant currency risk for the company as the weakened BRL increases the relative cost of debt repayment for Petrobras.

Moving forward, possible political interventions and anti-market friendly regulations in the domestic energy market can further dampen investors' confidence in the Brazilian capital markets. This can lead to further outflows of foreign capital for the economy, which will reinforce the downward pressure on BRL's value, worsening the capital intensive firm's ability to meet its outstanding debt obligations of USD 75bn. Should prices be suppressed, Petrobras will be either allowing for a supply shortage within the domestic market or selling at a loss once again.

Credit News

Oil price jumps above USD 70 after attacks aimed at Saudi oil facilities

Mar 8. The top oil exporter, Saudi Arabia, has recently been infiltrated by drones. The Yemen-based fighters, who claimed to be responsible for the ambush, sent 14 bombs and 8 missiles on Saudi. The concerns with security have led to a premium reflected in an uptick in oil prices. Brent crude rose to over USD 71 while the West Texas Intermediate rose to over USD 67. Nevertheless, representatives from Saudi assured that production was not impeded. Moreover, the country has extra production capacity which can be tapped into in the event that supply has been compromised. (FT)

Emerging markets suffer first outflows since October on rate jump

Mar 6. After months of inflows, the rapid sell-off within the bond market has led to notable hikes in US rates. The US 10-year yield has crossed 1.6% on Friday and is expected to rise further to 1.9% by year-end. The emerging markets were not sparred as foreign investment dipped into negative last week. Given the prospects of recovery, fears from the 2013 taper tantrum were revived. While a pullback on the prospects of recovery is normal, investors were caught off guarded as it is still rather early. Moreover, Powell in his recent FOMC speech did not give any hints with regards to tapering down the long-term rates. (FT)

Companies rush to issue convertible debt at rock-bottom rates

Mar 5. Companies have issued a record amount of convertible bonds at ‘rock-bottom’ rates in pursuit of locking low borrowing costs should stock and bond market volatility hamper investor enthusiasm. Airbnb locked the largest convertible deal of the year so far, with the issuance amount reaching USD 2bn. Interestingly, companies such as Airbnb have agreed to not pay interest on their debt, though the conversion price carries a heavy premium over current share prices. The current low rate environment, coupled with high valuations and high volatility lead to attractive convertible pricing. In January and February, companies raised USD 34bn, 68% higher than the first two months of last year. The issuance was primarily seen from two categories: high-growth companies and companies that were hard hit by the pandemic. (FT)

China tells banks to scale back lending to contain financial bubble risks

Mar 5. Chinese regulators have given domestic and foreign lenders guidance to restrict their loan book sizes against risks emerging from bubbles in domestic financial markets. Part of the business loans, which were originally supposed to be used on operational costs such as rents and equipment purchases, flew into the property and stock market, thus creating bubbles. This happened despite the nation's banking watchdog banning borrowers from using such loans on property and stock purchases. The head of China Banking and Insurance Regulatory Commission (CBIRC) highlighted bubble risks as a core issue facing China's property sector. (Reuters)

Chinese developer’s USD 4.6bn in offshore debt is in doubt after default

Mar 3. Following the series of Chinese defaults, a developer of industrial parks, China Fortune Land Development Co., has failed to repay a USD 530mn note recently. This cast doubts on their ability to make payment for its outstanding debt of over USD 9bn. Currently, the firm is facing a shortage of liquid assets as the local provinces failed to put forth cash from their partnerships. This led to China Fortune’s bonds trading within the distressed range. Now more so than ever, the previously expected implicit support from the Chinese government is put into question. Should China Fortune default, it would go on to show how serious Beijing is with regards to deleveraging. (WSJ)

Boeing looking for new USD 4bn revolving credit facility (Reuters)

Greece's Alpha Bank sells Tier-2 bond, yield at 5.5% (Reuters)

After weathering February storm, junk bonds count on Fed protection (Reuters)

Regulatory Updates

Libor to cease for most currencies by end of 2021

Mar 5. The formal call to stop Libor is meant to put pressure on financial institutions to expedite the transition. The publication of Libor for the UK, EU, Switzerland and Japan will be put to a stop by Dec 2021. For the US, the one-week and two-month rates will halt around that time as well. However, accounting for the over USD 200tn in USD contracts, banks are given up until Jun 2023 to fully transit. The relatively slow pace of the USD Libor transition is reconciled as the replacement rate rather new. In the coming months, more directions can be expected for the industry to manage the existing long-term contracts with a few synthetic Libor rates. (FT)

Bank of England given new mandate to buy 'green' bonds

Mar 4. Bank of England (BoE) is set to change its approach to buying corporate bonds after the government said that environmental and climate goals should be explicitly part of monetary policy. This initiative is set to help the UK government achieve zero greenhouse gas emissions by 2050. As a result, the BoE is set to adjust its corporate bond-buying program to 'account' for the climate impact of the bond issuers. These policies could significantly impact the bank's asset purchase preference and involve considerable regulatory changes to encourage private capital to follow suit. BoE is being encouraged to outline the steps it will take to reduce align policies with the temperature goals of the Paris Agreement, ahead of UN climate talks help in the UK in Nov 2021. BoE is also set to carry out its first climate 'stress-test' later this year, ensuring that the financial system helps the transition to a net-zero UK economy. (FT)

Saudi central bank extends deferred payment, guaranteed financing programs (Reuters)

Australian central bank boosts bond purchases after borrowing costs soar (FT)

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