Petrobras' turnaround effort improves its credit profile

by Crystopaz ANGGA

After a slow deleveraging progress in 2015, debt-saddled Petroleo Brasileiro SA (Petrobras) is now speeding up its debt-reduction effort. In an ambitious five-year plan announced in September, newly-appointed CEO Pedro Parente aims to slash Petrobras's net debt to EBITDA ratio to 2.5 in 2018 from 5 in 2015. The energy company has cut capital spending by 25% for the 2017-2021 period and plans to raise an additional USD 19.5bn from divestments in 2017-2018.

With USD 125bn of debt, Petrobras is the most indebted oil company in the world as it binged on debt during the commodity boom. Bogged down by the slump in commodity prices, a deep recession, and a massive asset write-down, the company posted a record loss of USD 10.2bn in Q4 2015 and a loss of USD 320mn in Q1 2016 (see Table 1). Amid a deteriorating financial profile and record-low market capitalization, the RMI-CRI 1-year PD for Petrobras soared to an all-time high of 446.2bps in January (see Figure 1). In February, Moody's downgraded all ratings for Petrobras with a negative outlook, citing a weakening credit profile and a tough business environment as the main reasons.

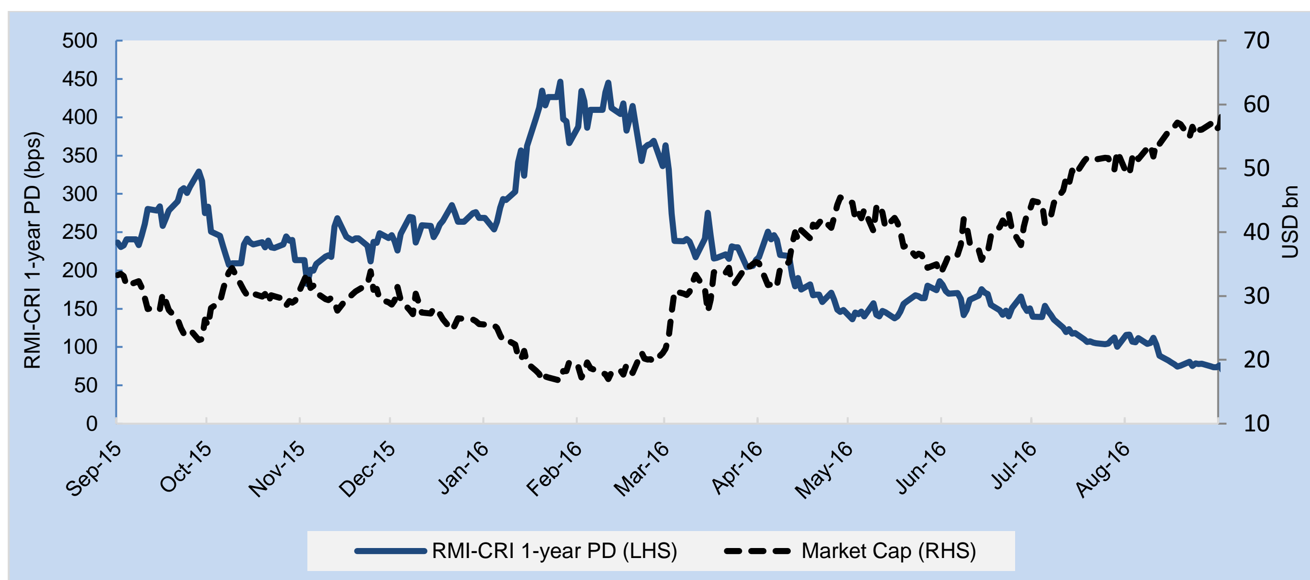

Figure 1: RMI-CRI 1-year PDs (LHS) and market capitalization (RHS) for Petroleo Brasileiro SA. *Source: RMI-CRI*

The bearish streak, however, ended in March when former President Lula, a close aide of President Dilma Rouseff, was detained, hastening the impeachment of President Rouseff whose oil subsidy in 2013-2014 had forced Petrobras to sell oil at a loss. Petrobras' stock price has since then rallied, driven by a rebound in oil price, a more market-friendly management, and a speed-up in divestitures. In light of increased oil production and overseas shipments, the company swung back to profit in Q2 after reporting losses for three consecutive quarters (see Table 1).

In the face of mounting debt, Petrobras has made divestiture a key priority in reducing its high leverage. The Congress' approval to relieve Petrobras of its status as a sole operator of Brazil's pre-salt oilfields was instrumental in its turnaround efforts as it allowed the cash-strapped company to reduce capital spending and sell its pre-salt oilfield assets. Petrobras' oil fields in the pre-salt region are highly sought-after as they are the most productive oil wells in Brazil. In July, Petrobras sold its first pre-salt exploration block to Norway's Statoil for USD 2.5bn. It also sold oilfield assets in Argentina and its natural gas distribution network for USD 1.4bn and USD 5.2bn, respectively. To date, the company has raised USD 9.1bn in 2016, up from USD 727mn in 2015.

Quarter	Q3 2015	Q4 2015	Q1 2016	Q2 2016
Revenue (USD bn)	23.4	22.1	18.1	20.3
Net Income (USD mn)	-1,068	-9,608	-320.3	105.6
Free Cash Flow (USD bn)	1.1	1.9	0.7	3.1
Net Debt/EBITDA (X)	5.2	5.3	5.0	4.5
Total Debt to Total Equity (%)	174.1	191.1	168.9	144.5

Table 1: Financial data for Petroleo Brasileiro SA. *Source: Bloomberg, Company filings*

The RMI-CRI 1-year PD for Petrobras has fallen to 70.4bps in September 2016 from a record high of 446.2bps in January, indicating a marked improvement in its creditworthiness. Petrobras' net debt to EBITDA ratio fell from 5.03 in Q1 to 4.49 in Q2 while debt to equity ratio improved to 124.9 percent in Q2 2016 from 133.8 percent last year. Despite recording a profit in Q2, net income fell by 30% YoY as the company booked an asset write-down of USD 658mn due to impairment charges and a voluntary dismissal program. Moving forward, the company plans to focus on the oil and gas business, and to exit from its non-core businesses in biofuels, fertilizers, and petrochemicals.

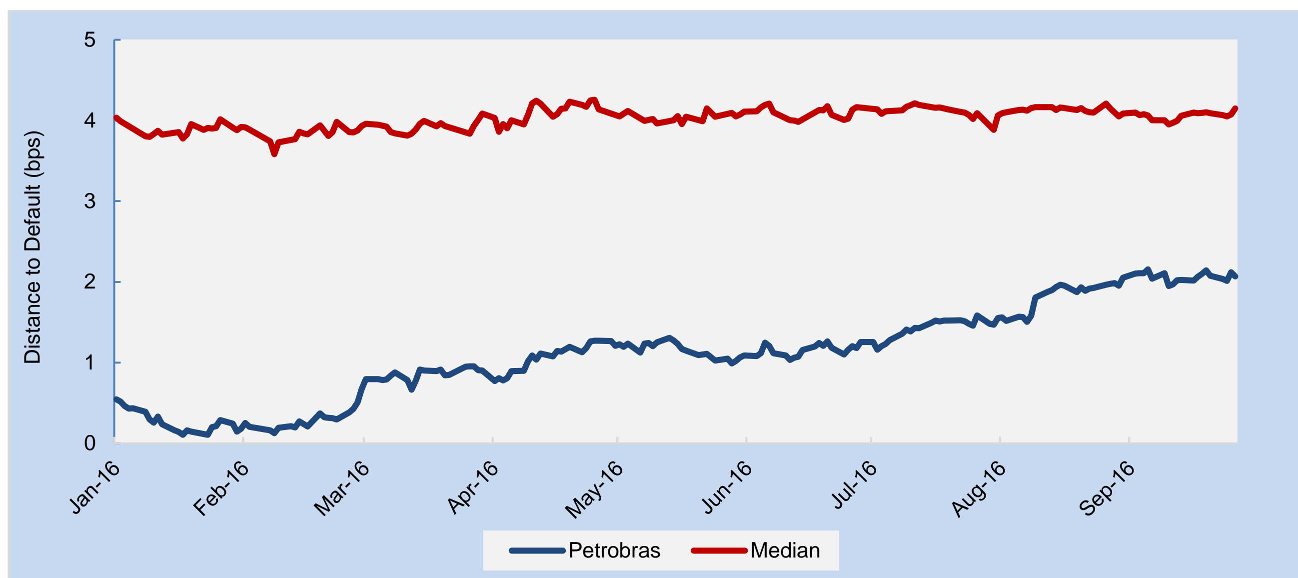

Figure 2: RMI-CRI Distance-to-Default for Petroleo Brasileiro SA and a median of 36 integrated-oil companies. *Source: RMI-CRI*

Despite the improving credit profile, Petrobras' credit health remains vulnerable. According to Fitch, Petrobras' success in leveraging hinges on its divestiture effort as its operating cash flow is projected to barely cover capital spending and interest payment. Brazil's downbeat economy and stagnating oil prices have also diminished buyers' interest in Petrobras' oil field assets, casting doubt over its ability to meet its divestiture target. The comparison between Petrobras's RMI-CRI's distance-to-default (DTD) and the simple median of 36 integrated oil companies' DTD also reveals a large gap between Petrobras' volatility adjusted leverage and its peers' (see Figure 2). DTD is a volatility adjusted leverage measure, and a low DTD is associated with a higher probability of default. While Petrobras' DTD has been increasing since the start of the year, Petrobras' likelihood to default is still significantly higher than its energy peers.

While uncertainties still linger around Petrobras' turnaround efforts, the company is at least on track in trimming its debt. Petrobras' success in deleveraging now depends on the management's ability to execute its divestiture plan and restructure its businesses. OPEC's recent decision to cut output might also provide Petrobras more breathing space.

Credit News

Perisai bond default could tug at Ezra's cash pile

Oct 3. Perisai Petroleum Teknologi's inability to secure approval of more than 75% of its note-holders, required for deferment of SGD 125mn notes, makes an escape from default a highly unlikely scenario for the upstream oil and gas services provider. Over 50 holders of approximately 32% of the notes had demanded immediate repayment of their principal and interest in a notice to Perisai, turning down a consent solicitation put out by Perisai, which sought waivers and a four month extension by the company. Perisai's default could mean woes for associated offshore services firm Ezra Holdings as heavily-leveraged Ezra Holdings is Perisai's single largest shareholder with a 22.5% stake through EMAS Offshore and another unit. (Straits Times)

Sri Lanka's debt crisis is so bad the government doesn't even know how much money it owes

Sep 30. Sri Lanka's debt levels has spiraled upwards while it has been trying to develop its infrastructure to increase its economic potential, pushing the country to the brink of bankruptcy and prompting an IMF bailout. Official estimates place the amount Sri Lanka currently owes its financiers at USD 64.9bn with China owning USD 8bn out of the debt. The country's debt-to-GDP currently stands at around 75%, and 95.4% of all government revenue is currently going towards debt repayment. Various interim solutions to the debt crisis have been proposed which includes offering debt-for-equity swaps to countries, such as China, that hold a substantial amount of Sri Lanka's debt and privatizing and outright sale of loss-incurring SOEs, which have yet to receive much interest. The IMF had agreed to provide Sri Lanka with a USD 1.5bn bailout in the form of a loan in April after the country agreed to a set of criteria to attempt to right the course of its wavering economy. (Forbes)

Bankruptcy of Dongbei Special Steel points to more market oriented approach to resolving SOE debt problems

Sep 30. Moody's Investors Service says that the bankruptcy of Dongbei Special Steel highlights a market oriented approach to resolving the debt problems of China's defaulted state owned enterprises (SOEs). According to the credit rating agency, the Chinese government is likely to adopt a differentiated support for SOEs. State Owned Enterprises that are engaged in activities closely aligned with national policies, or enterprises that are systemically important, will likely receive government support during financial distress. By contrast, other SOEs are likely to be resolve their debt problems through market oriented methods, with filing for bankruptcy as a measure of last resort. (Moody's)

Mexico raises interest rate after Peso plunges to record low (Bloomberg)

Romania keeps record low rates, eases reserve requirements (Bloomberg)

Ruchi Soya's creditor files winding up petition in High Court (Business Standard)

Regulatory Updates

EBA updated risk dashboard shows that low profitability and the high level of NPLs remain a concern for EU banks

Sep 30. The European Banking Authority (EBA) published a periodic update of its Risk Dashboard, which summarizes the main risks and vulnerabilities in the European Union (EU) banking sector. In Q2 2016, EU banks' ratio of common equity tier 1 (CET1) rose by 10bps to 13.5%, The ratio of non-performing loans (NPL) was at 5.5%, 10bps below Q1 2016. In spite of the improvement, credit quality and the level of legacy assets remain a concern. The coverage ratio for NPLs improved by 10bps to 43.9% (compared to the previous quarter), but with wide dispersion among countries. The average return on equity (RoE) was flat at 5.7% when compared to the previous quarter and around one percentage point (p.p.) below the second quarter of the last year. The cost-to-income ratio stopped its increasing trend of the four preceding quarters and decreased when compared to year-end 2015. (EBA)

ESMA consults on future reporting rules for securities financing transactions

Sep 30. The European Securities and Markets Authority (ESMA) has released a consultation paper on draft technical standards implementing the Securities Financing Transaction Regulation (SFTR) with the objective of heightening the transparency of shadow banking activities. The SFTR would require financial and non-financial market participants to report details of their securities financing transactions. According to ESMA Chair Steven Maijoor, regulation of securities financing is crucial for reducing "financial stability risks from financial market activities" as currently the securities financing transactions "faced little to no regulation." (ESMA)

EBA harmonizes the definition of default across the EU

Sep 28. The European Banking Authority (EBA) has finalized the definition of default for companies across the EU, which include specifying the criterion for default identification, indications of unlikeliness to pay and application of the default definition in a banking group and specific aspects related to retail exposure. A qualitative study providing information about the current practices of institutions with regard to the definition of default, as well as a report detailing the conditions for setting the materiality threshold for credit obligations that are past due, have been provided by the EBA. Financial institutions are expected to adopt the guidelines by the end of 2020. (EBA)

Bank rules driving high rent and house prices (Independent)

There's room for more bond-buying at the Bank of England (Bloomberg)

PBOC seen switching to monetary tightening as soon as 2017 (Bloomberg)

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