Q3 2017 Earnings Call

Company Participants

- Isabela Mesquita Carneiro da Rocha, Executive Manager-Investor Relations
- Ivan de Souza Monteiro, Chief Financial & Investor Relations Officer
- Jorge Celestino Ramos, Chief Refining & Natural Gas Officer
- Nelson Luiz Costa Silva, Chief Strategy &Organization Officer
- Solange da Silva Guedes, Chief Exploration & Production Officer

Other Participants

- André Natal, Analyst
- Lilyanna Yang, Analyst
- Luiz Felipe Carvalho, Analyst
- Osmar Cesar Camilo, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen. Welcome to Petrobras Conference Call with Analysts and Investors for the presentation of Third Quarter 2017 results. We would like to inform you that participants will be in listen-only mode during the company's presentation, which will be conducted in Portuguese with simultaneous translation into English . After the presentation, a Q-and-A session will follow, and further instructions will be provided.

Persons with us today with us today are Mr. Ivan de Souza Monteiro, Chief Financial and Investor Relations Officer; Ms. Solange da Silva Guedes, Chief Exploration and Production Officer; Mr. Jorge Celestino Ramos, Chief Refining and Natural Gas Officer; Mr. Nelson Luiz Costa Silva, Chief Strategy and Procurement Officer; Mr. Roberto Moro, Chief Technology and Production Development Officer; Mr. João Adalberto Elek Jr., Chief Governance, Risk and Compliance Officer, as well as other company executives.

I would like to remind you that this meeting is being recorded, and please be mindful of slide number 2, which contains a notice to shareholders and the investors. The words believe, expect, and similar ones related to projections and targets are mere forecasts based on the expectations of the company's executives regarding the future of Petrobras.

To begin, we will hear Petrobras' Investor Relations Manager, Ms. Isabela Carneiro da Rocha, who will present information regarding the third quarter 2017 results. Subsequently, questions from participants will be answered.

Please go ahead, Ms. Rocha.

Isabela Mesquita Carneiro da Rocha {BIO 19730664 <GO>}

Good morning and welcome to Petrobras' webcast relative to third quarter 2017 results, and thank you for joining us. So, let us begin. And again, please be mindful of slide 2, which contains a notice that the presentation may have projections, estimates, and expectations of the company that may differ from these estimates because of several factors mentioned here and in the annual report reports available on our website. Let us begin with slide 3. We will start by highlighting the main results achieved for 2017. Afterwards, we will come for the results that we committed to deliver in the 2017 to 2021 business and management plan. And then, we will detail some operational highlights.

Let's go to slide 4. Starting with safety, which is one of the main metrics of the company, our results have been better than expected. Our TRIFR, Total Recordable Injury Frequency Rate, per million man-hours reached 1.09, well below the limit we established for 2018, which was 1.4. With this result, we have already come rather close to the market benchmark in terms of safety.

In terms of financial performance, we achieved the net income of BRL 5 billion in the nine months of 2017, reversing the previous year's loss or BRL 266 million in the quarter, in keeping with the previous quarter.

Free cash flow was positive for the 10th consecutive quarter, amounting to BRL 37.5 billion, up 26% year-on-year and up 58% quarter-on-quarter. Adjusted EBITDA was BRL 63.6 billion, payable in both annual and quarterly comparison, with an EBITDA margin of 31%. There was a reduction in net debt over EBITDA ratio to 3.16%, and a reduction in leverage of 51% at the end of the third quarter of 2017. In operational trends, production remains stable at 2.67 million barrels of oil equivalent to date, but oil product sales volume fell by 6% compared to last year. On the other hand, exports increased by 39% and inputs decreased by 19%, with a net balance of 385,000 barrels per day, consisting crude oil and oil products.

Let's go to slide 5. In relation to external variables, we observed an increase in Brent prices, which reached $52 per barrel in both quarter and average for the year, and an appreciation of the Brazilian real, which was around BRL 3.2 per dollar in both the quarter and nine months of 2017. For the fourth quarter, we already see a significant increase in Brent prices, which reached the highest value since mid-2015 due to geopolitical tension in the Middle East.

Moving on, slide 6, we present the company's EBITDA and the breakdown for each business segment. EBITDA was BRL 19.2 billion in the quarter and BRL 63.66 billion year-to-date, stable in relation to the previous quarter and the previous year. The main highlights per business unit were: In E&P, a higher Brent price and increase in production, which resulted in a higher EBITDA of 32% despite higher production taxes. There were also lower write-offs of dry and sub-commercial holes and less idle equipment. In Downstream, there was a reduction in sales margins and sales volume in both diesel and gasoline. On the other hand, there was an increase in oil net exports at higher prices. As a result, EBITDA decreased by 47%.

In Gas & Power, we highlight an increase in natural gas sales and an increase of the share of domestic natural gas in the sales mix, greatly increasing GAAP margin. On the other hand, there was the impact of the sale of NTS, which resulted in higher selling expenses because we had to pay the tariff to use the gas pipeline. In Distribution, there was a significant EBITDA increase stemming from higher margins and distribution volumes, lower selling expenses due to lower provisions for receivables from the electricity sector and some legal claims.

Highlights in the quarterly comparison were: reduction of refining margins, higher diesel sales driven by seasonality, improvements in margins and volumes at Distribution of oil products, and power generation with higher PLV or spot price.

Slide 7. Here we highlight our financial results. Financial interest-bearing expenses reduced due to debt reduction, but there was an impact of BRL 2 billion when the company joined federal tax settlement programs, the portion (07:17), which revolves the payer later (07:18). Monetary and exchange variation increased with depreciation of the U.S. dollar over the net liability exposure in euro and sterling pound. And therefore, the net financial result was higher by 10% in the period.

On slide 8, we show you our net income. With all of the aforementioned factors coupled with a significant impairment reduction, the gain obtained for the sale of NTS, expenses for joining federal tax settlements programs, which we will also mention in more detail later, net income was positive by BRL 5 billion versus the previous year's loss. It's important to highlight that income was positive for the fourth consecutive quarter.

Slide 9, I would like to highlight free cash flow positive again for the 10th consecutive quarter, and 26% higher in the nine months of 2017 compared to the previous year, with an operating generation of BRL 66.9 billion in the year, and an investment of BRL 29.4 billion, 19% lower than in 2016, which is a free cash flow of BRL 37.5 billion, sufficient to pay interest, we will see on the next slide, of BRL 17.4 billion, and resulting in a free cash flow to equity of BRL 20.1 billion.

On slide 11, we see that in terms of liability management, we had amortizations in the nine months period exceeding borrowings by BRL 19 billion. BRL 91 billion in amortizations and prepayments, net of interest, and BRL 72 billion in borrowings. And we extended the debt profile, as we can see in the next slide, moving from an average term of 7.88 years to 8.36 years, and with a reduction in the average cost of debt from 6.1% to 5.9%. Thus, we have been able to extend debt maturity and reduce average cost of debt simultaneously. This liability management enables that some of amortizations in the 2018 to 2020 period to drop from BRL 48.1 billion to BRL 27.6 billion, including the operation announced on November 6.

Moving on, on slide 13, we see that gross debt stands at $113 billion, net debt at $88.1 billion, down 9% compared to December of 2016. Net debt over EBITDA ratio fell to 3.16, and the leverage to 51% in the third quarter of 2017.

On slide 14, please, we show that in terms of contingencies, we took advantage of tax supplement programs called PRD and PERT for the contingences considered as probable loss. With that, we reduced debt from BRL 1.7 billion, adding these two contingencies, to a real debt of BRL 1.1 billion, to be paid installments, with a negative impact on the results of around BRL 900 million. More information on these programs and other contingencies can be found in Explanatory Notes 20.2 and 29 in the financial statement.

On slide 15, we would like to show you our business and management plan, and then make comments on the business plan deliveries. Starting with safety, as mentioned before, with a Recordable Injury Frequency Rate per million man-hours reaching 1.09, well below the target established, is acceptable, reflecting the results of a culture focused on safety.

So, we'll talk about four pillars: one, competitive pricing, prices – two, reduction and efficiency of CapEx in 2017; three, reduction of operating cost; and four, the partnerships and divestment programs, several competitive processes and strategic alliances underway. On slide 16, that was CapEx, we review the annual projection, about $17 billion down to $16 billion already, and this is the result of the postponement of some FPS, so construction activities from 2017 to 2018, postponement of activities in the (12:00) gas pipeline, adjustments in the Tartaruga Verde schedule, and also reduction of support vessel tariffs, and efficiency and platform retrofit activities. So that is CapEx of BRL 16 billion includes all of these factors and also bonuses due to E&P bidding rounds adding BRL 2.9 billion for this year.

Moving on to slide 17. Let us talk about our management operating costs. We highlight a reduction of 9% year-to-date and 2% in the quarter, pretty much due to a 12% reduction in head count, which totaled 62,528 at the end of the third quarter, and a decrease in selling expenses by 2%, and a significant reduction in G&A expenses by 18% in annual comparison, general reduction of G&A expenses.

On slide 18, on divestments. After completing the sale of $13.6 billion in assets in 2015-2016 period with a cash inflow of $7.8 billion related to this program, we are maintaining the $21 billion target for the 2017-2018 period, highlighting several competitive processes in progress such as onshore and shallow water fields, distribution business, and Paraguay gas pipelines, fertilizers, production assets in Africa. We also intend to go through the IPO of BR Distribuidora (13:38), and there are several strategic alliances under negotiation with Total, Statoil, CNPC and BP.

On slide 19, we show our projection for 2017, an operating cash of $29 billion, which is on an average Brent price of $53 per barrel this year. Judicial guarantees of approximately $4 billion in a conservative approach because since – until third quarter, we've had around BRL 500 million deposited. Amortizations and prepayments are of $31 billion already executed, interest of $7 billion, CapEx of $16 billion, as we have seen, divestment of $7 billion considering $4.8 billion already cashed in, and the completion of the sale of other assets by year-end.

It's important to highlight that, number one, BR Distribuidora IPO was not included in this projection, although it may still occur this year this year. Number two, borrowings totaled $22 billion, and the final cash position should exceed $20 billion.

In terms of operational highlights, on slide 21, we show an increased production in Brazil by around 3% vis-à-vis last year, with a concentration on pre-salt, where the operating production increased by 32%. And we point out the acceleration of the production ramp-up with a reduction from approximately 20 months for the FPSO Angra dos Reis in 2010 to 10 months in the FPSO Cidade de Maricá in 2016.

On slide 22, gas production had similar behavior, up 9% in operated production, and with production records and use of domestic gas in the quarter. On the next slide, operating expenses in E&P reduced by BRL 6 billion, and lifting costs remain at the same level, between $10 billion and $11 billion per barrel of oil equivalent. The slight increase in U.S. dollars was due to the exchange rate effect, and pre-salt lifting cost remained below $7 of BOE.

Next, we highlight a reorganization of our exploration portfolio by acquiring 10 blocks in the three E&P bidding rounds with 11,400 square kilometers and BRL 2.9 billion in signature bonuses, Petrobras's share. We highlight in this process, the selectiveness of Petrobras's participation and the partnerships forged, maintaining the same consortium in the Sapinhoá area and relationships with important partners like Exxon in the blocks of Campos Basin, BP in the areas of Peroba and Cabo Frio Central, and CNPC also in the Peroba area.

Now, we also highlight the excellent exploration result in the pre-salt of Campos Basin with our 196-meter column in areas with an existing structure, such as Marlim. This kind of discovery makes the revitalization of these mature areas even more attractive, not only Marlim, but other mature areas.

On slide 26, in the trading area, we exported 708,000 bpd of crude and oil products, and imported 323,000 barrels per day, and continued being net exporters with a balance of 385,000 barrels per day, mainly crude oil.

Next, we show sales volume of oil products, 3% higher in the quarter and 7% lower year-to-date. In the quarter, there was an increase in diesel demand driven by seasonality. The share of domestic oil in the processed feedstock remains high at 93%. Refinery availability is also high at 96%. And the refinery utilization factor remains at 78%, while the utilization factor for conversion units such as catalytic cracking is higher at 84%. Last but not least, as for the balance of demand and supply of natural gas, there was an increase in demand and a significant increase in the production of domestic gas, like we saw before, allowing to reduce imports from Bolivia and also imports of LNG.

Thank you for your attention. And we can move on to the question-and-answer session.

Q&A

Operator

We are starting now the question-and answer-session. Our first question comes from André Natal with Credit Suisse.

Q - André Natal

Good morning, everyone. Thank you for the opportunity. I have a couple of questions, one about lifting costs, $11.2 to $11.7 in the quarter. When we try to do the math of the impact caused by the tax supplement program on this cost, it seems that that would explain only half of that increase. I would like to understand whether the rest of the increase is due to lower production, exchange rate or if there was an extraordinary fact explaining this increase in cost.

Another question has to do with G&A. You saw that in the nine months of the year versus 2016, G&A dropped substantially. But on the other hand, when we look at the quarter, quarter-on-quarter comparison, we see a 12% increase. So I would like to understand if there's any explanation for that, anything that would account for a good deal of this increase.

My third question, well, I would like to go back to a point that we talked about in the prior call for the second quarter regarding selling expenses for gas and energy. We saw that there was an increase because of NTS tariff, we understand that. But in this quarter, it seems that again there is a recurrence, something between BRL 1.5 billion and close to BRL 2 billion. So I would like to understand, could you break down how much of that was related to NTS and how much of that is recurring?

And finally, if it's possible, if you could share us more – give us more color on the prospects and the discovery at Marlim.

A - Operator

Thank you, André. Thank you for the questions. I will start with the lifting costs, I'll turn the floor to Solange Guedes, and then for G&A with officer Nelson, and as for selling expenses, with Jorge Celestino. And then Solange will talk about Marlim. Or perhaps you can talk about the second and fourth question in one go.

A - Solange da Silva Guedes {BIO 16088234 <GO>}

Good morning, André. This is Solange. You mentioned the lifting costs, but at the same time, you mentioned that there's values of the lifting costs. So I'll mention some aspects. Well, extraction cost remains in keeping just like production in the – if we consider the first nine months of the year 2017, these costs remain in keeping year-on-year, and there was an impact only of the foreign exchange. Net of the exchange rate, we had a lifting cost of $10.3, which is slightly lower than the same value in the prior year. So, this increase is basically due to a foreign exchange variation when we compare those periods. That was for the extraction cost.

For lifting cost, there are two other factors involved here; an increase in production impacts – in production taxes given Brent prices, that increased. And that increased proportionally more than the 14% that we saw in terms of appreciation of Brent oil prices. And essentially, because we're now taking ownership of a greater production in the pre-salt, and that is where we have higher production taxes.

Now talking about your second question, we are very happy and very proud to announce these results. In terms of Marlin, that was a spectacular result. If you imagine a discovery there, it was a column of 196 meters in a reservoir that we master completely. We know all of the information about it. But the next step, André, after this realization well, the rig remains in the well, and we are running a number of production tests now. This is a region where we already have other information coming from another well. And we expect that in the coming months, maybe by mid-2018, we will have defined that discovery, and we'll submit that to ANP so that we can put together a plan to explore that area.

But we can say with some certainty that the impact will be very positive in the project that we are redesigning for Marlim field. So again, the good news about this news is that we think that this is such an important result because it's in an area where we are designing a revitalization, revitalization for Marlim field. So it's almost like we are moving ahead with the exploration of this discovery.

A - Nelson Luiz Costa Silva {BIO 15817718 <GO>}

Good morning, André. Basically, what justifies the G&A increase is consulting services, but this is nonrecurring. I draw your attention to the total, consolidated total. If you look at the first quarter of 2016 and following until the third quarter of 2017, you can see that we have a clear downward trend in G&A expenses. So this is non-recurring. This downward trend will continue, which is what counts.

A - Operator

Thank you, Nelson. Jorge?

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

Good morning, André. Natural gas and energy expenses, these are due to NTS sale. Now, looking at the outlook, we are proceeding according to the plan. So, basically, NTS tariff account for the difference. And we are talking about meeting those performance targets that we had in our business and management plan, right?

Q - André Natal

Yes. Well, thank you very much, but going back to G&A, that 12% increase in the quarter is only due to consulting services?

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

Could you repeat that, please?

Q - André Natal

Of course. I just want to check whether I understood this correctly. The 12%, the G&A expenses increase, is due to consulting services. It sounds a little high, I just want to confirm.

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

Yes. We did have a non-recurring accumulation of payments, a relatively high payment for consulting services, you understood it correctly.

Q - André Natal

Okay. Thank you very much.

Operator

Our next question comes from Osmar Camilo with Bradesco.

Q - Osmar Cesar Camilo {BIO 17227387 <GO>}

Good morning. Thank you for the opportunity. I have two questions. This morning, it was announced that some pension funds joined an arbitration process or claim against Petrobras. What is the defense strategy of the company? Will you follow what was done in the U.S. with a focus on individual agreements? My second question, I just want to confirm information that you presented during the presentation. Do you expect to disburse signature bonuses of the September and October bidding rounds still this year?

A - Operator

Thank you for the questions. Yes, there was a note – advisory by the company about that point of arbitration, but I cannot give you any more on that. The company hasn't been notified yet. So I can only stress what we already said in the advisory. And as per the signature bonuses, we expect to pay them this year in the month of December.

Q - Osmar Cesar Camilo {BIO 17227387 <GO>}

Okay. Thank you very much.

Operator

Luiz Carvalho from UBS.

Q - Luiz Felipe Carvalho {BIO 18040760 <GO>}

Good morning. There's a lot of questions here. Ivan, a question that always comes to mind, and I try to address with you, is about dividend payout. Naturally, we cannot anticipate anything, but considering year-to-date income, approximately roughly BRL 5 billion, and a possible IPO for BR Distribuidora, I would just like to understand if there is any type of significant impairment for Q4, which might, so to speak, significantly – well, considering the current visibility that might have a significant impact on result, non-recurrent, over the fourth quarter.

Second question also to you, Ivan. The company has been working with a cash level, cash position much higher than what we understand to be necessary, or perhaps even compared to the track record or historical levels. I would like to understand the reason why the cash position is more conservative, maybe some possible disbursement, class action, or maybe uncertainty about the debt market down the road.

And the third question, I don't know if this is to Ivan or maybe to Solange, it has to do about transfer of rights. So, you have made public that we have a sense of urgency to try and solve the negotiation of the transfer of rights with the company by year-end in order to have the surplus auction in the first half of next year. So, what is the sense of urgency of the company, is it in line with this discourse of really trying to have it settled within 2017? And what about the dynamics of these meetings, is it weekly, monthly? Just to better understand your dynamics and how you're moving forward. Thank you.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Thank you for your question. Addressing the first question about impairment, the company has an expectation in the sense of substantial impairments just as we head in 2016. We constantly provide the same information, so the expectation remains the same about impairment. You also talk about the cash position. The cash level is conservative. This is how the company address considering the number of contingencies still pending. And it's important to highlight that this is a critical component. It was a highlight in the improvement of the company's ratings, and as always mentioned by the three credit or rating agencies, the significant solidity and liquidity.

Just as a reminder, 2018, we're going to have elections in Brazil, and it also brings some volatility to the market. So, if you followed operation (31:13), we are trying for 2018 to 2019, we want to be comparable levels in terms of cash generation and cash flow, including the arrival of new production systems and startups. So that's the right approach, it has proved to be very much discussed in-house, and we are comfortable with this level, owing to the regions that we mentioned. As to transfer of rights, Solange is going to answer your question.

A - Solange da Silva Guedes {BIO 16088234 <GO>}

Good morning, Luiz Carvalho. We shared with you recently, a formal approach that now, we have a formal group in the company, a team in charge of the formal grouping. And now, it adopts a formal tone. We are willing and ready to immediately begin these discussions with the government.

And we also shared before with all of you that we admit the existence of the surplus volume, which is a driver to make feasible all these discussions. Anyway, we're ready to have a formal process and we're very much interested in having a good deal to the company as soon as possible.

Q - Luiz Felipe Carvalho {BIO 18040760 <GO>}

Okay. Thank you. If I may, just a quick follow-up question. A question to Nelson. The question is about refining investment plan. Do you intend to make anything public this year about the strategy on how you intend to work with this area for refining at the company level?

A - Operator

Luiz, Jorge is going to answer your question.

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

Good morning, Luiz. We are still working on the model in order to submit it to the management and then the Board of Directors. So, first, we have to follow with a sequence of approvals.

Q - Luiz Felipe Carvalho {BIO 18040760 <GO>}

Perfect. Thank you.

A - Operator

Thank you, Luiz.

Next question in English. (33:36). Sarah (33:49), your line is open.

Hi. Good morning. Apologies for my technical problems. I wanted to see if you could give us any update on guidance, specifically on the divestment targets and the reduction of leverage, and particularly in light of the fact that net leverage stayed flat this quarter from last quarter. So you had mentioned in your Investor Day some of the strategies that you are going to use to reduce that leverage by the end of 2018 to the 2.5 times target. I just wanted to see if that remains intact. And we clearly see some reactions being taken this quarter, but I'm just wondering how that might change or not. Thanks.

Thank you. The company maintains the target for net debt over EBITDA for the end of December 2018, 2.5 times. Several divestment processes have already been announced and are underway according to the systems with the Federal Accounts Court, and perhaps maturity will happen in the following months and contribute to hit the target of the company deleverage. So there is no change as to the target that we set in the past.

Perfect. Can I just ask a follow-up question on the divestments? Do you anticipate any kinds of challenges, either legal challenges or valuation related challenges? And if that is the possibility, what sort of mitigations might you be taking in order to continue to achieve those divestment targets? Thanks.

We have a new law amended in Brazil setting for a set of rules, and they're expected to be followed up and complied with by state-owned companies vis-à-vis processes of divestment related to assets or companies. And this law has very much related to

Petrobras's investment legislation. So, any legal aspects are expected to be released (36:36) due to a legal framework which confirms the whole processes adopted and rules followed by Petrobras when it comes to the divestment program.

Okay. Thanks very much.

Our next question, Lilyanna Yang with HSBC.

Q - Lilyanna Yang {BIO 14003234 <GO>}

Good morning. Thank you for the opportunity. My question is about refining margin, about $15.5 per barrel. It was almost $25 per barrel a year ago. Oil prices increased, but the company kind of lowered the average selling price for oil products. My question is, what is the competitive environment of importers of the world now? Do you see players investing more or is your imports capability at a limit and you don't expect an increase in the future? In other words, cost of internalization, in your view, are they following? Are they dropping or increasing? We see that distribution companies such as BR (37:57) were able to increase their margin, just like its peers. Could you give us some color on that, please?

A - Operator

Thank you, Lilyanna. I'm going to give the floor to Jorge Celestino.

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

Good Morning. Regarding refining margins and competition landscape in the distribution area, there's a learning curve and efficiency increase in operations, both in our commercial policies adopted in the Brazilian market, and regarding logistics efficiencies and increase of capacity. So distribution companies and trading companies have improved the quality of their operations, have increased efficiencies, and with that, the market becomes more competitive.

In terms of a guidance of what the future will bring, we are looking at the market, and we do see some moves of new operations. But we cannot, at this point in time, give you more accurate detail on the limits of each one of the players because this is all related to their operating ability and capability. Objectively speaking, we have experienced greater competition and higher efficiency in our trading policy.

Q - Lilyanna Yang {BIO 14003234 <GO>}

Thank you. May I ask another question? At the current price of (39:37) shares, why not sell the shares in the market and cash it in? You're renegotiating with (39:46) as well. Could you give us some color on that?

A - Operator

Well, really, any – again, we'll limit ourselves to the advisory. We are engaged with (39:58) regarding reviewing the shareholders' agreement. This is what we're engaging in at this point. I cannot give you any more on that at this point.

Q - Lilyanna Yang {BIO 14003234 <GO>}

Okay. Thank you very much.

Operator

Thank you very much. We are now closing the question-and-answer session of Petrobras conference call. I now turn the floor to Officer Ivan de Souza Monteiro for his final comments.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Well, I would like to thank all of you for joining us. Any further question can be sent to our Investor Relations department. Thank you very much.

Operator

Thank you. Ladies and gentlemen, the audio of this conference call for replay and slides presentation will be available at Petrobras IR website at www.petrobras.com.br/ir. This concludes today's conference call. Thank you very much for your participation. Please hang up your telephones and have a great day. Thank you.