

Q2 2016 Earnings Call

Company Participants

- Renato Jerusalmi, Head of Finance and Investor Relations

Other Participants

- Albert Sebastian, Analyst

Presentation

Operator

Good afternoon, ladies and gentlemen, and welcome to PetroRio's conference call to discuss 2016 second quarter results. Thank you for standing by. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session for analysts and investors, when instructions to participate will be provided. (Operator Instructions) This event is also being broadcast simultaneously over the Internet via webcast and may be accessed at PetroRio's Investor Relations website at www.petroriosacom.br by clicking on the banner Q2 2016 earnings release.

Before proceeding, let me mention that forward-looking statements that might be made during this conference call relative to PetroRio's business perspective, projections, and operating and financial goals are based on the beliefs and assumptions of PetroRio's management, as well as on information currently available to the company.

Forward-looking statements are not a guarantee of performance. They involve risks, uncertainties, and assumptions as they relate to future events and therefore depend on circumstances that may or may not occur in the future. Investors should understand that general economic conditions, industry conditions, and other operating factors could also affect the future results of PetroRio and could cause results to differ materially from those expressed in such forward-looking statements.

I would now like to turn the conference over to Mr. Renato Jerusalmi, CFO. Please go ahead, sir.

Renato Jerusalmi {BIO 19910567 <GO>}

Good afternoon, everyone. We will begin our second quarter earnings results conference call. Our CFO, Mr. Blener Mayhew, had to travel unexpectedly and will not be able to participate in the call. My name is Renato Jerusalmi. I am the Financial Executive Manager responsible for the financial department and the Investor Relations department.

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Let us begin with the presentation. Please go to slide three where we find the main highlights for the second quarter '16. We had a production in the quarter of around 800,000 barrels in this quarter, rebounding to levels equivalent to those in the second quarter of 2015. Although there was a natural decline in production, still we were able to maintain the same level of production that we had a year ago. Our operating efficiency was around 97%, very positive.

Total net revenues totaled BRL103 million, 150% higher quarter-on-quarter and 7% higher year-on-year. PetroRio had two offtakes, which was quite good. Our EBITDA was BRL6 million positive compared to last quarter when we had a negative EBITDA and we reached the lowest lifting cost since the beginning of Polvo operation, around \$28 per barrel. It is with great satisfaction that we were able to reach this lowest lifting cost, 21% below quarter-on-quarter and 17% lower year-on-year.

Well workovers in Polvo Field were finalized in July, I will be speaking more about that later on, and resulted in a productivity gain of approximately 20%. And we also reached a record number of 1,500 days without non-fatal days lost to accidents, a benchmark in the oil and gas industry and in compliance with our HSE standard.

Moving to slide four now, please, I will speak a little bit about the Brent prices, about our commodity. We had a significant recovery of prices in the second quarter of 2016. Our average price was \$47 per barrel, 34% higher than in the first quarter, and as you know, the oil price is influenced by a number of variables, particularly the macroeconomic part, which influences the demand and production and inventories that influence supply.

So, of course, recovery in our analysis was due to disruptions in production. We had the wildfire in Alberta, Canada, about 1 million. In Nigeria, attacks to pipelines in Nigeria, that caused a loss of 700,000 barrels, and in Iraq, about 300,000 barrels. We had replaced [ph] construction in Kuwait [ph] which was quite relevant, but it lasted just a couple of weeks, about 1.5 million barrels impact. And all of that gave us a tailwind to push the oil price up. Secondly, we had realization in a production decline in the USA. The US was producing about 9.5 million barrels and now they are producing 8.4 million barrels, so about 1 million barrels less per day from the US.

And finally, the delays in the increase in interest rates by the Fed. In July, the market was presumed to behave [ph] slightly more negative. We continued to see market share war. OPEC was shipping at an all-time high, Saudi Arabia and Iran increasing production cost; Saudi Arabia and Iran it was 4 million barrels. And we had Brexit as well that brought more pessimism to the global economy, pushing prices down in July. And finally, we see a decline less than expected in global inventories of oil. Global inventories remain persistently high, gradually falling, and the market is following that very closely.

Our short-term view is that we will continue to see volatility, but in the long term, we believe in a strong recovery of the Brent price. Our thesis is that the combination of very high cut in the oil (inaudible) CapEx of all of the mainstream companies and cancellations of development projects will make the reserve replacement drop significantly and it will not be easy to replenish the whole production with a natural decline in oil field. So we can

see a stable demand and we see a more challenging supply looking forward. With that, we believe we will have a favorable scenario for a recovery in oil prices.

Moving to slide five, here we show you our production quarter-after-quarter. Our production in the second quarter was 8,780 barrels per day and this is the result of that increase that I mentioned in operating efficiency. And we are in the final campaign of field redevelopment. You will remember that in the first quarter we were right in the middle of the redevelopment campaign that entailed some exchanges of pump, some workovers in the wells, but in the second quarter we were getting to the end of that campaign and we had a workover intervention only in the last well, so that increased the production. We had two offtakes in the quarter totaling 777,000 barrels at a gross price -- gross selling price of \$45.41 per barrel, again the oil being sold at a much more attractive price compared to the first quarter.

Please go to slide six now. Here, we will talk about well workovers in the Polvo Field. That was our redevelopment campaign. We have about 20% productivity gain, our production as of August. At the end of July, we completed the workovers, so we stabilized our production at 9,100 barrels. Our previous estimate was at 7,500 barrels, so that entailed a 20% productivity gain.

We successfully accessed the new reservoir, sandstone, in a well that we were finishing the workovers in this well in the end of July and we were successful with this new reservoir. I will explain later on what kind of opportunity PetroRio can derive from that.

We have the potential to expand the field less than -- in more than a year with these workovers and we estimate that our proven reserves estimate should increase to a little over 1 million barrels. We're still completing the final studies for our reservoir engineering. We haven't got a final number, so we are comfortable with a number of over 1 million barrels.

Another important point regarding the results of this campaign is that we are going to have a higher gas production, and this higher gas production will generate a savings of around \$1 million as a result of the switching of a boiler that uses lower diesel. Total investment amounted to \$14.4 million, very close to our estimate. And in the quarter, the second quarter, investments totaled \$9.3 million.

Here, we try to show you our estimates between production curves without workovers and after the workovers, and we can see that the dark blue bars would be our annual production before well workovers and in green, estimates after well workovers, which obviously will generate a significant gain for the company.

And finally, we understand that we had a successful case in the redevelopment campaign. After the focus on the reservoirs and all of the investments, we were able to practically triple our reserves compared to when we bought the assets. It was estimated by BP to be 5 million, and we are estimating reserves at around 16.5 million barrels. So we remain focused on the success of Polvo, and obviously, we want to replicate this success story to other assets. And finally, we are considering a feasibility study for drilling new wells, also

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because of this new reservoir that we access and which proves that it is productive. We are at a very initial phase of the study, but it opens up a very interesting work front for us. We have the potential of drilling one or two other wells. These would be low-risk wells, because the reservoir is a proven success, and obviously at Polvo since a good part of the costs are fixed costs, the more production we can add, the more we can expand the lifespan of the field and generate value from our assets.

I think that it is important to mention that with our entrepreneurial and innovative culture, we were pioneers in using a new technology for oil containment and collection in case of oil spills. This was approved -- this plan was approved by IBAMA, and we're using a new equipment called Side Collector that is installed in a dedicated vessel, and we expect an annual savings for PetroRio of around \$3 million and that's also relevant. We are always focused on reducing costs and thinking out of the box to innovate.

Now the next slide, we see two charts showing Brent compared to our lifting costs and then Brent compared to our total costs, excluding royalties. In the second quarter, we can see a favorable movement, Brent price increasing, lifting costs reducing. Obviously, the bigger the gap between the two lines, the higher our margin will be. So this is an easy way to follow the company's margins, and we can see the positive combination in the second quarter both in the top chart that shows those two curves spreading and in the bottom chart, the same. In the top chart, we can see that we achieved an all-time low lifting cost of \$28.17 per barrel.

Please go to slide eight. Here, we show you our operating costs. This chart, I believe, shows very well our obsession for reducing costs. We reduced costs from \$240 million in 2013 to \$109 million (sic) in 2015 and we are trying to reduce costs by 17% to \$90 million.

And the same goes for G&A. We see a drop from \$61 million to \$20 million in 2015, and trying to get a further reduction of 32%. I want to remind you that our G&A is all in reais and with the real appreciation, this goal becomes a little bit more challenging. As you are probably following, our Brazilian currency, BRL, is appreciating.

And finally, one final comment, I think that the most important thing is that we have a G&A structure in the company which is prepared to grow. We will enjoy relevant synergies if we acquire new assets. Our back-office structure and our technical structure will be able to easily absorb more assets, and if we acquire more assets, we will be able to significantly reduce costs as we grow.

On slide nine, we give you our pro forma income statement in the second quarter. Like I said, two offtakes totaling 766,000 barrels at an average gross selling price of \$45, total revenues of BRL103 million, COGS \$85 million, I am just rounding the numbers so that it is easier for you to follow. Royalty is about BRL8 million, which give us a positive results of operations of BRL10.6 million. So we were able to reverse a negative operating result of the first quarter, which was a very challenging quarter with a low Brent price and we are reversing that we've made positive results.

G&A, G&G, and project expenses remained constant, around BRL15 million, and we have other revenues, BRL10 million, generating a positive EBITDA of BRL6 million. So, again, here we are reversing the first quarter negative EBITDA and now have a positive EBITDA in the second quarter. Then we have depreciation around 21 million and a financial income of minus 35 million, you saw that the financial income has approximately 40 million negative due to foreign-exchange variations.

Again, I'd like to remind you that our cash is mostly denominated in dollars. If the dollar depreciates and the real appreciates, we have a downward foreign exchange variation, which is a non-cash expense. And it is very important that you all understand this, that this is a foreign-exchange variation that does impact our net result.

Net of this foreign exchange variation, assuming that the dollar rates were constant, our profit would probably be BRL11 million, instead of a loss of BRL51 million. And obviously, this foreign exchange variation for (inaudible) business, so we had a loss of BRL51 million.

On slide 10, we always like to show this slide. This shows our cash flow variation. We started the year with about BRL500 million in cash and oil income, 140 million; divestments and M&A, 133 million, a positive financial result in terms of cash of BRL16 million. OpEx, minus 223 million, and here we can see the exchange variation of minus 124 million, which is the effect of better strong [ph] BRL appreciation along the year. And we closed with BRL439 million as final cash in the second quarter of '16. When we look at our dollar cash, net increase in our dollar cash -- cash in December of '15 was \$127 million and we ended the quarter with \$135 million, so -- in dollars this is increasing.

As my final statement, I think I would like to share with you what I envision for the future of the company. I think that PetroRio has a very interesting value proposition and it is based on a tripod that I would like to mention. I think that the first leg of this tripod is the operating leg. We want to replicate the Polvo success in other offshore assets. Basically what we did in Polvo was a turnaround, reducing the OPEC [ph] costs and focusing on reservoir engineering.

Believe it or not, mainstream oil companies do not pay attention to small fields. So if they produce in thousand -- in thousand barrels, a field that produces 2,000 barrels is not significant. But for us, we pay 100% attention to the smaller fields, so we can focus on reservoir engineering and we can show what we are doing with Polvo. We're doubling, tripling our reserves, increasing production and expanding the lifespan of the field. So this is the first pillar, the operating pillar.

The second pillar is the financial one. We have a sound balance sheet. We have practically no debt, just 30 million in convertible debentures that will be converted sometime in the future, and a relevant cash position of around \$135 million. So we can still contract debt if necessary to acquire new assets and Polvo Field has no debt, has absolutely no debt attached to it.

And finally, the final leg is a pillar of capital expense. I think that we have here an excellent balance between a technical team and a financial team to assess new assets, and we're

focused on acquisitions that will generate value to shareholders here. You will not see acquisitions that will not generate value to shareholders. Our management is very experienced in private equity, M&A, and business and we are very focused on making acquisitions that will generate value to shareholders. Sometimes in competitive processes we see some bids that do not make sense, and we will not participate in bidding processes that will not generate value to our shareholders.

I just wanted to share this view of the company with you, and with that, I close and I remain available for questions. Thank you for your time.

Questions And Answers

Operator

Ladies and gentlemen, we will now begin the question-and-answer session for analyst and investors. (Operator Instructions) The first question is in English, from Albert Sebastian.

Q - Albert Sebastian {BIO 1786077 <GO>}

Yes. Good afternoon, gentlemen. I have a number of questions. First, could you just indicate what the production was for the Polvo Field in July?

A - Renato Jerusalmi {BIO 19910567 <GO>}

Yes, we're estimating about 8,700 barrels as an average production in the month of July.

Q - Albert Sebastian {BIO 1786077 <GO>}

I'm sorry, what was that again?

A - Renato Jerusalmi {BIO 19910567 <GO>}

8,700 barrels.

Q - Albert Sebastian {BIO 1786077 <GO>}

8,700 barrels for July, okay. And what is the --

A - Renato Jerusalmi {BIO 19910567 <GO>}

700.

Q - Albert Sebastian {BIO 1786077 <GO>}

And what is the -- 700. What is the status of the receivable from Rosneft? I believe that Rosneft still owes PetroRio \$15.5 million and you haven't received it. I would have thought you would have received that from Rosneft by now?

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A - Renato Jerusalmi {BIO 19910567 <GO>}

Well, regarding Rosneft, we are respecting some contract clauses, some milestones, in terms of local content and taxes related to the environment. So we are waiting their completion of these milestones to receive the rest of the payment that they owe us.

Q - Albert Sebastian {BIO 1786077 <GO>}

And how about the payment from -- the reimbursement from Shell of \$7 million? What is the status of that? When do you expect to receive it?

A - Renato Jerusalmi {BIO 19910567 <GO>}

The Shell receivable, well, we are at a final negotiation with the Shell. Shell is interpreting the contract that they could make some adjustments to that receivable. We are at a final negotiation stage with them. If we do not reach an agreement, we will probably resort to the legal system.

Q - Albert Sebastian {BIO 1786077 <GO>}

I see. And what -- the status of the drill rigs, it sounds like you are -- are you under contract at this particular point in time to sell the land drill rigs, and when do you expect that to close?

A - Renato Jerusalmi {BIO 19910567 <GO>}

Would you please repeat the question, sir?

Q - Albert Sebastian {BIO 1786077 <GO>}

The drill rigs that are available for sale, have you reached a contract to sell the land drill rigs, and when do expect to receive the proceeds?

A - Renato Jerusalmi {BIO 19910567 <GO>}

Understood. Well, we had an accounting write-off of the drill rigs of about BRL6.7 million. We are at a final negotiation phase with Rosneft to sell to them two drill rigs. And we are already considering the sale price and we expect that in the short term we should complete the sale of these two drill rigs.

Q - Albert Sebastian {BIO 1786077 <GO>}

Okay. And finally, my last question concerns the acquisitions. What type of acquisitions do you see available in this market?

A - Renato Jerusalmi {BIO 19910567 <GO>}

Well, acquisitions are our focus, so we are very dedicated to acquisitions. We are participating in some assets that are being sold by Petrobras and we're also looking at some bilateral negotiation processes involving other types of assets. At this point, I cannot give you more information on that, so what I can tell you is that we are moving

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ahead really well. As you know, M&A processes are difficult to predict, but we believe that we are advancing in a very attractive acquisition for the company.

Operator

(Operator Instructions) This concludes today's question-and-answer session. I would like to invite Mr. Jerusalmi to proceed with his closing remarks.

A - Renato Jerusalmi {BIO 19910567 <GO>}

Well, ladies and gentlemen, thank you very much for joining us on this conference call. We remain available if you have further questions and I hope to have you join us for the third quarter results conference call.

Operator

This concludes PetroRio's conference call for today. Thank you very much for your participation and have a good day.

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