

Q3 2014 Earnings Call

Company Participants

- Milton Romeu Franke, Chief Executive Officer
- Ricardo Bottas Dourado, Chief Financial Officer

Other Participants

- Andre Sobreira, Analyst

Presentation

Operator

Good morning, ladies and gentlemen, thank you for standing by. Welcome to the Audio Conference Call for the Third Quarter 2014 Results of HRT. At this time, all participants are in listen-only mode. Later, we'll conduct a question-and-answer session for analysts and investors, and further instructions to participate will be given at that time. (Operator Instructions)

This event is also being broadcast simultaneously over the Internet and may be accessed through HRT's Investor Relations website at www.hrt.com.br/ir by clicking on the banner 3Q13 Earnings Release. As a reminder, this conference is being recorded and the presentation will be available to download shortly after it has ended also through HRT's Investor Relations website.

Before proceeding, let me mention that forward-looking statements that might be made during this conference call relative to the company's business perspective, projections and operating and financial goals are based on the beliefs and assumptions of HRT's management and on information currently available to the company. Forward-looking statements are not a guarantee of success and 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 HRT and could cause results to differ materially from those expressed in such forward-looking statements. This conference call is attended by Mr. Milton Franke, Ricardo Bottas and Eduardo Larangeira Jacome.

I would now like to turn the conference over to Mr. Milton Franke, CEO of HRT. Please, go ahead, Sir.

Milton Romeu Franke {BIO 17311636 <GO>}

Ladies and gentlemen, good morning, and thank you for joining us today. I am very sorry for this delay. It was due to technical problems. But it is with great pleasure that on behalf of HRT, I am here with the company officers to start this third quarter 2014 earnings conference call.

Please go to slide two, so we can start. Please be mindful of slide number two, which contains a disclaimer to investors regarding forward-looking statements. Please read this disclaimer carefully.

Please turn to slide three, where we see the highlights for the third quarter of 2014. Here I would like to highlight that the third quarter of 2014 continued to confirm our expectations regarding the results of our first acquisition of production assets i.e., Polvo Field officially added to the company's portfolio in January of 2014. As we will share in the final part of this conference call, HRT revenues totaled more than R\$400 million in the first nine months of 2014. And EBITDA was R\$95 million. Accumulated production year-to-date at Polvo Field reached 2.7 million barrels of oil, with an average output of 10,000 barrels per day.

Operating efficiency, which measures time and production for the field was 98%, a number that makes us very proud. No work over stoppages that were performed in this third quarter. With consistent to production behavior, considering only the current producing wells enabled us to extend our expectations regarding the economic lifespan of the field to 2017. And this does not include the investment that HRT intends to make to the development of undeveloped 1P reserves and further 2P reserves that we have in this field. During this period of operating stability, we also intervened two performance assessment, one the Ibama, the Brazilian environmental agency which monitored an emergency drill that we conducted, and another by ANP, the Brazilian oil agency which reviewed our management first assets with a focus on the operation of our platform and drilling rig. ANP identified opportunities for improvement, which were promptly observed by HRT and have contributed significantly to increase our operating efficiency and to manage the risk of our operation.

On November 10th, we submitted to the Ministry of Mines and Energy of Namibia, the documentation requesting to extend for another three years with exploration terms of our four petroleum exploration licenses held. We're also completed the divestment of IPEX, which have been continuously generating negative results for the company. We received in this quarter, R\$7.2 million for the factors.

Finally, it is important to highlight the first issuance of the debentures convertible into shares totaling R\$19 million. We need to provide the part of the necessary funds to faster the company's development and growth. These funds will be used exclusively for the acquisition of production assets and for investments to develop all the fields.

Please go to slide four. On slide four, we show you the volume produced for Polvo production in the company's operating efficiency. We had previously mentioned that Polvo has been a turning point for HRT. On slide four, we show specifically the operating performance of Polvo field, but it is important to point out that this quarter's production

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behavior compared to 2013. Well, we can clearly see a change in the natural production downward trend standing primarily from a high operating efficiency and some reduction in the number of workovers in producing wells.

The operation led by HRT since the beginning of 2014 compared to the pattern seen last year, showed a 12% increase in output compared to estimates for this period of 2013 and showed a 14% reduction in the total cost for the Polvo operation. These are extremely important outcome in the (inaudible) of lower oil prices. Additionally, it is public knowledge that Polvo Field to present a number of opportunities for output increase both through the recompletion of existing producing wells and through the drilling of new wells. Right now, HRT is invested in the recovery of this drilling rig on board over a platform, which will take about three months in preparation for a workover in a well that has been temporarily shut-in and for the drilling of two wells to develop 1P and 2P reserves.

We believe that these activities will be possible to increase production and extend the lifespan of the field by around three years. The initiatives to reduce the operating costs have been implemented and we working to identify further synergies to bring about additional cost reductions, which were controlled substantially to extend the economic lifespan of the fields.

I will now turn the conference over to our CFO, Ricardo Bottas, who will walk you through our financials for the period.

Ricardo Bottas Dourado

Thank you, Milton. Good morning, everyone. In the third quarter, HRT exported its first shipment of oil with a volume of 577,000 barrels, and a final price of approximately \$88 per barrel. Despite the reason to decline in oil prices, HRT has maintained an average final price for exports in 2014 of approximately \$96 per barrel, considering the first shipments of HRT in 2014. The 14.7% [ph] price reduction of this first shipment, vis-a-vis the last shipment was partly offset by the exchange rate effect with the dollar appreciating 7.5%.

We are closely following oil prices in the international markets as well as the exchange rate variation, which has been positive for HRT. We are also working on production costs, and managing finally these effects on the company's results. In 2014, HRT posted direct production costs, net of amortization which basically have an effect on the amortization of intangible assets of Polvo Field. And including royalties for the direct production cost was about \$65 per barrel considering that this production of 10,000 barrels in this quarter.

Next shipment is expected for the end of December, with a volume of 500,000 barrels considering the 60% related to HRT's stake, not considering any additional volume that might be added to HRT's portfolio after 40% stake of Maersk assignment (inaudible) approved by

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On slide six, in the third quarter of 2014, HRT posted a net revenue of R\$127 million due to the previously mentioned shipment of 577,000 barrels in the end of the quarter. Accumulating in the nine months of the year, revenues amounted to R\$405 million in sales of 1.8 million barrels of oil, direct production costs, COGS, incurred costs related with suppliers, HRT personnel inventories, et cetera, linked with the volume of oil produced and sold by HRT.

Amortization costs, as I mentioned before, we represent the amortization of values posted as intangible assets, related to the assignment and abandonment costs of Polvo Field during -- considering the less spend of proven and developed reserves. Royalty costs corresponds to about 10% charges in volumes produced in the period. I'd like to remind you that in this period, HRT produced in a 60% stake approximately 1.6 million barrels. The consolidated gross income represents the key results of the production operation of Polvo Field, net of corporate expenses G&A and geology and geophysics expenses, G&G incurred in Solimoes in Namibia and the costs to preserve these two assets.

If we were to exclude amortization costs from gross profit, amortization associated through amortization of intangible assets with the deployment of Polvo assignment in provision for abandonment, we would see a gross margin over revenue of 43% both in the third quarter and year-to-date. (inaudible) reduction in consolidated operating expenses 53% down in the third quarter and 71% down year-to-date when compared with the same periods of 2013.

Moreover, it is important to highlight that in these two periods of last year, we posted dry well right off, an impairment provision, not recorded in 2014 and also in 2013, there were also exploratory activities going on in Namibia and the demobilization in Solimoes. Personnel expenses were down 42% as a result of the significant 34% reduction in the company's headcount. There was a reduction in the average compensation per employee as well. So on the results of these initiatives to reduce costs and expenses primarily costs is coming from the maintenance of our structure in Solimoes, G&A, expenses coupled with third-party services for 30% reduction approximately.

It is important to mention, as I mentioned before, in this period of comparison, in 2013, we had the exploration campaigns underway in Solimoes in Namibia. In 2014, all of the maintenance costs were reduced, maybe costs in 2014 are allocated directly in the 2014 results, because there are no drilling activity is going on. No in Solimoes, and no in Namibia.

EBITDA in the third quarter of 2014 totaled R\$24 million and R\$95 million in the first nine months of the year with EBITDA margins up 19% and 23% respectively. The financial result in the third quarter, showed a high positive results given the exchange rates variation in the period. Year-to-date the 2014 financial results was lower than that of the same period of last year given the higher cash balance in 2013, before we entered the exploration campaign in Namibia, and confidentially revenues from financial investments in 2013 which were higher than in terms of '14.

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The most important to remember, they reposted interest expenses in the first quarter of 2013 resulting from the loan facility taken for the acquisition of Polvo fully repaid in this same period. Vis-a-vis, our consolidated results analysis, the company posted net income of approximately R\$10 million in the third quarter compared with a loss of 724 million quarter-on-quarter, in a net income in the nine months of 2014 up R\$21 million vis-a-vis loss of R\$1.4 billion in the first nine months of 2013.

Moving to slide seven, we'll see the analysis of our cash position. It is important to emphasize our cash generation of 182 million in the first nine months even considering the equipments related to maintenance and demobilization of activities in Solimoes and Namibia amounting to around R\$91 million in this period. These investments has been gradually declining in recent quarters and may be dramatically reduced as of the fourth quarter of 2014. And next year with the transfer of our Solimoes operation throughout next as well as with a new extended trends of our licenses in Namibia.

Our cash position in the end of the third quarter was R\$404 million. Our liquidity growing 160% as compared with the beginning of the period. Here we highlight that 100% of the funds are available, in that 98% of the cash is in US dollars considering the origins, it came from oil experts.

I'll turn the floor back to our CEO, Milton Franke.

Milton Romeu Franke {BIO 17311636 <GO>}

Thank you, Ricardo. In the next slide, ladies and gentlemen, I'll reiterate our message of optimism that has been driving us since the second half of 2013 and more strongly in 2014, since we closed the acquisition of Polvo Field and begin HRT operatorship and oil production in the offshore compensation. And after having completed, the biggest exploration campaign of both in Solimoes with 11 wells drilled and Namibia with three offshore deepwater wells. Negotiations with Rosneft and our farm down assets in Namibia continue with a positive outlook in both cases.

We continue relentlessly in the implementation of measures to reduce cost and we are planning rig openings and well drillings increase output exposal. We are working and acquiring new production assets as well to be added to our current portfolio. HRT now restructured as prepared and on its way to grow. Results have been consistent, our cash position expand, cost control and reductions are no longer our projects, but rather has become part of the company's philosophy.

Results of our shareholders therefore, it's crucial to support those growth in the company's management remains focused in order to develop Polvo Field and to seek new assets to increase our results or the reproductions and ultimately our cash generation.

We thank you for your attention and remain available to answer your questions. Thank you very much.

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Questions And Answers

Operator

Ladies and gentlemen, we're starting now the question-and-answer session for analysts and investors. (Operator Instructions) Our first question is from Andre Sobreira from Credit Suisse.

Q - Andre Sobreira {BIO 16337358 <GO>}

Good morning, everyone. Good morning, Milton and Ricardo. I have three questions if I may. Firstly, I would like to hear more from you about convertible debentures. Secondly, I would also know how do you see the strategy in the lower oil environment? And thirdly, could you also may comment on Polvo unitization processes with (inaudible) is this significant or not, is it something that should be on our RADAR? Thanks you.

A - Milton Romeu Franke {BIO 17311636 <GO>}

Andre, Ricardo is going to answer the first question and then I will come back for questions number two and three.

A - Ricardo Bottas Dourado

Andre, how are you? Thank you for your questions. Your question about the debentures, it came from planning within our announcement -- our previous announcement as a plan to develop Polvo Field, we had already mentioned this before, it is an investment plan amounting to \$70 million to \$75 million, which includes the retrofit of the rates and also the drilling works of another two wells in underdeveloped 1P reserves and 2P reserves. We also had a transaction and we started to the transaction and now, we are waiting for the ANP process to acquire 40% of Maersk. The amount of this transaction will be announced at the end of the process and we're still into production asset. We had already mentioned this to the market.

With a clear focus on Campos Basin due to the potential increase in synergy with Polvo Field, effectively there is focus with this for assets at Campos Basin, which doesn't mean that we are not paying keen attention to other locations still, but we do have this referring. This debenture was designed by management and it is about 30 to 60 days for us to have a better understanding of the model that would generate this potential interest by our shareholders, because it was designed for the current shareholders of the base of debenture.

In order to fund at our capital need, however, this is fully related in line to the development of Polvo Field and also to fund partially the equity part, which will be necessary for us to work on the new acquisitions.

So when it comes to use of proceeds to this transaction phase of HRT and the summary of the transaction is already public, it is contexture with debenture or a five-year turn, 90% CDI compensation, but there is a discount of 20% when it comes to averages once the reference state of the approval of the debentures, vis-a-vis 10 previous trading sessions.

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And the average of 10 prior to the date in which the shareholders are investing the debentures decide to confirm the lowest amount we've applied. So there is an increase due to discount, but on the other hand, it also shows the needs to be an investor of that close to company on the long-term because it also brings some conversion at 12 months lack, by enlarge that debenture condition Andre.

Thank you. I'll give the floor to Milton, so he can talk about the strategy and our view with the Brent Price and also to talk about the discussion of unitization potentially, unitization between Polvo and Maersk.

A - Milton Romeu Franke {BIO 17311636 <GO>}

Andre, answering about HRT strategy. I believe it is very clear that the company is very tight and diligent in order to lower our exposure, exploration asset and also to expand our exposure to production assets. We all know, the oil industry has a lot of professionals involved, so the first half HRT after Polvo acquisition, we set up a commercial management at HRT and we also have a team of professionals to work with the managers.

And we also began to work at alternative for future acquisitions particularly in production of Martelo Field which are already in production. And we pay keen attention and monitor other things, for instance, fast and also improved performance in the fields we currently have. Right now, we have Polvo and performance when it comes to production measures by a non-KPI, which is operating efficiency in production, our levels already very high, about 98% over this quarter, weigh above what we have posted and the marketing general has been posting.

On the other hand, we also lowering our costs, we always visiting agreement, trying to streamline everything we can. And results have been quite positive in this part of the program, cutting down cost, optimizing production and output, these are the two key elements of these equation that allows you to deliver oil for competitive prices.

Naturally, we also follow the behavior of oil prices in the International and foreign markets. Based on our experience and from information we have, our cost might be even lower than we already achieved.

And before our challenges, we also had other modalities of oil production in Brazil and worldwide, that we've suffered before. We'll come to know, competitive prices before the arrival to us. So our (inaudible) is that oil prices will remain in this range between \$80 to \$90, rather than continuously going down. So we feel comfortable with that delivering oil, as we are producing right now is still good business in Brazil.

With regard to the unitization of Tubarao Martelo field, I don't have much to say right now, all I can have you is that now we are in a phase of gathering informations and also precisely understand what is happening when it comes to the ANP framework and also OTC, which is the production part of Tubarao Martelo field, so that later on, we can expect our opinion and tackle the necessary measures. But as we see, this is the moment to study, to analyze and to gather data so that later, we can have a smooth and strong competition. Thank you, Andre.

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Q - Andre Sobreira {BIO 16337358 <GO>}

Thank you, Milton.

Operator

(Operator Instructions) This concludes the question-and-answer session. I would like to give the floor back to Mr. Milton Franke for the closing remarks. Please go ahead sir.

A - Milton Romeu Franke {BIO 17311636 <GO>}

Dear friends, who are having some grizzling in radio, and also save some time to listen to HRT. We thank you all for your attendance. We are convinced that we are on the right track to build the new HRT. We'll be closing this year at a new office. (inaudible) the whole team concentrated into single floor in a new building. We have very aggressive plans, when it comes to the new future of HRT. And we keep on searching for cooperation and your attention. Thank you very much. Best regards.

Operator

This concludes HRT earnings conference call. Thank you all for joining us. Have a good day.

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