

Q3 2013 Earnings Call

Company Participants

- Milton Franke, CEO of HRT Participacoes
- Ricardo Bottas, CFO and IRO HRT

Other Participants

- Andre Sobreira, Analyst
- Angisenta Polunga, Analyst
- Caio Carvalhal, Analyst
- Gustavo Gattass, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. welcome to the audio conference call for the Third Quarter 2013 results of HRT. (Operator Instructions) As a reminder, this conference is being recorded and the presentation will be available to download shortly, also through HRT's Investor Relations website.

Before proceeding, let me mention that forward-looking statements are based on the beliefs and assumptions of HRT's Management and on information currently available to the Company. They involve risks, uncertainties and assumptions as they are related 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.

The teleconference is attended by Mr. Milton Franke, Mr. Ricardo Bottas and Mr. Nilo Azambuja.

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

Milton Franke {BIO 17311636 <GO>}

Ladies and gentlemen. good morning and thank you for joining HRT's Third Quarter earnings conference call. It is with great pleasure that on behalf of HRT I am here with HRT

officers to present the Third Quarter results and highlight the main achievements of the Company in the last quarter.

Next slide. This is our disclaimer. Please be advised that some forward-looking statements contained in our presentation, they have to be taken with cautionary statements -- as cautionary statements.

Next slide. We start this quarter presentation with this expression rightsizing HRT, meaning that some of our activities have to be downsized like the case of Solimoes, while others have to be upsized, which is the case of our Polvo project. However, HRT downsizing has to follow a general guideline of value creation, meaning that critical staff and assets have to be retained in the Company.

On this slide we have five points that I will elaborate further on the next slide namely downsizing to a sustainable value creating platform. Number two is Solimoes, considering our material gas discoveries we have developed an optimized work plan. Third, Polvo closing is imminent; operations team in place with material cash flow, growth opportunities. Number four is progress with non-core asset divestments, focus on cost optimization and cash preservation.

If we are able to follow these five points, we believe that HRT will be building flexibility and options for 2014 and beyond so that we continue our life in the oil and gas sector.

Next slide, please. Talking about the first point, the point that was downsizing to a sustainable value creating platform. We are working on, number one, on portfolio diversification. We want to increase our participation in production assets. Polvo is our first and potential new venture in oil and gas, but we also want to reduce our participation in the exploration assets. We have this two very large and high-risk assets in exploration, and we are hardly working on the farm-down processes for Solimoes and Namibia.

With this we will reduce our risk on the geological and operational and financial, and we will start to have some income. We are again building a new and simpler organization. We are adjusting our management team. We previously had five officers, now we have only three. And we reduced our total compensation with management.

We also reduced our headcount from 600 in 2011, we are today around 150 in 2013. We are adjusting our headquarters structure. We had previously up to six floors in our main offices, now we are reducing to only two floors. And we are adjusting our processes and, for example, the by-laws that have some adjustments proposed for the next general assembly.

At the same time we call your attention that we have still in our Company important assets, not only the gas discoveries in the Solimoes, I will come back to this a little bit later, but also in Namibia. This Windgat non-commercial oil discovery is the first oil discovery in Namibia and we understand that our Namibian assets have value. We have some cash flow income forecasted for Polvo. We have some relevant tax losses in Brazil

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and Namibia. And we have a technical team with strong knowledge about our assets and about the Brazilian international basin.

It is clear that if we downsize and want to create value we have to observe certain guidelines. We have to keep our assets, and this includes our staff, and still we have to come to a smaller and less expensive organization. I want to conclude this slide saying that we have during this time our teams in Rio and in HRT America and Canada working to extract value from the assets we have in our portfolio.

We are working on the technical data. This is not only the case on the gas discoveries in the Solimoes, but also the case in the wells we have drilled in Namibia with this non-commercial discovery in -- oil discovery in Windgat. And we have already started to plan and design our first well in the Polvo field.

If I go to the next slide about Solimoes, and we have included in this presentation a table with some numbers about our gas discoveries and some previous wells that were drilled. And here we're using the wells we have in these fixed blocks that are listed on the left side and the estimated flow rates we tested in wells and the volumes we have mapped, you come to recoverable volumes in production numbers in cubic meters per day over 4.5 -- around 4.5 million cubic meters per day.

This is a mean estimate based on mapping done in-house by HRT. And this is just to give you a flavor of what is still ongoing inside HRT preparing the information for the farm-down in the Solimoes.

We have worked in the Solimoes on a program and on the commitments we have to develop a plan, what we call a prudent plan for 2014. This was discussed with our partner. This implementation of this plan will implement a strong cost reduction in this basin and we are preparing to move forward in our gas monetization projects.

With Rosneft we have observed progress over the quarter in our discussions. And at this time we say that we are looking for eventually farm-down our assets in the Solimoes for further potential strategic partners. We are talking to some of them. And I want to conclude this slide mentioning that we received the first payment recently from Rosneft, around BRL36 million cash cost, and we are having still discussions and advancing in our discussions with Rosneft.

To conclude, we believe that we have a clear commitment to work together in the Solimoes. And we believe that our negotiations will come -- will lead us to a positive outcome for the both companies in the next weeks or months.

If I pass to the next slide, with respect where we talk a little bit about Polvo. And here I want to really stress that Polvo is opening a new opportunity, a new business opportunity for HRT. We have the operations team in place, we are evaluating material cash flows from this field and growth opportunities. We have a plan, proposal. And we are very happy with this opportunity and looking forward to other production opportunities.

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The Polvo transition process with BP is progressing as planned. And here I want to praise the good work plan and climate developed by BP with HRT. And our strategy in Polvo includes to work on the off-sites. There is still a fair amount of 1P undeveloped reserves that we want to develop and produce as well as 2P reserves.

Our first development well in Polvo is planned for 2014, second-half of the year, closer to mid of 2014 than to the second part of 2014. We have held joint meetings with our partners and suppliers. We are evaluating cost to introduce cost reductions and we have a firm strategic interest in asset confirming value. All results generated by Polvo to BP starting from January 1, 2013, will be accrued to HRT to a reduction in the purchase price. I think this is mostly known by our shareholders, but it's important to stress this at this point.

Just to conclude my speech about Polvo, HRT's strategy for this field will work not only on the upsides, but we will try to observe operational efficiency, cost reductions, but still complying with strict -- with strict compliance with the operational safety measures introduced by BP in their operation in this field.

If we go to the next slide, this slide still in rightsizing HRT deals with our divestments, non-core asset divestments. And here I have two words to say; one is this is really part of a strategy of this (presentation) to HRT management. The same strategy we use for these non-core asset divestments, we keep the same reasoning with respect to HRT's staff. All non-core functions are being outsourced, while we are really working to repaying all the core functions and the core people for HRT.

The sale of Air Amazonia was the first step. We have completely executed in this divestment plan. We also divested one of our airplanes and the other two are already negotiated. We believe that we will have a sale of the rigs executed over the next months with some candidates we are discussing it. We are on a positive track in this respect. We have candidates for IPEX and we are following the same line.

But we still have important steps to work on this direction not to -- I still have to mention because it's not important in money pouring into HRT, but it is as a strategy of the Company, we have sold our cars and many other items, smaller items that were a source of cost and in this process of divestment.

We pass with this to the next slide. And this will be the last slide on my short presentation. This time our presentation will be shorter than the ones we had in pervious calls. And this was a result of feedback we received from you guys that fit into our calls to give you a little bit more time for questions and answers after we finish the presentation.

And this last slide is our focus on cost optimization and cash preservation. I think it has been many times advertised and talked about by our officers that cash control, liquidity and fixed cost reductions are the main focus of HRT's Management.

This was, the same focus was used in renegotiating the Solimoes main contracts in reduction of G&A and corporate costs and to have -- to make able that we could conclude

like we did our Namibian operations and that we still have resources available to continue our life in the Company.

We adjusted our work plans for Solimoes and Namibia. They have been working with our partners in this respect, and we will come back to our investors and our partners with changes in our work plans if they may occur in the future.

With respect to additional sources of capital, we don't have only new funds from this divestment plan. We mentioned the aircrafts, the rigs and the labs. But we are also working on farm-downs to reduce our exposure in the Solimoes and Namibia.

In the Solimoes we have our databank concluded and we are talking to companies and we are working on to reduce our working interest in these 19 blocks we have in the basin. The same thing we are doing for Polvo, for Namibia.

In the long-term debt may be raised for new wells to be built in Polvo and we have this group in our -- managed by our Board where we are looking for M&A transactions, and new business opportunities for HRT as a whole, as a Company, not only with respect to our assets, but when we really look for our Company as a whole.

To conclude, this so-called inorganic option for the future of HRT, we are under discussions with several organizations and institutions, and we believe that this could bring some positive outcomes for HRT.

I will now pass the floor to Ricardo Bottas, our CFO, for the presentation of HRT financials for this three quarter of 2013. Ricardo, you have to run.

Ricardo Bottas {BIO 18071813 <GO>}

Thank you, Milton. Good morning, everyone. In the slide 9, the Company ended the Third Quarter with losses of BRL724 million due to the write-off of costs from dry and noncommercial wells. Additionally, the Company performed an impairment test after the conclusion of the 2013 exploratory campaigns where the amounts adjusted in the intangible assets held the subscription bonus. The total amount of the adjustments in Third Quarter was BRL750 million.

Lower financial results are mainly due to the reduction of the cash balance as well as the effect of the financial expenditures from the loan for the acquisition of the Polvo field. Note that in the Second Quarter there was a nonrecurring income from foreign exchange variation over the cash balance abroad -- held abroad due to depreciation of the US dollar against the Brazilian real by 10% in that period.

It's very important to highlight the results of cost reduction initiatives where operating expenses were reduced by 39% compared with the Second Quarter of 2013 and by 59% when compared with the Third Quarter of 2012.

The next slide, 10, presents the cash flow with change in the cash balance, with emphasis on recurring and nonrecurring disbursement. Inflow from revenues, most of them financial revenues; inflows from receivables, the cash cost from Galp; and the loan from the Polvo acquisition.

In the table below you can see the breakdown of the disbursement by projects for nine months. The exploratory campaign costs around BRL688 million refers to gross disbursements for exploration activities, drilling, logistics allocated to intangible assets plus the cost of personnel expenses, third-party services and other expenses allocated to the income statement.

The slide 11, as shown in the previous slide, the Company ended the Third Quarter with a total cash of BRL608 million being 25% lower than the position of the previous quarter, primarily due to the Namibian offshore campaign.

The chart also presents the breakdown of the Company's liquidity considering the cash collaterals given as guarantee to rent the rig and drilling related service hired to the Namibia exploration campaign. And the funds in escrow account to support the deal with BP for the acquisition of Polvo.

We have some important subsequent events to date. In October, HRT agreed with Transocean and Schlumberger to anticipate the releasing of the cash collateral, \$70 million, which was restricted under a standby letter of credit to fulfill the remaining payments concerning the Namibia exploration program. Due to that, in the Fourth Quarter, Transocean and Schlumberger have released its \$40 million and \$20 million respectively and the remaining amount, \$10 million, will be released by the end of November 2013.

In Solimoes, as Milton mentioned, Rosneft's settled part of the due amount of cash cost and BRL36 million was received by HRT. Also in October 15th, HRT Oil and Gas paid the first loan instalment due to Credit Suisse regarding the Polvo acquisition facility in the amount of \$14 million.

The deal with BP to buy 6% working interest on our Polvo field, the platform and the rig has a reference date of January 1, 2013, and since then our results would be accounted reducing the purchase price originally at \$135 million.

It's important to remember that these amounts, 10% was paid when we signed the contract in May 2013, leaving \$121.5 million out of which \$95 million was deposited in guarantees in an escrow account. When the closing occurs after ANP's approval, the unpaid balance to BP will be divested from the results of the field. And the balance payable will be accomplished with the funds held in escrow. The difference will be returned to the liquidity of HRT plus the ROE inventory assets at the FPSO.

Such events combined with the new cash flow from Polvo, the receipt of outstanding cash costs, new inflows from assets divestments and savings from the cost reduction initiatives will improve our liquidity ratios.

Thank you. And now I hand you back to our CFO -- CEO, Milton Franke, for his final remarks.

Milton Franke {BIO 17311636 <GO>}

Thank you, Ricardo. If we go to our last slide, this reinventing HRT may look very optimistic expression from our part, but this is really the mood over the last week's work inside HRT. HRT is becoming a different Company, certainly smaller, simpler and more focused. Our main assets in the Solimoes and Namibia are going through important reevaluations of their potentials and we are in search for new partners.

Polvo brought into HRT new employees, new goals, and the transition work with BP has also helped us a lot. In respect to HRT financials, the cash forecast for the next 12 months is comfortable considering cash flows from Polvo, cost reductions, asset sales, and cash from our partners. Cash plans for the end of the year is around BRL200 million.

In conclusion, HRT is reinventing itself to come out with a more balanced portfolio, with a lower cost and with a new vision for the future. To conclude my remarks, a word about the call for a special shareholders' meeting in January 2014 that just came out over the last days. If you read the agenda of the call, you will see that several important steps will be taken in that assembly. I call therefore all of you to be present and to participate in the future of HRT. I thank you all for listening to this call.

Questions And Answers

Operator

(Operator Instructions) Caio Carvalho, JPMorgan.

Q - Caio Carvalho {BIO 16605563 <GO>}

I have two questions here; one of them is a little (weaker). I just wanted to understand about the relations with Rosneft, what is -- if there is any -- there is significant remaining value to be required from them. And as far as you can go, I understand there's certain limitation on what you can disclose, why this position (inaudible) is that, let's say, normal under -- normal understanding of the term or can we expect these to continue going forward. So that's my first question.

The second question refers to the impairment. In the page 10 of the release, you provided a very detailed, on the Namibia especially, about the subscription bonus, the goodwill and the impairment. We can see that there is still about BRL1.3 billion that's still related to the assets that you have on those blocks. But it raised my attention particularly when it refers to the P&L (sic) 24. That is the one that represents 80%, 90% of this value. And when we look in the previous stages we see that this is one of the lowest volume that we have in terms of oil.

So my question would be can we expect -- I mean, is it just a matter of time to have this impaired? And what is the timing you expect to have it on the financial statement, by Fourth Quarter, or do you expect to actually do it over 2014, or moreover you expect to only do this when you have a higher visibility of what would be the remaining operational activities on the block? And these are my questions. Thank you.

A - Milton Franke {BIO 17311636 <GO>}

Caio. Good morning and thank you for being with us in this call. With respect to the first of your question, you probably remember that the company that was the partner with HRT was TNK-BP and that more recently TNK-BP was acquired by Rosneft. And Rosneft, this transition from TNK-BP to Rosneft was really a little bit, took more time than we expected.

But our relations on the technical side were very positive; no big issue. There was and there is an issue with respect to the payment of the cash cost, but the ongoing negotiations, they tell us that we will be coming to an agreement and we are very positive with respect to this, that in the short future we will come to agreement in respect to not only to how to proceed in the Solimoes but with respect to any payment that is still outstanding.

For the second question I ask Ricardo to help me.

A - Ricardo Bottas {BIO 18071813 <GO>}

Caio, thank you for your question. That difference because as you could see in the original balance of the subscription bonus, when we had that stock swap with UNX in the 2011, the last part of the subscription bonus comes from the PEL 24. So the most part of the amount in that transaction comes from the PEL 24, okay?

Q - Caio Carvalho {BIO 16605563 <GO>}

Okay, understand. And I'm not sure if it's possible to disclose but the time to have these on the financial statement going forward, is this -- can we expect more in the Fourth Quarter and maybe 2014, or you would expect some operational development to decide what to do with this impaired volume or this potentially impairable volume?

A - Ricardo Bottas {BIO 18071813 <GO>}

Caio, we are very confident that these current figures are okay with our current view on Namibia assets. And we are planning to have an updated (VNM) report by the First Quarter of 2014, and then we could reevaluate these impairment (inaudible).

Q - Caio Carvalho {BIO 16605563 <GO>}

Okay. Thank you.

Operator

Andre Sobreira, Credit Suisse.

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Q - Andre Sobreira {BIO 16337358 <GO>}

I have a couple of questions surrounding cash. The first one is a little bit more direct and to ask if you can give us your estimates of how much do you think you have cash by, you will end the year with cash in your balance sheet excluding any further divestments.

The second is really to confirm the BRL156 million that you have in letter of credits for Transocean and Schlumberger, you expect all of that to come back to HRT as unrestricted cash. Just to check if that is correct?

And the third one is on the escrow account with BP, you have BRL211 million. If you paid (\$135 million for the (inaudible) it is looking to me that the cash generation from Polvo so far this year is very, very low, much lower than what you had expected. Has something happened there? How is production going? And we knew it came down from 13 kpd to 8 kpd, but I just wanted to see what the cash generation is like and if you are having a correct assessment over here?

And finally, just to, how much do you estimate are your future commitments in the Solimoes in monetary terms? And if you decide not to honor those commitments, how should we think about the treatment with (B&P)? Do you have to pay any fees and how large would that be? Thank you.

A - Ricardo Bottas {BIO 18071813 <GO>}

Thank you, Andre. About your first question, as Milton mentioned in his last slide, our cash forecast for year-end, it's BRL200 million.

In terms of letter of credits for Namibia, we still have from that \$70 million \$62 million to be paid to Transocean and Schlumberger. So we will receive back something around \$8 million to \$10 million.

About the view with BP, it's important just to understand that cash restricted is related to the escrow to cover and to work as a guarantee for the deal. But \$135 million will be reduced with the results from the asset since January 1st up to closing. And these adjustments were not included in our financial statement up to now.

And your last question about our commitments in Solimoes, we have for the blocks we have an extension for four years, guarantees between BRL7 million and BRL14 million, and the commitment to drill one well per block. On average, it's almost BRL9 million in terms of commitment.

Q - Andre Sobreira {BIO 16337358 <GO>}

Not BRL9 million in total for all the blocks?

A - Milton Franke {BIO 17311636 <GO>}

No, no, no, on average per block.

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Q - Andre Sobreira {BIO 16337358 <GO>}

Okay. Thank you very much for the help.

Operator

Gustavo Gattass, BTG Pactual.

Q - Gustavo Gattass {BIO 1702868 <GO>}

I had a couple of questions that I just wanted to touch on. The first one with regards to the Polvo field, there are a number of mentions in the press release about contracts that have been transferred or renewed. I just wanted to know if you guys could give us some idea of whether or not the FPSO rental contract had already been extended. That would be my first one.

The second thing that I just wanted to check with you guys is how should we understand the HRT and Rosneft settlement? Was that basically they settled the first cash call or did they settle part of the first cash call, or? Is it comparable? Are we looking at BRL35 million compared to the BRL80 million or is it BRL35 million compared to roughly, I don't know, I don't remember what it was, I think it was roughly BRL57 million in the previous quarter or something like that, so that's the second question.

And just the third question, just for the ease of understanding something that you guys put on the press release as well, if I go to the page 19, on your cash flow there is a BRL20 million charge for expenses with the issuance of shares. And I just didn't understand that. I just want to know what it relates to.

A - Milton Franke {BIO 17311636 <GO>}

Gustavo, thanks for coming to our call. With respect to the first question, with respect to Polvo field, yes, the FPSO contract has been renovated.

With respect to this settlement with Rosneft, they paid the first two cash calls and the number we have used the first two cash calls, and there is still some outstanding payments to be done. But we are discussing how and when this will happen. And we are very positive that this will not be a problem in the future. With respect to your questions from page 19, Ricardo will help me with the answer.

A - Ricardo Bottas {BIO 18071813 <GO>}

Gustavo, these expenses in cash flow and our income statement as well comes from the adjustment in accordance with international accounting standards. And the difference between the acquisition cost and market value should be recognized on the grant date. So whether or not the options have been exercised by the employees (inaudible) you should recognize the expenses, and this happened in January this year.

Q - Gustavo Gattass {BIO 1702868 <GO>}

Okay, I'll have a chat with you, Ricardo, a little bit later on that. Maybe I'm looking at the table wrong.

But Milton, if I could just have one follow-up on Polvo, can you share with us for how long the contract was extended, and whether or not it is the same conditions, or did something change?

A - Milton Franke {BIO 17311636 <GO>}

I cannot give you the timeframe of this contract, but it covers the expected production time we have for the field.

Q - Gustavo Gattass {BIO 1702868 <GO>}

Okay. Thank you, guys.

Operator

(Angisenta Polunga), Bank of America.

Q - Angisenta Polunga

We can observe that your corporate expenses, your SG&A on this quarter, they added up to around BRL70 million. You guys did a good job on reducing those. What can we expect in terms of, or what's your target, corporate expenses looking forward in terms of -- in quarterly terms or annual terms? Thanks.

A - Ricardo Bottas {BIO 18071813 <GO>}

Thank you, Angi. We cannot disclose our forecast in terms of the results for the next year. But I think, yes, it's important just to take into consideration that in these small amounts for this quarter we still have some termination expenses when we have these layoffs. So our expectation is to keep -- put that level of expenses lower for the next quarters.

Q - Angisenta Polunga

Great, thank you.

Operator

(Operator Instructions) This concludes today's question-and-answer session. I would like to invite Mr. Milton Franke to proceed with his closing statements. Please, sir, go ahead.

A - Milton Franke {BIO 17311636 <GO>}

Dear ladies and gentlemen. I thank you all again for coming to this call. We certainly agree that HRT is passing through challenging times. But measures are being taken by current administration to resolve our challenges.

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And I will come back to our last slide where I concluded saying that HRT is really reinventing itself with a more balanced portfolio, lowered costs, and with a vision that if we adjust our portfolio, if we focus in cost reductions we will have a future. And that's what we expect not only ourselves to believe on, but you, that are our investors, that you believe in HRT and its management.

I thank you very much again, and we will be back in the near future. Bye-bye.

Operator

Thank you. That does conclude the HRT audio conference for today. Thank you very much for your participation, and have a good day.

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