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Bonds of debt

Monday's news that the business-baleful Brazilian president, Dilma Rousseff, had widened her lead in polls leading up to the first round of Brazil's 2014 presidential election on Oct. 5 sent the yields on Petrobras debt shooting higher. Petroleo Brasiliero SA (PETR4 in Sao Paolo, PBR in New York) is the world's most heavily encumbered energy company. Its net debts, in the sum of $110 billion, are ubiquitous. Are they also worrying? "Yes," we will presently get around to concluding.

Debt alone does not condemn the debtor, of course. The trouble with Petrobras is that its capacity to pay has receded almost as fast as its debts have multiplied. In 2007, which happens to be the latest full year in which the company earned positive free cash flow, earnings before interest and taxes covered interest expense by 12.7:1. By the second quarter of 2014, that telltale ratio had slipped to 2.2:1.

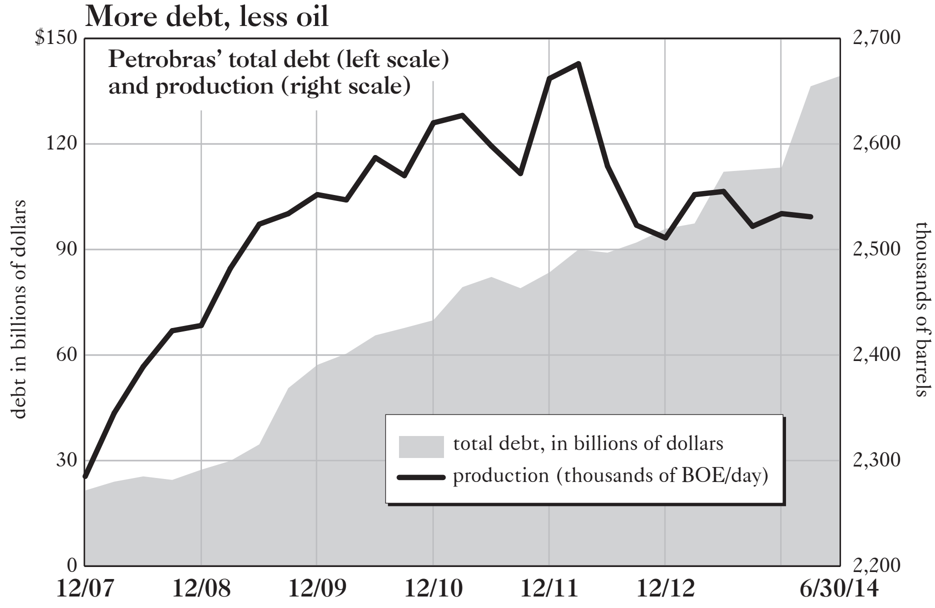
The Petrobras story comes in three parts, like a triptych: Credit, including interest rates; the Chicago caste to Brazilian politics; and liquidity, or lack thereof, in the world's corporate bond market. In preview, we judge that BBB-rated Petrobras is overdue for a downgrade, that Brazilian politics—which have accelerated both the buildup of Petrobras' debt and the build-down of its cash flow—may continue to poison the corporate well and that the illiquid state of the dollar-denominated corporate debt markets will deepen the losses of any who belatedly choose to sell Petrobras notes, bonds or tradable bank debt.

Altogether, the Petrobras story is one for this age of midget interest rates and raging yield hunger. A chronic burner of cash, the company was paying an average blended interest rate of just 5% on June 30. Even after the Monday sell-off, no dollar-denominated Petrobras bond was quoted at a yield of as much as 6.6%. At the 10-year point on the Petrobras yield curve, the quoted rate was 5.57%. What Petrobras ought to be paying to borrow is a question to which there can be no precise answer. Imprecisely, we venture, "more than it's paying now."

Like the U.S. Treasury, Petrobras chooses to borrow in dollars (69% of the company's debt is greenback-denominated, including dollar-linked local debt). Also like the Treasury, Petrobras is flattered by ultra-low dollar interest rates. There the comparison stops, however, as Petrobras can only earn dollars, not print them. Question No. 1 is whether it can earn enough of them. Question No. 1 (*a*)—it almost deserves to be question No. 1—is whether a Petrobras creditor is being adequately compensated for bearing the risk that the company can't earn enough of them.

Such risks seemed remote enough in 2010 when the Petrobras front office—virtually with a wave of its hand—raised $70 billion in the biggest equity offering of all time. This was in the full flush of the news of the discovery of the mighty Libra oil field, one of the great energy finds of the age. Counting up the seven or eight billion barrels of estimated new reserves that Libra

More debt, less oil



source: The Bloomberg, company reports

would contribute to the company's grand total, Petrobras made bold to declare that its production would reach 5.4 million barrels of oil equivalent per day by 2015, so surpassing the output of Exxon-Mobil. "It wasn't in Frankfurt, it wasn't in New York, it was in our Sao Paulo exchange that we carried out the biggest capitalization in the history of capitalism," exulted President Luiz Inacio Lula de Silva at the time of the financing. Putting the taxpayers' money where his mouth was, Lula boosted the Brazilian government's stake in Petrobras to 48% from 40%. By 2011, the state's position topped 50%.

The national oil company proceeded to do the government's bidding. To maximize returns for the stockholders? Not the first order of business. The political objectives of Lula's successor, the aforementioned Dilma Rousseff, trumped mere earnings per share. Notably, in the name of controlling domestic inflation, the government directed the Petrobras refining division to sell imported diesel and gasoline at a loss.

Then, too, the government seems not to have been overly punctilious in financial management. In March, the former head of Petrobras' refining division was arrested in connection with an investigation into alleged episodes of money laundering. Paulo Roberto Costa, who has copped to taking a bribe, accused a minister, three state governors, six senators and dozens of congressmen from the incumbent Workers' Party with scrubbing their own dollar bills ("Operation Car Wash," the case has come to be known). It happens, too, that Rousseff was chairman of Petrobras when, in 2006, the company bought a refinery in Pasadena, Texas, for a final consideration of $1.2 billion. Of that purchase price, Petrobras has already written off $500 million. In was in the process of buying the refinery that Costa admits to having his palm greased.

Contemplating Rousseff's political prospects, one naturally thinks of her sister in South American anticapitalist politics, Argentine President Cristina Fernandez de Kirchner. The difference between the two is that Fernandez is a lame duck, Rousseff a still quacking one. In Argentina, almost any political change will be for the better, or so we think (*Grant's*, Sept. 5). It's not so cut-and-

Cheap enough?

source: The Bloomberg

dried in Brazil. Possibly, the country's economic management would improve even under a new Rousseff government. Then, again, as Lucas Aristizabal, the Fitch Ratings analyst who covers Petrobras tells colleague Charley Grant, more than the mere normalization of energy policy would be needed to put the company back in the black. A decision to allow the sale of fuel at non-subsidized prices, Aristizabal points out, would generate a boost to free cash flow on the order of $10 billion to $12 billion a year (free cash flow being defined as operating income minus capital expenditures). Petrobras is expected to burn more cash than that both this year and next. In 2013, it combusted $19 billion. Between 2008 and the close of this year, it will have torched some $80 billion.

So it can't be said that the Petrobras creditors have been caught unawares. Operational and financial difficulties have been piling up for years. "The promised riches of the Libra field have been very slow to develop," Grant relates. "Company-wide production averaged 2.4 million barrels of oil equivalent per day at the time of the triumphant 2010 financing. It averaged 2.6 million barrels of oil equivalent in the second quarter of 2014, not quite on track to overtake Exxon-Mobil. Should this figure hold up over the full year, production will have compounded at a rate of just 1.8% since 2007, when it stood at 2.3 million BOE."

The year 2007 marks a great divide for Petrobras, as it does for so many other corporations, governments and individuals. Since the eve of the Lehman collapse, Petrobras' annual capital expenditures have nearly doubled, to $40 billion from $21 billion. In 2007, the company's ratio of total debt to EBITDA was a svelte 0.8:1; now it weighs in at 5.3:1. At the end of 2007, debt accounted for 8.7% of the enterprise value of the firm—that is, to the sum of debt and stock market capitalization minus cash. Today, debt constitutes 64% of enterprise value, the 68% drop in the share price since October 2009 having materially contributed to the leveraging trend. In 2007, there were 68,931 employees. At the close of 2013, there were 86,111. Since 2007, EBITDA has grown at a compound annual rate of all of 1.1%.

To conserve cash, Petrobras eliminated the common dividend in 2012 and 2013 (it resumed payments in May at the rate of 48 cents per American Depository Receipt share). On Jan. 31, it again issued equity, $460 millions' worth, at a per-ADR price of $12.05; the 2010 offering came to market at a price of $34.49 per ADR. Nor has the company neglected the debt markets.

Investors operating in a world of ZIRP and QE were all too happy to lend, especially in the context of an emerging market, indeed, a "BRIC" growth story. At year-end 2007, gross debt on the Petrobras balance sheet footed to $21.9 billion; as of June

30, it stood at $139 billion, of which floating-rate obligations (revolver, term loans and floating-rate bonds) amounted to $68 billion. If the company does no more borrowing in 2014, growth of indebtedness over the seven years will have registered at the compound annual rate of 30%. It would be rash, though, to count Petrobras out of the fourth-quarter borrowing picture. In February, the Petrobras audit committee advised management to reduce debt—to which hint management responded by borrowing $8.5 billion in the next two weeks.

If sell-side estimates compiled by Bloomberg are on the beam, Petrobras will be burning much less cash come 2017; the consensus forecast is $837 million. One marvels at the confidence of the prognosticators. To venture any such prediction, they had to have guessed the oil price and the dollar/real exchange rate. They had to have taken a view on the composition of the next government and of the size of Brazilian energy-price subsidies. How could they know? How can anyone?

"Bondholders seem to share the sell side's optimism, or at least complacency, as do each of the three major rating agencies," Grant remarks. "Anyway, the looming Petrobras debt-maturity schedule has occasioned no scramble for the exits, either from the investors or the agencies. Maturities look manageable in the coming year, more difficult in the out years. Thus, $7.2 billion in principal falls due in 2015, while $12.7 billion matures in 2016, $8.7 billion in 2017 and a whopping $16 billion in 2018. These sums must either be paid or refinanced. As noted, 69% of the Petrobras debt is dollar-pay; 20% is denominated in reais, 8% in euros, 2% in pounds sterling and 1% in yen."

If we remember our Graham and Dodd, bond selection is, or ought to be, a "negative" art. Inasmuch as the upside to buying a bond at par is the return of one's funds with interest, an investor's first priority must be safety. In the high-grade, full-price wing of the bond market, as the masters pointed out, there are no three-baggers.

The equity opportunity is, of course, different. The aforementioned $10-$12 billion in free cash flow improvement from a hypothetical policy normalization would be the sweetest of fodder for the bulls. The major oil deposits haven't disappeared—Petrobras has 13 billion barrels. Oil prices have fallen; they may recover. Besides, Petrobras enjoys a near monopoly on domestic sales in Brazil. If those immense capital outlays finally start to bear fruit, the equity holder may just have bought a turnaround story—for the industry as well as the company—for nine times the 2014 earnings estimate and 7.8 times the 2015 forecast. Add in a 3.4% dividend yield that should improve in the bull scenario, and you can make a case for the stock.

For the bonds? The upside, even for the conscientious fiduciary, comes down to keeping up with the debt indices and climbing the mutual-fund performance rankings. It is the job of *Grant's* to deplore the Fed. It is the job of the professional fixed-income investor to generate income (heaven help them). He or she may therefore browse among the following: Dollar bonds issued by the Mexican state oil firm, Petroleos Mexicanos, rated BBB+ and maturing in 2045, to yield 5.45%; dollar debt of triple-C rated YPF SA, the Argentine oil company, maturing in 2024 to yield 8.29% (the bonds pay an 8.75% coupon and trade at a premium); Gazprom dollar bonds maturing in 2034 to yield 6.9% and Rosneft dollar bonds maturing in 2022 to yield 6.6%; and dollar bonds issued by B-rated Venezuelan state oil firm PDVSA yield in excess of 15% (Nicolas Maduro being thereby revealed as a greater menace to the world's creditors than even Vladimir Putin). As absolute investment opportunities, this publication will pass on the lot.

Relative values are a different matter. By standard credit metrics, Petrobras appears not merely to be absolutely unattractive but also relatively overvalued. Thus, by Bloomberg's calculations, the Brazilian state oil champion showed a ratio of debt to EBITDA of 5.3:1 at the end of the second quarter. It's more leverage than other state-controlled and/or despot-tainted energy businesses present. Pemex's ratio was 1.12:1, Rosneft's 1.84:1, Gazprom's (at the end of the first quarter) 0.95:1, and YPF's 1.41:1.

Interest-coverage data show a similar pattern. As noted in the case of Petrobras, EBIT was sufficient to pay interest expense by 2.2 times over in the second quarter. It's a lower ratio of interest coverage than that of YPF (3.0 times) Pemex (12.2 times), Rosneft (just under 10 times), Gazprom (21 times) and even PDVSA (11.1 times in 2013). Not that the coverage data are always dispositive. Thus, the cost of protecting against non-payment over the next 10 years in the credit-default swap market will run you 318 basis points for Petrobras, 171 basis points for Pemex, 347 basis points for Gazprom and 1,600 basis points for Venezuela's pride and joy, the possibly imminently defaulting PDVSA.

Certainly, Petrobras is a paragon of good governance and balance-sheet strength in comparison to its Venezuelan counterpart, but as an absolute value, it makes you want to reach for your copy of "Security Analysis." As we write, the Petrobras 5 3/8s of 2021 are quoted at 102 and change to yield 4.95%. One year ago, they fetched 5.98%; in 2012, at some manic risk-on moment, they were priced to deliver just 3.25%. Mr. Market, have you been thinking this through?

Liquidity is the final panel of the Petrobras triptych. According to second-quarter survey data compiled by the Trade Association for the Emerging Markets (EMTA), Brazilian dollar debt trades more frequently than the dollar-denominated securities of any country

Petrobras bond trading volume—second quarter 2014

coupon	maturity	par outstanding ($ millions)	trading volume ($ millions)	as percent of outstanding
3.875%	2016	$2,500	$131	5.2%
7.875	2019	2,750	412	14.9
5.75	2019	2,500	531	20.4
4.375	2023	3,500	761	21.7
5.375	2021	5,250	1,394	26.6
6.25	2024	2,500	1,271	50.8

sources: Trade Association for the Emerging Markets, the Bloomberg monitored by EMTA besides Mexico. "Not that that is necessarily saying much," Grant observes. "The Petrobras 3 7/8s of January 2016, a $2.5 billion issue that came to market in 2011, is a case in point. Just $131 million of par value traded on the secondary market in the April-June period, equivalent to 5.2% of the outstanding (which may include some double-counting between survey participants). The nearby table tells all that the EMTA survey uncovered on Petrobras. A careless glance down the far-right column would seem to suggest that, really, liquidity in the more popular Petrobras issues flows like water from a tap. Please note, however, that volume as a percentage of the outstanding issue is registered over the course of a calendar quarter."

The Petrobras 6 1/4s of 2024 count as one of the most actively traded corporate issues in the market. Last Wednesday, in fact, according to Finra's TRACE market aggregation system, the 6 1/4s ranked No. 5 in frequency of trading, comparing favorably to bonds issued by the likes of AT&T and Verizon. Past trading data are, of course, no guarantee of future liquidity. To borrow from Christopher Whalen, senior managing director at Kroll Bond Rating Agency, "Liquidity is something you really can't measure. You either have it or you don't. If they pick up the phone, you have liquidity. If they don't, you don't."

That the phone may one day ring off the hook—say, on the day after the agencies get around to demoting Petrobras to speculative-grade status—is the burden of a new, must-read report from Blackrock entitled, "Corporate Bond Market Structure: The Time for Reform is Now." "[T]he secondary trading environment for corporate bonds today is broken, and the extent of the breakage is masked by the current environment of low interest rates and low volatility, coupled with the positive impact of QE on credit markets," the Blackrock authors warn. "The current environment also breeds complacency—for issuers and investors alike. . . . A less-friendly market environment will expose the underlying structure as broken, with the potential for even lower liquidity and sharp, discontinuous price deterioration."

Such a scenario would be very heaven for value seekers, of course. Who might these people be? The kind who, almost by definition, owned no Petrobras.

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