FINANCIAL ENGINEERING

TOMORROW'S INVESTMENT NEWS ALREADY TODAY

12 August 2023 *Research Report – Issue #9*

Petrobras *(preferred share)*

Still pumping out massive dividends

source: David ROUMANET on Pixabay

AFTER THE BLOCKBUSTER YEAR 2022, A RESUMPTION OF SUCH HUGE PAYOUTS BECAME UNLIKELY.

To be clear, we're not talking about dividend yields of *"only"* 5–6% here.

Depending on at which price you bought the stock *(and which of the two classes)*, it was possible to collect dividends with an unbelievable yield of even 40% – just last year alone. But these times are over, mainly for two reasons: First, energy prices came down compared to last year and second a political change with more intervention brought huge uncertainty.

But now we have more clarity.

Although some risks remain, like wasting shareholder's free cash flow for non-core projects or to appease the public with gifts paid by the company, the new dividend yield should still be at least 10% p.a. – conservatively calculated. With higher oil prices there's room for more.

As a bonus, the company starts to repurchase its own stock. This is a factor that is not so frequently discussed, but I have a new idea what could be behind this move.

Topics of this report

About simplicity

To the point – from proven successful people

"Behind every stock is a company. Find out what it's doing."

&

"All the math you need in the stock market you get in the fourth grade."

&

"If you're prepared to invest in a company, then you ought to be able to explain why in simple language that a fifth grader could understand, and quickly enough so the fifth grader won't get bored."

(Peter Lynch)

"That's been one of my mantras – focus and simplicity. Simple can be harder than complex: You have to work hard to get your thinking clean to make it simple. But it's worth it in the end because once you get there, you can move mountains."

(Steve Jobs)

"I am suspicious of thick and overly detailed reports. What is good is usually also quite simple, so lengthy explanations should not be necessary."

(Marc Faber)

"I don't look to jump over 7-foot bars: I look around for 1-foot bars that I can step over."

(Warren Buffett)

„Simplicity is the ultimate sophistication"

(Leonardo da Vinci)

Why do I write short reports and not long, extensive ones?

Short answer: It's about simplicity, comprehension and your time in todays information overloaded world.

Long answer: For me the big goal (and challenge) is to be clear and on point with my investment theses. For every aspect I look at, the aim is to write down the main points cleanly on a single page.

The research I am doing beforehand is not reduced, however, quite the opposite. My research process is extensive. I am spending several hours of time to crush together what is necessary into an easily comprehensive and digestive format for you.

It is a service from me and also my philosophy to be spot on.

Because I value your time!

Foreword

Here's my idea to substitute Pioneer: Petrobras (A-share)

LAST WEEK, I CLOSED THE CASE OF PIONEER NATURAL RESOURCES.

But I didn't offer my Premium Members any direct alternative with exposure to oil and gas. I only mentioned that there are even two for my Premium PLUS Members.

A reader and Premium Member from the first hour pointed me to this fact and that's true. I was a bit too quick in this regard – I should have first brought this new report and then closed PXD in hindsight.

I am still standing firmly behind my closure contextually, but the timing could have been better.

Such feedback is precious and always welcome!

What is also true is that I could not bring this new report earlier as I was awaiting a really important announcement from **Petrobras** *(in short: **PBR.A**, I am favoring the preferred A-share, instead of the common PBR)* regarding their new shareholder return policy.

It was crystal-clear that a massive dividend cut would come after the gigantic payouts last year – but how high? As it did not depend just on lower energy prices compared to last year, but also on the new left-leaning Brazilian government that is less market friendly, everything was possible. Petrobras is the first obvious corporate target being milked to make special donations and gifts to the public, against the interests of equity holders. But on the other side, the Brazilian government itself is the biggest shareholder and thus a beneficiary of big payouts – in addition to corporate taxes.

Now after some more news and an explicit formula how to calculate the new distributions have been published, finally here is my idea to swap *(possibly)* sold PXD shares.

What I liked is that the market did not react negatively at all to this announcement. Looking at it in isolation, a cut from a 60% free cash flow distribution ratio to just 45% *(even more, see below)*, i.e. by a quarter, is rather big.

But it seems that the market expected even a higher cut, so in the end nothing really happened with the share price.

Part of the truth, however, is that the new 45% will include from now on also share buybacks, meaning the real dividend payout will shrink somewhat closer to 40%. I will outline why I think the buybacks make sense for shareholders, but also for the government itself.

Nonetheless, I am still expecting great returns, even though there

remain a few risks as to further interventions by the government.

All in all, a new dividend yield of 10% at current prices should be realistic, with slightly higher oil prices even closer to 15%.

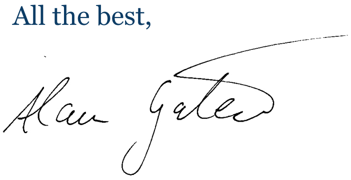
The reason is that Petrobras is an ultra low-cost producer – see in my **latest Weekly** why this is key.

As a plus, Petrobras now starts to repurchase its preferred stock, the A-share that is my latest idea.

Usually, I don't like buybacks by energy companies due to their pro-cyclical nature, buying back stock at high prices. But there are indeed good reasons regarding Petrobras worth being aware of.

I hope you enjoy this new report.

All the best,



Alan Gałecki

Founder of Financial-Engineering.net

The investment case in a nutshell

What you need to know on one page – because I value your time

PETROBRAS IS MOSTLY KNOWN ONLY FOR ITS GIGANTIC PAYOUTS.

Especially during the year 2022, as the dividend yield, depending on which stock class and at which price one bought, could realistically have been even 40% – in just that one year alone!

With the new-old left-leaning government this party is over – or is it not?

What is clear, is that these huge payouts won't occur again in the same quantity, due to lower energy prices compared to last year and due to the new government. It is no secret that majority state-owned Petrobras is the prime target of the government when it comes to milking it and making special gifts to the public like subsidized fuel and heating gas prices.

I firmly expect this to happen.

But nonetheless, Petrobras due to its ultra-low production costs is a massively profitable company that will likely still be paying out dividends with a double digit yield in relation to the current price of the A-share that I picked for this new report.

Petrobras fits perfectly into my two recent mega-topics for this current decade of ultra low-cost commodity producers and offshore energy production.

The politically aligned and chosen management with the latest results also announced its new shareholder return framework which includes a reduced free cash flow payout ratio of 45% *(prior: 60%)*.

That was more or less expected, even a bigger cut was thought to be possible.

source: Markus Winkler on Pexels

However, these new 45% ratio also includes stock buybacks which was not the case in the past.

Bottom line, I am expecting with a c. 40% payout ratio for dividends still at least a dividend yield of 10% p.a. for the A-share.

The announced buyback targets only the preferred A-share and not the common – 3.5% of floating stock shall be repurchased within a year which at current prices should only cost a billion USD, to show you how discounted the stock is.

But I think that this is not just a simple buyback like many energy companies are doing it. I sincerely think that it has been implemented at the request of the government to reduce payouts to international stock holders.

Dividends in the past have been seen as wasteful donations to especially US holders.

With repurchasing and retiring the preferred shares – which the Brazilian government does not hold – more dividends will stay inside of Brazil, at the same time increasing the government's economical ownership in a rather elegant way, making it look like this is a gift to shareholders.

Yes, it is, because the government itself is the biggest shareholder.

Read on for the whole story...

Brief overview of the stock

Key facts and longterm chart

Petróleo Brasileiro *(Petrobras)*	
ISIN / ticker	BRPETRACNPR6 / PBR.A US
Home bourse	New York *(USA, the A-share ADR)*
Share price *(as of 11 August 2023 market close)*	12.44 USD
Market Cap / enterprise value *(diluted)*	85.9 bn. USD / 115 bn. USD*
Shares outstanding *(basic / diluted)*	13 bn. shares – *(7.4 bn. common + 5.6 bn. preferred)*
Average 3 month daily volume	9.1 mn. shares / ~113 mn. USD

** Net debt for me is: financial debt + pension liabilities – cash and short-term investments, while Petrobras doesn't count the pension liabilities, but adds leasing liabilities.*

source: Chart from tikr.com

The business model

What is the company doing?

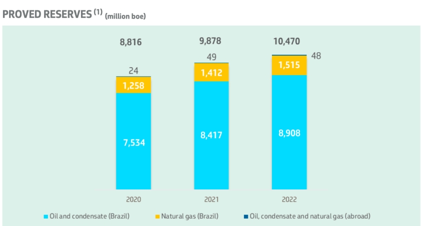
MANY WILL ALREADY KNOW PETROBRAS AS ONE OF THE BIGGEST ENERGY PRODUCERS.

But the key differentiator and also the key advantage is that Petrobras is to the biggest part an **offshore energy** explorer and producer, as this represents 90% of its business.

Of its assets, only less than 30% are already developed, meaning there are massive untouched resources. Currently, there are 245 fields or blocks in exploration or production, *(partly in joint cooperation with international partners).*

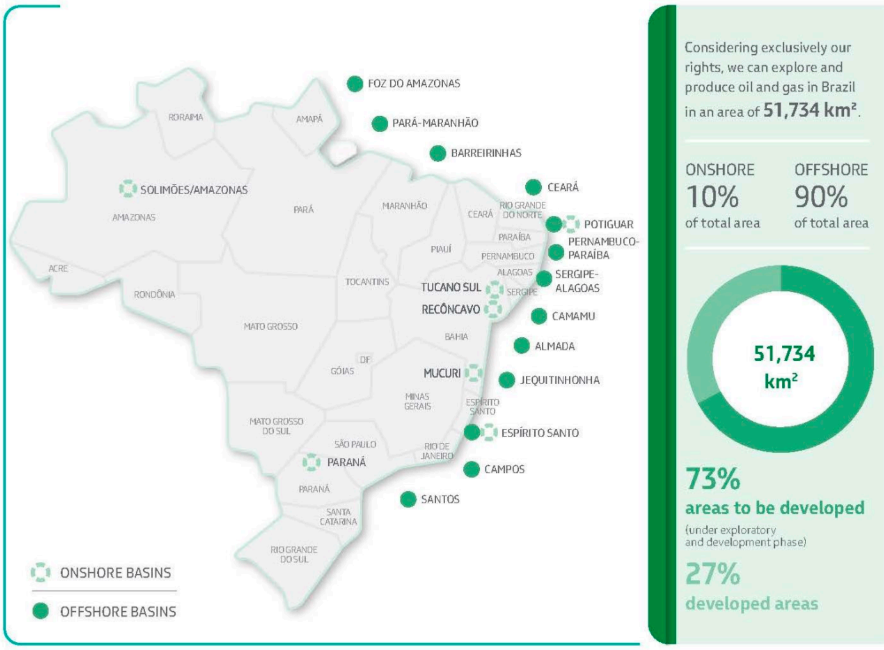
As of the latest annual report, Petrobras disclosed total developed proved reserves of 10.5 bn. barrel of oil equivalent *(boe),* of which 85% are oil. At current production rates of 860 mn. boe, this alone shall last for 12 years. With more than 70% still untapped, they likely won't run out of oil anytime soon.

And you see below that over the last three years the reserves have even grown! The so-called *"replacement ratio"* in 2022 after depletion has been a strong 169%, i.e. it was more found than produced.



Source: Petrobras annual report 2022, p. 93

To be more precise, Petrobras is mainly operating offshore the Brazilian coasts in the so-called deepwater and ultra-deepwater environment.



Source: Petrobras annual report 2022, p. 65

If you have read my Weeklies about offshore energy *(here)* as well as my latest issue from Thursday about **low-cost** commodity producers *(here)*, you'll have noticed that Petrobras is a prime candidate that **fits perfectly into both roles**.

Besides its huge reserves, offshore energy production in Brazil, has these big advantages:

- production costs of only between 20–30 USD per barrel, meaning others will throw in the towel way earlier in the case of low energy prices *(for comparison: Pioneer is estimated to have costs of around 35–40 USD per barrel, as the most cost efficient US shale producer)*
- it has among the lowest carbon intensity and is said to be overall more environmentally friendly *(or less damaging)* than fracking
- despite its political problems and the government constantly intervening, it is unlikely that they will go completely ESG-gaga, as they depend on energy production and to some extent exports *(I view their external communication only as pseudo-commitments and lip-services)*

All in all, despite its individual risks, I am still preferring Petrobras over its peers like ExxonMobil or Chevron. By the way, Exxon itself is heavily investing in the fields offshore Guyana, due to these advantages – it's close and similar to Brazil.

Not only does Petrobras have the advantages discussed above, it also has a way more attractive total shareholder return program, which I am going to discuss on the following pages.

Leadership & capital management

What is the company doing with stockholders' money?

YOU CAN NEARLY FORGET WHAT MANAGEMENT PUBLICLY SAYS.

What counts is what they are doing and more important what they will be doing. I have some ideas.

Petrobras is a state-owned oil giant which was incorporated in 1953.

The CEO gets exchanged whenever politics wishes. Currently, there's a CEO with ties to the ruling worker's party of president Lula installed. I think for an investment in the stock of Petrobras, it's important to know that the government cannot simply nationalize this company without compensating for it.

On the other hand, the Brazilian government is heavily dependent on Petrobras, because:

- they are a huge taxpayer
- The government is among the shareholders and thus a direct beneficiary of *(huge)* dividends
- The government needs Petrobras to appease the public with gifts here and there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Petrobras changes pricing policy but uncertainty remains

State-owned company announces new commercial strategy for diesel and gasoline, cut prices on the same day

Por Kariny Leal, Fábio Couto, Felipe Laurence — Rio de Janeiro, São Paulo

Source: Valor International

In May 2023, it was announced that Petrobras would abandon its international parity pricing policy *(IPP)*, meaning charging domestic buyers international prices which caused uncertainty, because it is an open secret that this would happen under the new government.

Shareholders	Common Shares	%	Preferred Shares	%	Total Shares	%
Brazilian federal government	3,740,470,811	50.26	-	-	3,740,470,811	28.67
BNDES	-	-	135,248,258	2.41	135,248,258	1.04
BNDES Participações S.A. – BNDESPar	-	-	900,210,496	16.07	900,210,496	6.90
All members of our Board of Directors, Executive Officers and members of our Fiscal Council (permanent and alternate) (28 people in total)	-	-	64,213	0.00	64,213	0.00
Others	3,701,983,331	49.74	4,566,519,821	81.52	8,268,503,152	63.39
TOTAL	**7,442,454,142**	**100.00**	**5,602,042,788**	**100.00**	**13,044,496,930**	**100.00**

Source: Petrobras annual report 2022, p. 270

Thus, Petrobras is ~~forced to subsidize~~ showing good will by subsidizing domestic fuel prices which without a doubt negatively impacts its financial results. But all in all, that's not moving the needle too much, even if more intervention should occur which brings us to capital management and what to expect regarding distributions.

Last year's dividend was rather un-repeatably high. Under Lula, I don't think this will happen again. With the now announced new formula of paying out 45% of free cash flow *(with gross debt staying below 65 bn. USD which is the case)*, we can determine a dividend yield of at least 10%. Q2 was weak due to lower oil prices. Petrobras still generated a FCF of 6.7 bn. USD *(annualized 26.8 bn. USD)*.

45% of that is 12 bn. USD which **is a yield of c. 15% to the current market cap** of 85 bn. USD.

But there's a catch.

The 45% are referring to dividends and now also **buybacks**. Here, it gets interesting. 3.5% of floating preferred stock will be repurchased which will cost c. 1 bn. USD.

The remaining 11 bn. USD put against the 85 bn. USD equity value still yield 13%. Keep in mind this back-the-envelope calculation is based on an annualized weak Q2 2023 performance! There should be a decent enough margin of safety to keep *"my"* 10% threshold.

There's something else I want you to know. My following thoughts are **of more speculative nature**, but this is what I really expect.

The government hates the fact that big dividend payments are sent abroad. It could use the buyback to get rid of the *"wasteful"* preferred shares which are majority-owned by international investors.

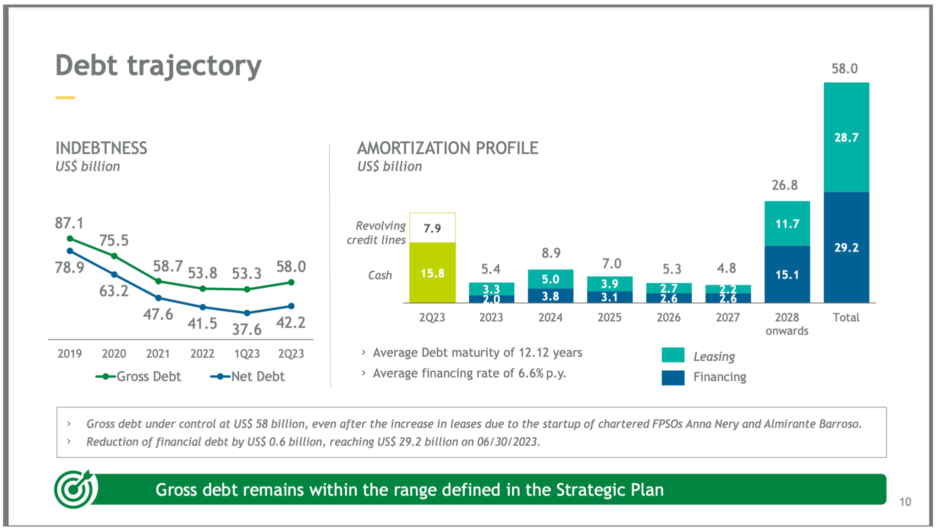
But they receive the full dividend!

See above, the government holds 50.3% of common stock *(voting rights)* and none of the preferred. Thus, the direct economic interest is diluted to only 28.7%.

By buying the preferred stock back and retiring it, less dividends will be distributed internationally via it. At the same time the government receives more, because their economic interest increases!

The financials

Cash flow statement, balance sheet, income statement



Source: Petrobras Q2 2023 earnings presentation, p. 10

THANKS TO PREVAILING STRONG OIL PRICES, THE FINANCES ARE ALSO STRONG.

In the past, Petrobras factually was one of the most heavily indebted companies with net debt of more than 100 bn. USD. It even faced bankruptcy in an environment of low energy prices and at the height of the political corruption scandal.

Petrobras managed to clean up the mess and shore up its finances. It is a different company, respectively its position is stronger now.

You can see to the right above that gross debt with 58 bn. USD is below the maximum target range of 65 bn. USD, allowing for the full payouts discussed on the previous page.

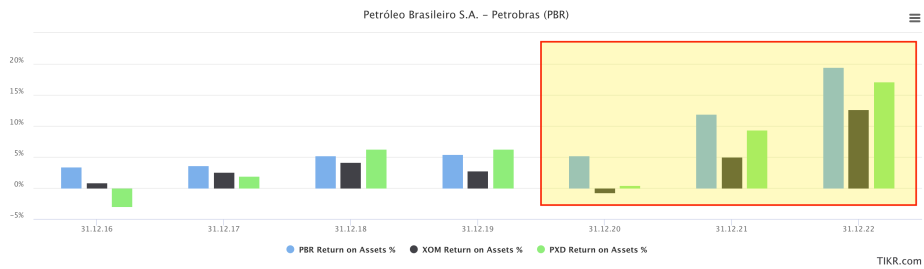
Net debt is even only at 42 bn. USD which is not much when you consider that Petrobras is throwing off c. 30 bn. USD in free cash flow *(annualized)* in the current price environment, likely even 35–40 bn. USD as prices have rebounded significantly since the weak Q2.

Its outstanding debt is also well structured *(c. half is due only past 2028, average maturity 12 years)*, meaning over the next years there is no big principal due, only small portions that Petrobras ideally will even pay back in full.

Cash on hand is there to do so and more will flow in.

It would not make much sense to keep the cash on hand and then refinance at higher rates, as much of its debt is in USD. Annualized interest payments are c. 3.5 bn. USD, so there's certainly room for improvement.

As I already wrote earlier in this report, Petrobras has ultra-low production costs with its offshore fields. At somewhere between 20–30 USD, it is truly a money printing machine.



Source: TIKR.com

To highlight this, on the second chart from TIKR you can see a comparison of the returns on total assets between

- Petrobras
- ExxonMobil
- Pioneer Natural Resources

(and how Petrobras easily beats them) which are among the best US energy companies.

However, the difference is, the US peers have production costs around 30–40 USD per barrel, which is a huge difference, namely 50–100% more!

It makes much sense to focus on the lowest-cost producers as their shareholder returns likely will also be the most generous.

Valuation and what to expect

Valuation always matters!

WE CAN KEEP IT REALLY SIMPLE HERE.

Petrobras has and likely will have a **significant valuation discount** due to its Brazilian origin, even more so for as long as the socialist government remains in place.

But I see it more as a chance than an issue. As discussed in the section about capital management, I'm expecting a **dividend yield of at least 10%**, maybe even going towards 15%, should oil prices be above 80 USD per barrel Brent as they currently are again.

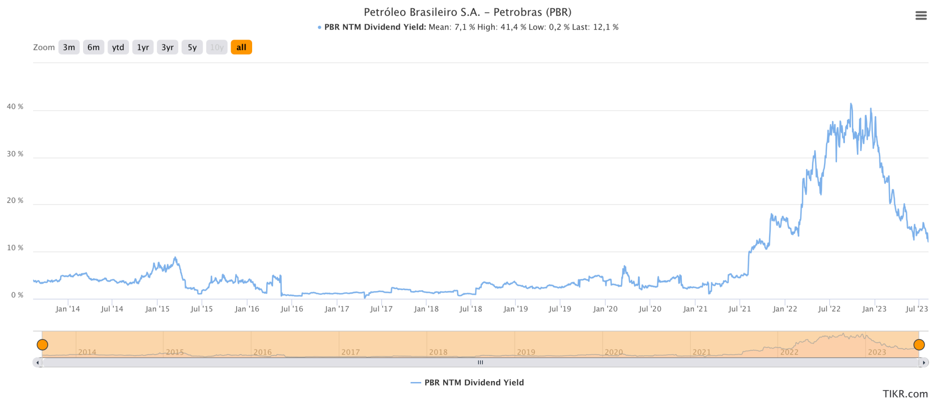
The enterprise value is c. 130 bn. USD *(calculated the way Petrobras counts its net debt and somewhat lower my way)* with an equity market cap of 85 bn. USD and net debt of 42 bn. USD.

With an expected free cash flow of say 35–40 bn. USD, you get an EV / FCF of only c. 3–4x, which is not expensive.

Thus, the total shareholder yield should be comfortably in the double-digits.

I also think that as soon as oil prices will be higher, Petrobras will increase their stock buybacks and not necessarily the dividend in the same proportion to pursue what I think to be a nice solution to lower the hated dividend payments to abroad investors and effectively increasing government's share in the dividend.

A nice side-effect is that the preferred stock should outperform the common from here on and also close the c. 10% discount it currently has compared to the common stock.



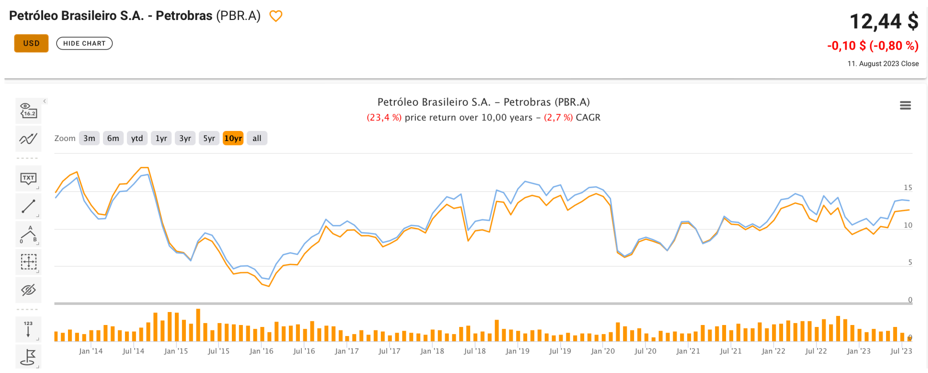
Source: TIKR.com

The reason for this gap is that despite more common stock in total outstanding, due to the majority stake by the Brazilian government, effectively the preferred equity has a higher share when comparing the floating stock *(49.7% of common stock outstanding are floating vs. 81.5% – s. the table on p. 7)*.

This way, I wouldn't lose too much time on thinking about an appropriate valuation multiple as the most likely outcome is that the discount to other international peers will remain.

What I would focus on are the gifts government makes to the public by using Petrobras and how far this impacts the finances as well as results of Petrobras.

As long as the dividend stays above 10% to current stock prices, I would just collect the payments.



Source: TIKR.com

You can see on the second chart above that often and also currently the common stock *(blue)* trades slightly above the preferred shares *(orange)*. However, there were also times when the preferred traded at a premium, namely before 2015.

Investment risks

Important to think about – what could go wrong?

WHERE THERE ARE CHANCES, THERE ARE ALSO RISKS.

Here is what I think to be the most important risks to consider:

- fluctuating energy prices
- The Brazilian real as the main currency for Petrobras' domestic operations – this is important because a deprecating currency increases energy prices in Brazil *(possible causing social unrest and more intervention)*
- Government can plunder the company beyond what one expects anyhow
- Petrobras is a state-owned company that thus prone to political scandals, although it officially improved its corporate governance
- The CEO comes from the president's workers party
- Production costs can increase, lowering margins
- Resources and reserves could be lower than expected
- Shareholder returns could be reduced further for *"the good"* of the public

source: Drew Rae on Pexels

Sources

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