Deutsche Bank
Markets Research

Rating
Hold

Global Emerging Markets
Brazil

Oil & Gas

Company
Petrobras

Reuters	Bloomberg	Exchange	Ticker
PBR.N	PBR UN	NYS	PBR

Date
24 February 2013

Forecast Change

Price at 22 Feb 2013 (USD)	15.26
Target price	19.00
52-week range	30.52 - 15.19

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Where to from here? Reviewing Petrobras' 3 "P"s

Too early to become constructive on the stock
Petrobras continues to underperform both the local market and global peers, following disappointing 4Q12 earnings and gloomy outlook presented by top management. Despite the sharp decline in the shares, we believe that it is still early to turn more constructive on Petrobras' investment case. In this report, we discuss what we believe should be the next key triggers for the story and we update our thoughts on how the three "P"s of Petrobras' story are expected to perform this year.

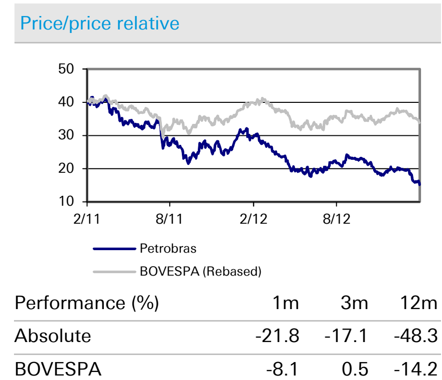
Reviewing the story's three "P"s
Petrobras is a three "P" story: (1) production, (2) pricing, and (3) politics. 1H13 should be a challenging period, as production is expected to be lower YoY and gasoline and diesel pricing is not expected to change. As production ramps up in 2H13, sentiment should improve, especially if the stock is more depressed following weak fundamentals in the first half. However, as refining losses persist (and possibly increase), we are unsure if higher production alone could change the sentiment towards the stock. Politics is the wild card: at this point we expect the negative interference with local content, pricing and capex to remain, but as the deterioration of Petrobras' financial performance gets the attention of the media and is used during next year's campaign, the government could be forced to review its use of Petrobras.

ON versus PN: what is the fair discount?
According to our calculations, dividends should converge by 2020, but we believe that as cash flow generation improves, dividends paid to holders of both classes should be the same a few years before that. Petrobras should become cash flow positive by 2017. If we assume that dividends converge by then, the premium of the PN over the ON should be 9%, if they only converge in 2020, the premium on the PN over the ON should be 10%. Trading patterns also have an influence on the ON and PN gap.

Valuation
We reduced our price target from $21 to $19 to reflect lower refining margins. Our PT is DCF based. Upside risks: increased production and prices; downside risk: more government interference. Please see details on page 8.

Key changes			
Target price	21.00 to 19.00	↓	-9.5%
EPS (USD)	1.74 to 1.62	↓	-6.8%

Price/price relative



Performance (%)	1m	3m	12m
Absolute	-21.8	-17.1	-48.3
BOVESPA	-8.1	0.5	-14.2

Forecasts And Ratios

Year End Dec 31	2011A	2012A	2013E	2014E	2015E
Revenue (USDm)	140,709	142,025	155,508	167,997	177,004
EBITDA (USDm)	35,870	26,831	27,028	31,847	37,120
EBITDA margin (%)	25.5	18.9	17.4	19.0	21.0
Net Income (USDm)	19,197	10,692	10,549	12,666	15,327
EPS (USD)	2.94	1.64	1.62	1.94	2.35
P/E (x)	10.9	14.0	9.4	7.9	6.5
EV/EBITDA (x)	7.2	8.1	7.4	7.0	6.4
Dividend yield (%)	2.9	2.1	2.6	3.7	4.5

Source: Deutsche Bank estimates, company data

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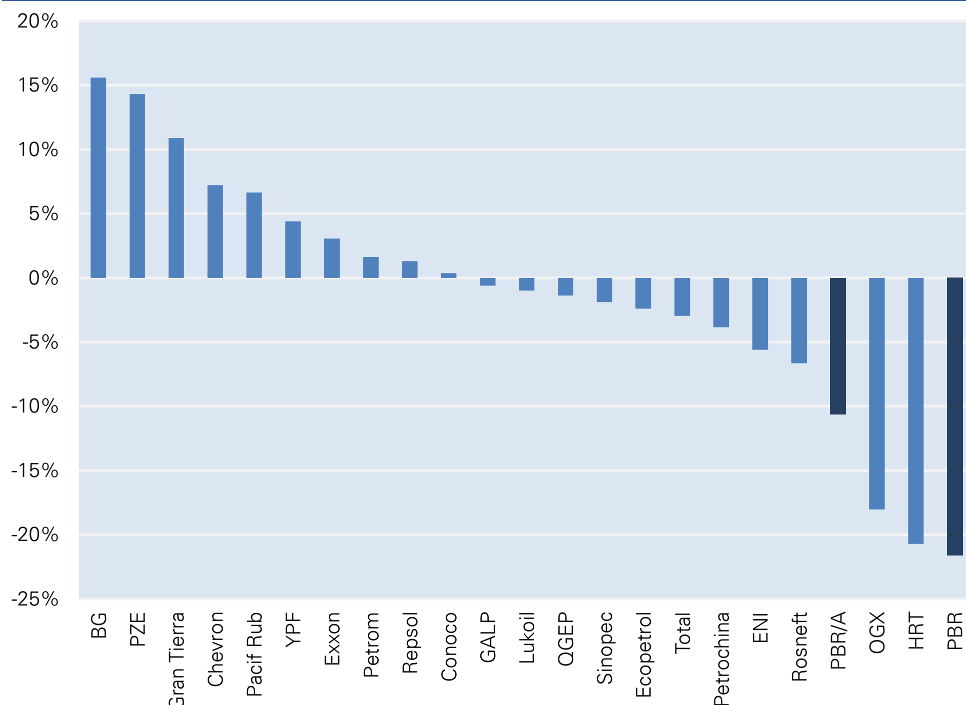
Petrobras

Too early to become constructive on the stock despite sharp underperformance

Petrobras continues to underperform both the local market and global peers, Figure 1, following disappointing 4Q12 earnings and gloomy outlook presented by top management. Despite the sharp decline in the shares, we believe that it is still early to turn more constructive on Petrobras' investment case.

Figure 1: Global oil stocks YTD performance



Source: Deutsche Bank and Bloomberg.

Where to from here? Reviewing the 3 "P"s

In this report, we discuss what we believe should be the next key triggers for the story this year. As we have highlighted in previous reports, Petrobras is a three "P" story: (1) production, (2) pricing, and (3) politics.

On Figure 2 we summarize how the three "P"s are expected to perform this year.

Figure 2: Petrobras – how three main triggers are expected to perform in 2013

	1Q13	2Q13	3Q13	4Q13
Production	-	-	+	+
Pricing	-	-	-	-
Politics	=	=	?	?

Source: Deutsche Bank.

Conclusion: 1H13 should be a challenging period, during which the stock is expected to remain under pressure. Production is expected to decline YoY mainly due to maintenance shutdowns. Refining losses should continue, as we don't expect another price increase. Politics: we don't expect any surprises on the political front in 1H13, as pricing is not expected to change and Petrobras' investment program for 2013 has already been announced.

As production ramps up in 2H13, sentiment should improve, especially if the stock is more depressed following weak fundamentals in the first half. However, as refining losses persist (and possibly increase), we are unsure if higher production alone could change the sentiment towards the stock.

As the 2014 Presidential election approaches, politics should become more relevant for Petrobras. The issue of politics is tricky: while it make senses to assume that the government attitude towards Petrobras should not improve (need to control inflation, to boost local economy and to strengthen political alliances), we believe that as the deterioration of Petrobras' financial performance persists, the government may be under the (negative) spotlight and forced to decrease its influence at the company.

1st P: Production – flat domestic oil output in 2013

Domestic oil production is expected to be negatively impacted by maintenance shutdowns in 1H13, but trends should improve in 2H13 leading the way for a strong growth in 2014. The following units are expected to start up during the year (the units at Sapinhoa and Bauna and Piracaba have already started production according to schedule), adding 480tbpd of capacity, Figure 3.

Figure 3: Planned production units for 2013

Field	Producing unit	Start up	Capacity (*)
Sapinhoa Pilot	FPSO Cidade de Sao Paulo	Jan-13	54
Bauna and Piracaba	FPSO Cidade de Itajai	Feb-13	80
Lula NE Pilot	FPSO Cidade de Paraty	May-13	78
Papa Terra	P-63	Jul-13	88
Roncador - III	P-55	Sep-13	180
Papa Terra	P-61	Dec-13	(**)
Total			**480**

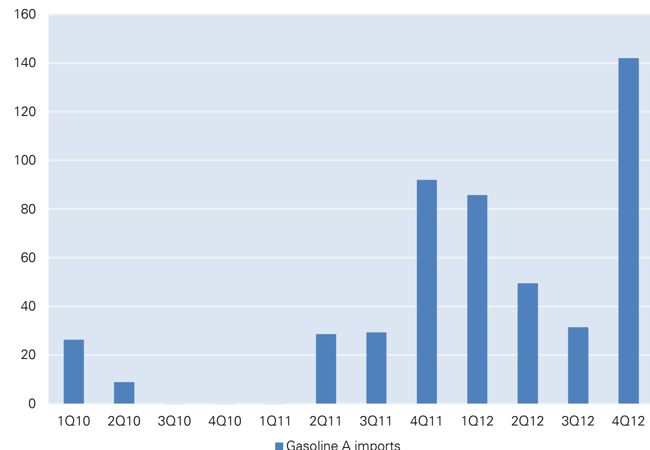
Source: Deutsche Bank and company reports. (*) Net for Petrobras. (**) P-61 will use the processing capacity of P-61.

2nd P: Pricing – no expectation of another increase in 2013 – subsidies to continue pressuring results as the discount to international parity increases

Demand for refined products has increased sharply since 2010, especially that of diesel and gasoline which went up by 16% and 45%, respectively. (Figure 5 and Figure 7). Petrobras was able to increase the production of diesel and gasoline via refinery revampings. Capacity utilization ratio rose to 98% at the end of the year, while the % of domestically produced oil processed by the local refineries increased. That helped minimize imports, Figure 4 and Figure 6.

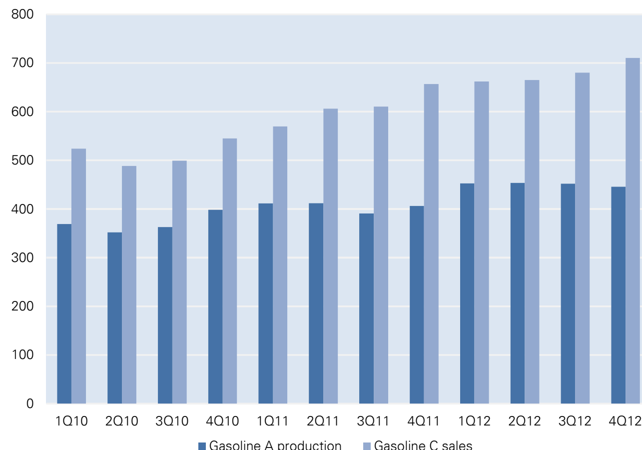
Nonetheless, the refining segment has been reporting operating losses since 1Q11 and despite several gasoline and diesel price increases, operating results are still in the red. As we don't expect any additional price increase beyond what has been allowed late January, refining losses should continue to limit stock performance going forward.

Figure 4: Gasoline imports (tbpd)



Source: Deutsche Bank and ANP.

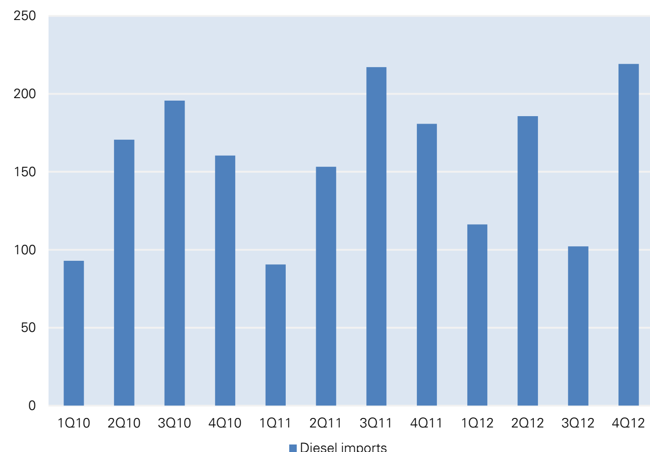
Figure 5: Gasoline A production and gasoline C sales tbpd



Source: Deutsche Bank and ANP.

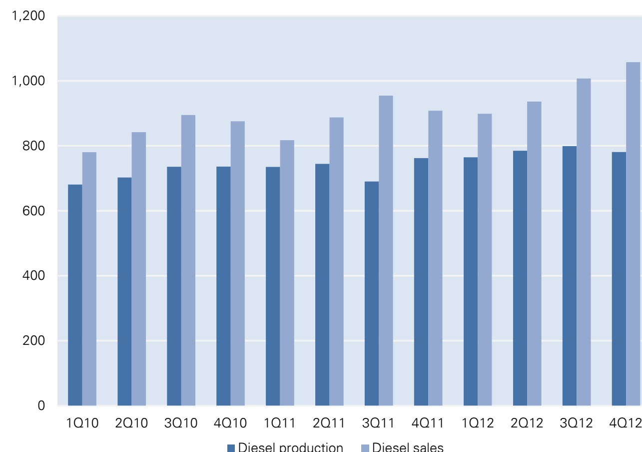
Despite maintenance shutdowns, Petrobras expects a similar throughput this year, but a higher % of diesel produced. That is expected to increase diesel output by 5% in the period, mitigating the negative impact of diesel imports and sales at a loss.

Figure 6: Diesel imports (tbpd)



Source: Deutsche Bank and ANP.

Figure 7: Production and sales of diesel (tbpd)

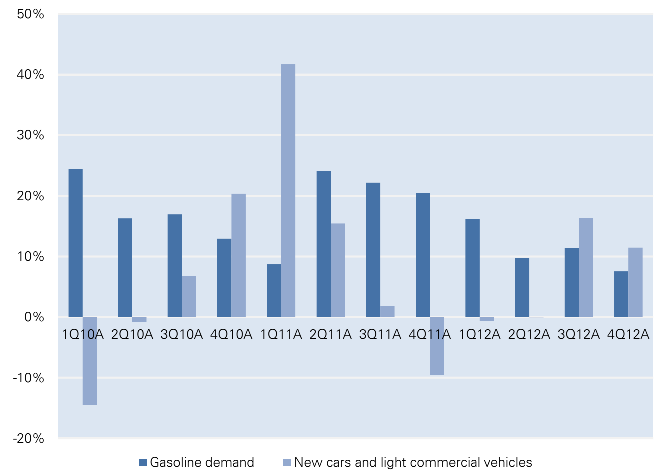


Source: Deutsche Bank and ANP.

Petrobras expects overall demand of refined products to continue to increase, but at a slower pace of 4%. Still, that should continue to put pressure on results as imports continue to be priced at a premium to domestic prices.

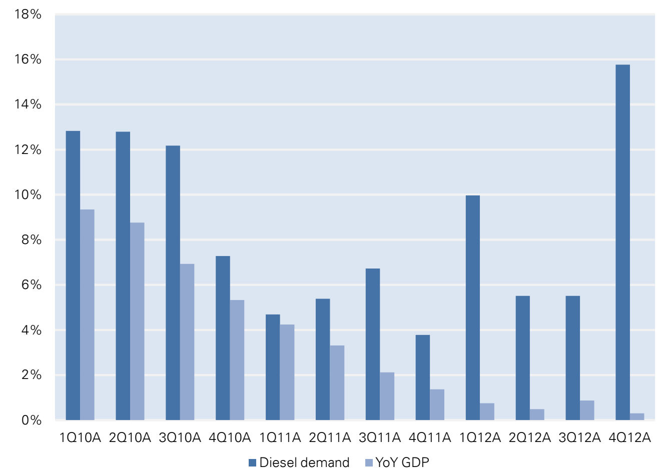
On Figure 8 and Figure 9, we present the leading indicators of gasoline and diesel demand. For gasoline, sales of new cars and light vehicles during 2012 indicate that demand should remain strong and possibly higher than the 4% expected by Petrobras. Diesel demand is historically correlated to GDP but growth was strong even during 2012.

Figure 8: Gasoline demand versus sales of light vehicles



Source: Deutsche Bank and company reports.

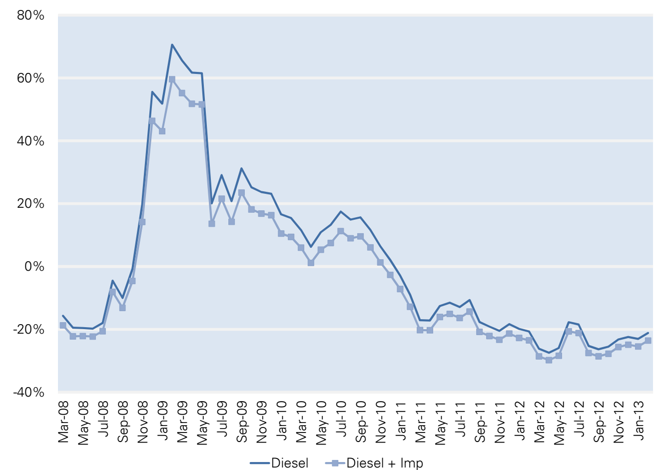
Figure 9: Diesel demand versus GDP



Source: Deutsche Bank and Bloomberg.

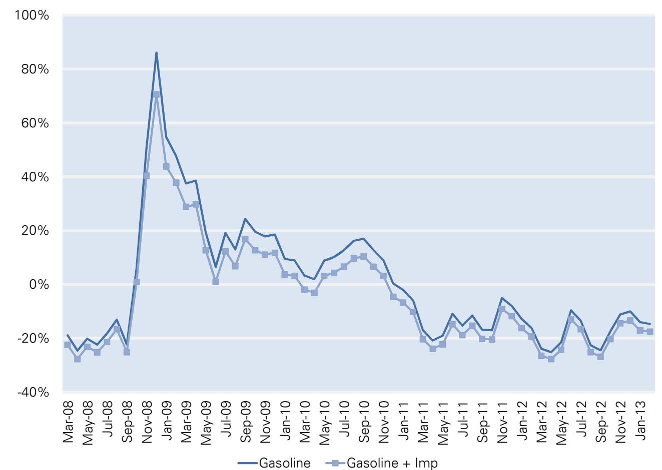
Despite the price increases, the discount of domestic prices to import parity persists. We estimate that current discounts are (with and without import costs): diesel (24% and 21%) - Figure 10 and gasoline (18% and 15%) - Figure 11.

Figure 10: Diesel – domestic and import prices



Source: Deutsche Bank, MME and Bloomberg.

Figure 11: Gasoline – domestic and import prices



Source: Deutsche Bank, MME and Bloomberg.

Another initiative that could provide some relief for Petrobras is the increase of ethanol content in the gasoline C mix, which has been discussed by the government. Officially, there is no decision yet, but a quick calculation indicates that at current volumes and prices, the savings on lower gasoline imports could reach US$1.6bn/year.

3rd P: politics – the wild card. Political influence should continue to destroy value at Petrobras, but things could improve

So far, political influence has been extremely negative to Petrobras: local content policy (and Petrobras' decision to commission locally more than what has been contracted with the ANP), pricing of gasoline and diesel and Petrobras' capital expenditure plan to name a few. The new management (technical) is one of the few positive actions taken

by the government. As the 2014 presidential election approaches, the risks of negative government interference at Petrobras increase. Those risks should include pricing and in capex, although we think it is unlikely that Petrobras' capex could increase significantly next year.

However, we believe that the deterioration of Petrobras' financial performance has caught the attention of the media and should be an important point during next year's campaign. As such, we see that, under the negative spotlight, the government could be forced to review its use of Petrobras.

ON versus PN: what is the fair discount?

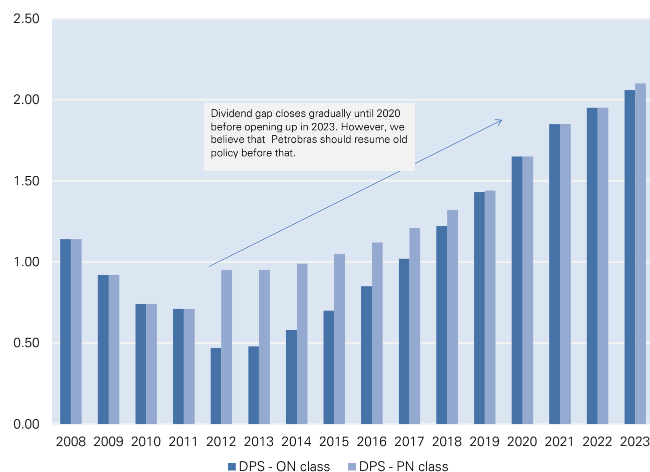
For the first time in several years, Petrobras' ON and PN dividends were different. Up to now, the ON shares received the same dividend calculated for the PN shares. However, to preserve cash, the company decided to follow its bylaws this year, resulting in a dividend for the PN share of R$0.96 being higher than the ON share dividend of R$0.47.

Since then, the market has been trying to identify the correct premium of the PN stock versus the ON stock. The gap between the two classes of shares depends of one's assumption of when the company should return to the policy of paying similar dividends for both classes of shares.

According to our calculations, dividends should converge by 2020, but we believe that as cash flow generation improves, dividends paid to holders of both classes should be the same already a few years before 2020.

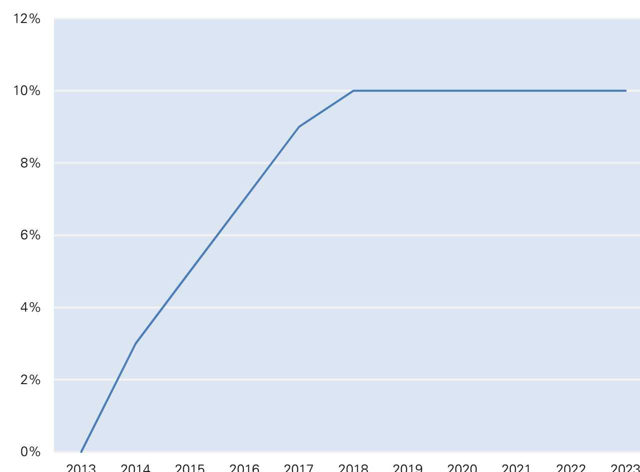
Petrobras should become cash flow positive by 2017. According to Figure 13, if we assume that dividends converge by 2017, the premium of the PN over the ON should be 9%. According to our estimates, the highest premium should be 10%.

Figure 12: ON and PN – dividend per share



Source: Deutsche Bank and company reports.

Figure 13: Gap PN / ON based on return of same DPS



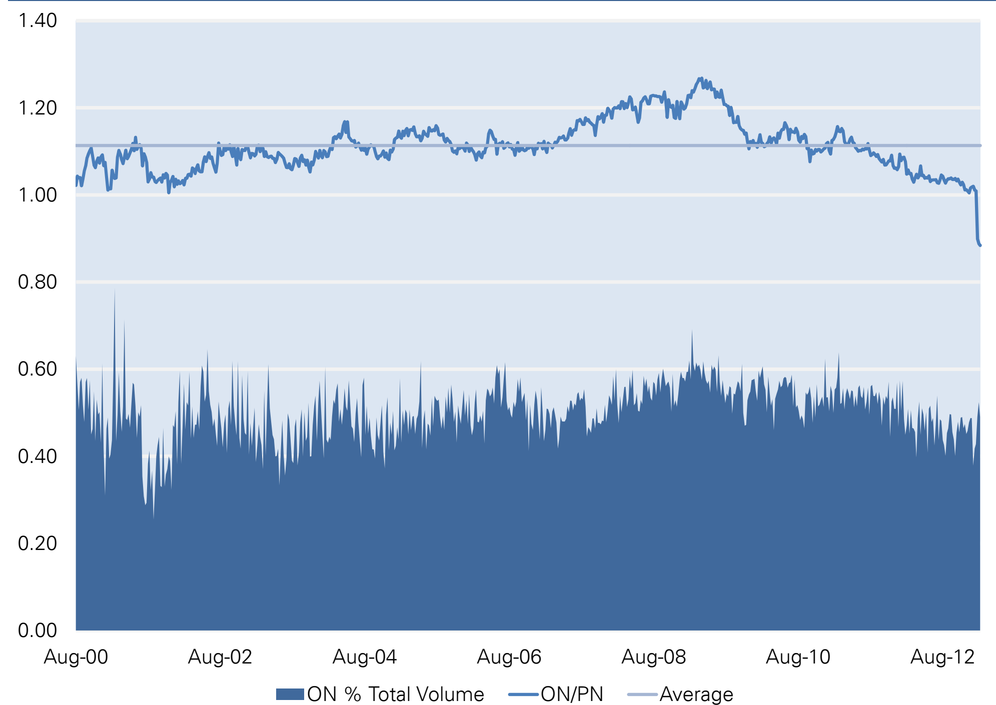
Source: Deutsche Bank and company reports.

ON/PN: looking at trading patterns is also important

The spread between the two classes of shares is also a function of trading patterns: historically, foreign investors have preferred the ON shares while the PN shares have been mostly held by Latin American dedicated and local Brazilian investors.

The reason is a bit cultural as the ON shares were the first to be fully listed in the NYSE (2000). We also note that in the international press, Petrobras has always been referred as PBR. In the past, the spread widened following significant events, either positive (increasing the premium of ON shares over the PN shares) or negative.

Figure 14: ON / PN premium (discount) versus ON share volume as % of total



Source: Deutsche Bank and Bloomberg.

Valuation and risks

Our PT is derived using DCF analysis. Our DCF assumptions include a US$110/barrel long term oil price forecast. We use the DCF methodology because we consider it a superior indicator of value to multiples, as it relies on free cash flows generated over a longer period of time rather than the profitability of a single year. Our WACC of 10.1% is based on 30% leverage and 9.2% after-tax cost of debt. We also assume 10.4% cost of equity based on a 1.9% sovereign risk premium that reflects Brazil's risk improvement over the past year, a 3.0% risk free rate and a 5.5% equity risk premium (historical average), along with a 1.0 Beta to the local market and a 3.0% terminal growth rate (which is below long term inflation expectations for Brazil).

Upside risks to our target price being achieved include: 1) sooner-than-expected recovery in oil prices and 2) increased flows into Emerging markets, which tend to benefit Petrobras due to its high liquidity. Downside risks include: 1) lower-than-expected oil prices, 2) delays in Petrobras execution of the production schedule, 3) interference from Petrobras' main shareholder, the Brazilian government, and 4) Brazilian macroeconomic factors.

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Petrobras	PBR.N	15.26 (USD) 22 Feb 13	1,7,8,17

*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies

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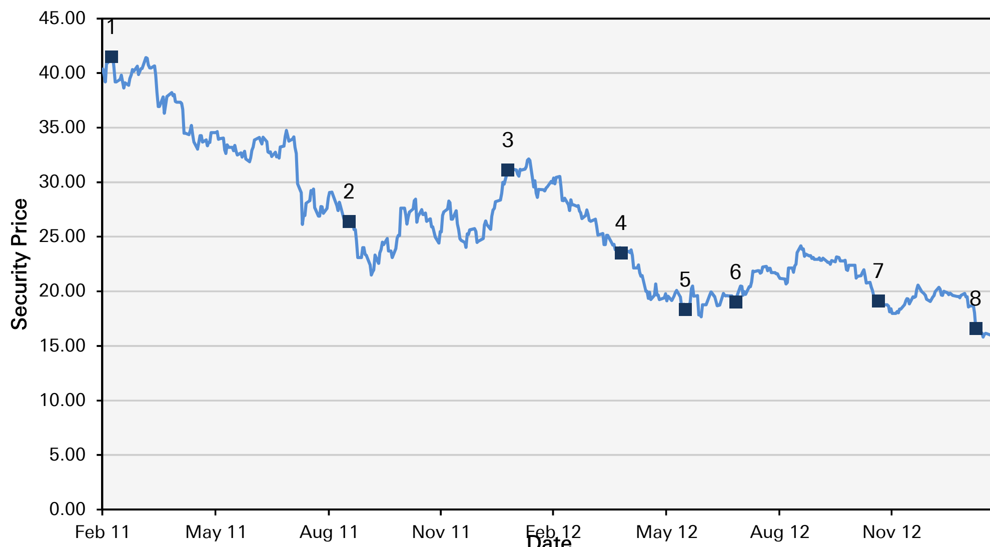
Historical recommendations and target price: Petrobras (PBR.N)

(as of 2/22/2013)



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2.	16/09/2011:	Hold, Target Price Change USD40.00	6.	26/07/2012:	Hold, Target Price Change USD26.00
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4.	24/04/2012:	Hold, Target Price Change USD32.00	8.	06/02/2013:	Hold, Target Price Change USD21.00

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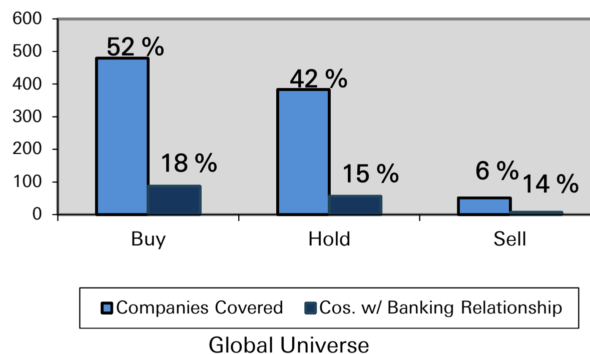

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