Brazil-U.S. Business Council

Brazil Bulletin

Interview: Petrobras CEO Graça Foster, CFO Almir Barbassa, Refineries Director José Carlos Coxenza, and Production Director José Miranda Formigli

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Top managers of Brazil's embattled state-run energy company Petrobras met with reporters following the belated January release of third-quarter earnings. The managers were frank in discussing sensitive issues such as corruption and steep losses to asset values. The third quarter report showed a stark 38% quarter-on-quarter decline in earnings to R$3.1 billion. The report's release led to an immediate 10% fall in the price of preferred Petrobras shares on the Brazilian Stock Exchange for an accumulated 12-month loss of about 40%. Petrobras CEO Graça Foster was insistent that the company can solve its problems and come back "stronger than ever." She announced a 25% reduction in the company's 2015 investment budget, as well as other measures, to boost profits and investor confidence. Excerpts follow (*Note: a few days after the interview below, Foster and the other directors resigned in the face of the continuing corruption probe. See news item below for more details.*):

- **Graça Foster:** "We are tightening our belts when it comes to all company expenses, including capital investments. Oil exploration activity will be reduced to the minimum. We will cut back on projects unlikely to contribute directly to the bottom line in 2015 and 2016. The essence of our 2015 business plan amounts to a restructuring of Petrobras itself. We will restructure it to an appropriate and healthy size. We are doing this in all good faith and I am confident we'll come out stronger."

- **Almir Barbassa:** "If we decide that the company is experiencing a situation of financial stress, then it is possible we might suspend dividend payments to shareholders."

- **Foster:** "If more evidence of corruption emerges, then losses from corruption will increase. The numbers we have now are not firm. They are dependent on more information from prosecutors. The more contractors shown to be involved in corruption, the higher the losses."

- **Carlos Cosenza:** "We are studying new delivery dates (for a projected new refinery in Pernambuco and a petrochemicals complex in Rio de Janeiro). This is due, in part, to the need to hire new contractors and is also due, in part, to changing market conditions."

- **Foster:** "The production curve will certainly flatten. It's not going to coincide with our original projections for the period 2014 to 2018."

- **José Miranda Formigli:** "For us to take part in eventual auctions of new oil exploration blocks will require a tremendous amount of selectivity. In every case, we will need to evaluate if it's worth it for us to participate."

- **Barbassa: "**Our objective is to release an audited annual earnings report (by the end of June) but there are aspects of this that don't depend on us. We are working feverishly, day and night, to produce an audited report."

Top News of the Week

Divided Petrobras board names banker as CEO in face of spreading scandal. In a 7-3 vote last week, the Board of Directors of state-run energy giant Petrobras voted to accept the resignation of company President Graça Foster and appoint banker Aldemir Bendine in her place. Bendine served for six years as President of the Banco do Brasil, also government-controlled. The three board members voting against the Bendine nomination were representatives of minority shareholders. The seven "yes" votes were all government appointees. Investors, more broadly, also objected, throwing Petrobras preferred shares for a one-day loss of 7%. Market analysts said Bendine is perceived as being too close to the administration of Brazilian President Dilma Rousseff. The president is widely perceived as having been tardy in investigating allegations of corruption at Petrobras. Meanwhile, the corruption probe by police and prosecutors continued last week. The latest allegations focus on João Vaccari, national treasurer of the ruling PT (Partido dos Trabalhadores). Prosecutors allege that Vaccari funneled the equivalent of as much as $200 million from Petrobras projects to PT coffers over a period of several years. The party official denies the allegations. The scandal will gain even more traction in the coming weeks as a new Chamber of Deputies investigative committee opens for testimony. The scandal has contributed to a major decline in President Rousseff's popularity. A Datafolha poll over the weekend showed only 23% of respondents calling the Rousseff administration "Good or Very Good," down from 42% in December.

Government report shows risng risk of power rationing. A report last week by the government's Electric Power Monitoring Committee showed an increased probability of power rationing later this year. The committed hiked the prospect for rationing to 7.3% from a previous 4.9%, pushing the risk over the 5% limit regarded as "safe" by government planners. Power rationing is becoming increasingly likely because of low levels of rainfall at hydroelectric generating stations. Rainfall in Brazil's Southeast and Center-West regions in January was equal to only 38% of the historical average, the lowest rainfall level since 1931. Low rainfall levels have also led to increased chances for water rationing in Greater São Paulo, Brazil's biggest population center. Meanwhile, consumers will face much higher electricity bills this year, with or without rationing. Average rate hikes awarded to utilities so far this year by the National Power Authority (Aneel) have ranged from 25% to 45%. The rate hikes are needed to cover higher generating costs in the face of drought-induced scarcities.

January auto output, sales show industry still in the doldrums. January proved another disappointment for Brazil's embattled auto industry. Production of 204,751 was down 13.7% from January of 2014 while sales were off 18.8% at 253,800, according to figures last week from the National Motor Vehicle Manufacturers Association (Anfavea). The only good news came from the fact that the continued lag between production and sales has helped draw down inventories. Total inventory at the end of January was 318,500, down sharply from 351,000 at the end of December. But the year ahead could prove grim for automakers. January 1 saw the lapse of an IPI industrial taxation abatement, making most cars more expensive by at least 3%. Continued high inflation and rising interest rates are also likely to crimp sales. Meanwhile, Brazilian consumers are increasingly worried about job security in a sluggish economy.

Business News

Investment News:

Brazilian shopping centers had a good year in 2014 and expect a repeat this year, according to the **Brazilian Shopping Center Association** last week. Total billing in 2014 was R$154.4 billion, up a healthy 10.1% from 2013. The association is expecting an 8.5% increase in 2015 as consumers shift from more expensive downtown stores to thriftier and more convenient shopping centers. Expansion is also coming as shopping center investments shift from large metropolitan areas to smaller hinterland cities. The industry expects a 9.4% rise in investments in 2015 to R$16.3 billion, opening 26 new centers this year.

Company News:

Irish building materials holding company **CRH** last week emerged as Brazil's number three cement manufacturer following conclusion of a complex international transaction. Under the deal, CRH purchased international holdings of two European companies, Holcim and Lafarge, for more than $7 billion. The holdings include six cement manufacturing and processing facilities in the Brazilian states of Rio de Janeiro and Minas Gerais. Market estimates value the Brazilian properties at about $350 million. The deal makes CRH Brazil's number three producer, behind traditional market leader Votorantim and InterCement, controlled by contractor Camargo Corrêa.

Brazilian Calendar

Wednesday, February 11, Brazilian Census Bureau (IBGE) release of monthly retail sales data, Rio de Janeiro

Indicators

Foreign exchange rate: **R$2.78 = $1.00**

Brazilian supermarket sales rose by a modest 2.24% in 2014, in inflation-adjusted terms, with another year of sluggish growth likely in 2015, the **Brazilian Supermarkets Association** said last week. Growth was more robust in 2013, at 5.36%. The association is predicting another year of soft growth in 2015 because of continued job insecurity, high interest rates and worrisome inflation. Supermarkets may also face higher costs in the event of electric power and water rationing.

Brazilian airlines obtained their best ever average load factor in 2014 on a combination of rising demand and a modest reduction in seat offerings, the **National Aviation Authority** said last week. The 2014 load factor weighed in at 79.8%, the highest since the index was first employed in the year 2000. Brazilian airlines reduced their seat capacity by 0.94% last year but witnessed a 5.81% rise in demand. Gol continued as the market leader, with a 38% share. This year could be even better, according to market analysts, with Brazilian airlines likely to pay less for jet fuel. A hoped-for second-half economic recovery could promote more air travel for both leisure and business.

Brazil began the year 2015 with another **foreign trade deficit**, although this time slightly smaller than in the first month of 2014. According to Trade and Development Ministry data last week, Brazil ran up a January monthly trade deficit of $3.2 billion, lower than the $4.1 billion posted in January of 2014. Both imports and exports were down sharply this year, however. Lower international commodities prices hurt export revenues while declining domestic demand pushed down imports. Nevertheless, officials are expecting a modest trade surplus this year, reversing the $3.9 billion 2014 deficit.

Brazilian **industrial production** fell back by 3.2% in 2014, its worst performance since the recession year of 2009, the Brazilian Census Bureau (IBGE) said last week. In 2013, industrial output managed to post a 2.1% gain. Production declined in 2014 because of falling exports, a sluggish domestic economy and continued competition from cheap imported products, according to economists.

Monthly **inflation** soared in January to 1.24% from 0.78% in December, reaching a peak not seen since 2003. January monthly inflation brought the 12-month rate to 7.14% from 6.41% in December. Prices were pressured in January by food, fuel and housing costs. Food prices have risen in the wake of a drought in the Southeast while fuel costs rose because of annual hikes to bus and subway fares in big cities. Economists said more inflationary pressures are coming as the government awards stiff annual hikes in electric power rates. Inflation is now running above the ceiling of Brazil's inflation targeting range for the year of 2.5% to 6.5%.