SPECTRUM

Petrobras and Pemex: Putting ESG analysis in the oil mix

Audra Stundziaite
Senior Credit Analyst, Hermes Credit

Jaime Gornsztejn
Associate Director – Engagement, Hermes EOS

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At the surface, the oil industry might appear impervious to the cleansing efforts of responsible investors. But if we drill deeper, it is clear that integrating environmental, social and governance (ESG) analysis into investments – and engaging with companies – can deliver both a better financial return and a public good.

Undoubtedly, oil poses more than a few headaches for ESG investors. Besides the obvious high carbon content of petroleum products, the industry as a whole has accrued a reputation as risky across a range of ESG measures. These include: environmental preservation, workers' health and safety, executive pay and, as demonstrated by the Petrobras scandal, political corruption.

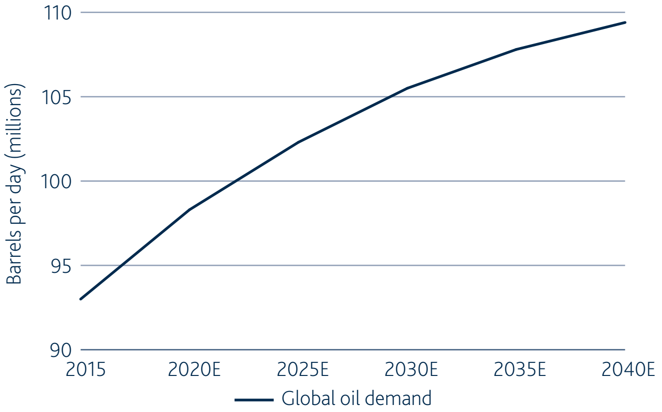
Yet in spite of – or perhaps because of – its blatant shortcomings, the oil industry attracts long-term investors who are prepared to engage on ESG matters. Despite rising sales of electric cars and the risk of fossil-fuel deposits becoming stranded assets, the oil industry is not disappearing any time soon. According to OPEC, global oil demand should increase until at least 2040 (see figure 1). That said, even if OPEC's own growth expectations of 109m barrels of daily intake by 2040 prove to be overly optimistic, engagement on ESG factors – including climate change scenarios – will remain as important as ever.

For credit investors, oil companies are a significant presence, as they are the largest debt issuers in the global high-yield market, accounting for approximately 16% of notional debt. With so much at stake, it would be short-sighted to abandon the oil field to disengaged industry participants. And credit investors, like shareholders, need to discuss ESG concerns with oil firms if the industry is to improve. In turn, companies like Petrobras and Pemex, the Brazilian and Mexican state-owned oil majors, are heavily reliant on credit markets for financing and should be compelled to engage with bondholders.

Aware of the importance of ESG risk – to credit valuations returns and society – we assess them as part of our fundamental analysis of issuers.[1] In doing so, we draw on multiple sources of information, including Hermes' proprietary ESG Dashboard reports on listed companies and the insights gained by the corporate engagement specialists in Hermes EOS.

When we identify a significant ESG risk within a company, we work with Hermes EOS to learn more – what actions are underway to improve the situation, and what are the implications for long-term returns? Two of our recent collaborations with Hermes EOS focused on Petrobas and Pemex, whose debt we invest in. These engagements, which we discuss in this issue of *Spectrum*, show that ESG factors can add demonstrable value at a time when investors are struggling to discern whether the oil barrel is half full or half empty.

Figure 1: Global oil demand is expected to grow



Source: OPEC 2016 World Oil Outlook

SHALE PUTS OLD OIL ORDER UNDER THE PUMP

Oil prices are typically volatile but the last three years have proven especially problematic for investors in the world's most-traded commodity. From a high of $108 per barrel in June 2014, the benchmark West Texas Intermediate (WTI) crude oil price nosedived 50% to just $55 per barrel by December of that year. Following two years of dramatic volatility in oil markets, WTI had halved again by February 2016, bottoming out at $26 a barrel.

Investors belatedly attributed the unexpected collapse of the oil price to an historic shift in OPEC policy and the increasing efficiency of US shale production. Specifically, in November 2014 Saudi Arabia – the most influential OPEC member – broke with tradition by maintaining production levels in the face of falling oil prices. Its primary aim was to protect its market share from the burgeoning US shale sector.

OPEC, in collaboration with Russia, reinstituted production cuts late in 2016, which appears to have stabilised WTI prices within the range of $45-$55 per barrel. But given the standing threat of easily mobilised US shale production, oil prices are unlikely to test the $100-per-barrel mark in the short-to-medium term.

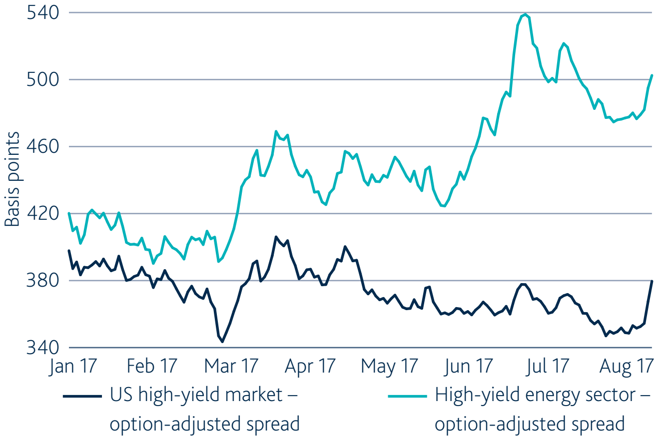
In spite of the production cuts, which have been extended to March 2018, oil has slipped towards the bottom of the forecast price range due to concerns about rising US production, with WTI trading below $47 per barrel at the time of writing.

[1] To read a study by Hermes Credit and Hermes EOS about the impact of ESG risk on credit valuations, see "Pricing ESG risk in Credit Markets", by Mitch Reznick and Dr Michael Viehs, published by Hermes Investment Management in April 2017. Available at: https://www.hermes-investment.com/ukw/blog/perspective/pricing-esg-risk-in-credit-markets/

STATE-OWNED STRENGTH IN A WEAK MARKET

Against that backdrop – and considering that most shale producers barely break even at current WTI prices – it should come as no surprise that the high-yield energy sector has underperformed the broader corporate high-yield index by about 1% in the year to early August (see graph below).

Figure 2. So far, 2017 has been a lethargic year for the energy sector



Source: Barclays Live as at 10 August 2017.

Given challenging fundamentals, we have been underweight the sector and this has benefited our year-to-date returns. Yet despite the weak outlook, we have identified robust instruments from oil companies that have also contributed positively to our performance.

As mentioned previously, both Petrobras and Pemex have attracted our attention for several reasons. Petrobras and Pemex – ranked 10th and 8th respectively in terms of global oil production – benefit from substantial scale, low costs of production and implicit government support.

Just as importantly, though, the two oil giants have boosted their performance and reputations by embarking on material strategic refurbishments. Following sustained engagements with investors, including Hermes, Petrobras and Pemex have made rapid improvements in their financial, operational, corporate governance, environmental and sustainability measures.

PETROBRAS: CLEANING UP AFTER CAR WASH

Petrobras ranks as Brazil's number one corporate entity and among the largest integrated oil firms globally. The business is listed on the local and NYSE stock exchanges but remains majority-owned by the Brazilian government, which holds about 65% of the company.

Notably, Petrobras sources almost all of its oil offshore with about 80% derived from deep-water wells. The company began ramping up production from 2008 after making major oil discoveries in deep offshore fields located more than two kilometres below the geological salt layer, which formed at the time of the Gondwana landmass.

To exploit its discoveries, Petrobras more than quadrupled its borrowing levels over the next five years to a peak of about $140bn in 2014, compared to just $30bn previously. In the process, the company increased its leverage ratio from one-times to five-times.

While Petrobras has eased off the debt-pedal somewhat since 2014, its current borrowings of roughly $114bn mark it out as the largest constituent of the Global High Yield Index.

With leverage rising faster than production, mounting interest costs put extreme pressure on Petrobras's cash flows by 2015, ahead of the $12bn in principal payments it was due to pay in 2016. Unfortunately, the Petrobras debt squeeze coincided with slumping oil prices and, to the further dismay of investors, a major corruption scandal flowing into the public domain.

An official investigation, launched in 2009, eventually uncovered a deep-seated bribery culture within Petrobras. According to the investigators, government-appointed senior executives at Petrobras had systematically squeezed about $1.9bn in bribes from suppliers and contractors, funnelling the proceeds back to politicians.

The corruption scandal, known as *Lava Jato* or Operation Car Wash, highlighted the Brazilian government's conflicted role as both Petrobras's controlling shareholder and the nation's policy maker. For example, the Brazilian government had habitually used Petrobras to control internal inflation – directing the company to sell petrol to domestic consumers below international prices. The activity saw minority shareholders shouldering losses while putting strain on free cash flow available to pay bond-holders.

Unsurprisingly, the exposé revealed Petrobras's lack of adequate corporate-governance mechanisms to manage these conflicting interests. However international investors have been pushing for better governance procedures within Petrobras for some time.

As far back as 2012, for instance, Hermes EOS has pressed for board changes at Petrobras that would see the independent directors take up the two seats reserved for minority shareholders that were not closely linked to the government. Historically, the Brazilian government had stacked the Petrobras board by appointing nine of the 11 seats and allowing minority shareholders – including state-controlled pension funds – to vote for the remaining two.

But in 2013, after a period of intense negotiations, Hermes EOS and a group of international investors were successful in seeing their two independent director nominees elected to the Petrobras board. By the 2015 AGM, at the height of the Car Wash scandal, the Brazilian government itself put forward independent board directors in lieu of the traditional state appointees.

Since then, Petrobras has begun to further bolster its corporate-governance framework, starting with the appointment of a chief compliance officer who, following international best practice, reported to the board rather than the chief executive. The pace of reform accelerated further in the second quarter of 2016 when new CEO, Pedro Parente, took the helm and imposed new rules that have heartened investors, including:

- Petrobras managers will be hired solely on merit;
- Economic rationality will dictate commercial strategy; and, most importantly,
- Petrol pricing will be managed independently and without state interference.

Satisfied with Petrobras's board composition, Hermes EOS started focusing on the governance of its many subsidiaries – which facilitated much of the corruption revealed by Car Wash. There are up to 100 of these businesses, and none of them are listed and therefore required to report publicly. Hermes EOS has encouraged them to adopt the same best practices as Petrobras, such as its board nomination process.

The engagement with Petrobras has also expanded to cover its commitments to environmental sustainability. The company, which previously demurred on climate change discussions, has shown its interest in changing by inviting Hermes EOS to present its expectations of what oil companies should be doing in response to the rising global temperature.

In addition, Petrobras's new corporate strategy, which was revealed in September 2016, emphasises debt reduction and focuses on targets that include:

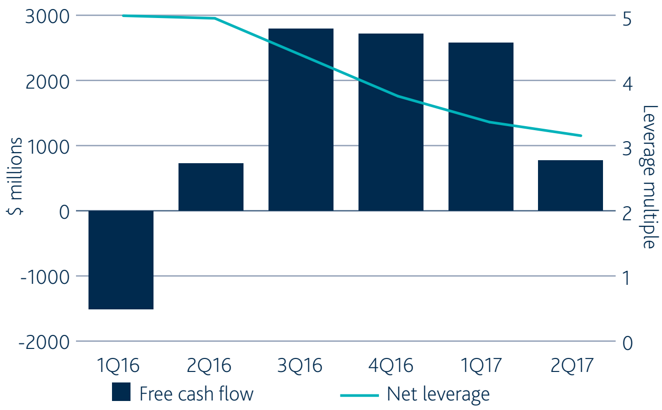
- Reducing leverage to 2.5-times by the end of 2018;
- Selling $21bn of assets by the end of 2018;
- Pursuing partnerships and joint ventures, which are projected to reduce capex burdens by 25% by 2021;
- Increasing cash flows by improving efficiency and reducing headcount; and
- Reducing accident rates.

Petrobras still has some work to do but these initiatives have already struck paydirt, as demonstrated by the following achievements:

- Leverage has declined from 5-times in the second quarter of 2016 to 3.15-times a year later;
- Free cash flow has been generated for the last five consecutive quarters; and,
- Moody's upgrading Petrobras debt from B3 up to B1 with positive outlook.

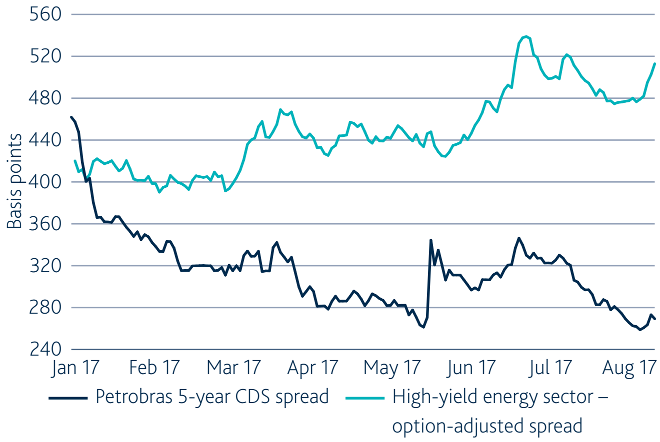
Strategic turnaround combined with substantially strengthened corporate governance resulted in Petrobras spreads rallying despite the overall weakness in the energy sector weakness (see figure 4).

Figure 3. Petrobras: Improving free cash flow and declining net leverage



Source: Petrobras company filings as at 11 August 2017.

Figure 4. Petrobras has outpaced the energy and broad high-yield markets this year



Source: Barclays Live as at 11 August 2017.

PEMEX: SEEKING SUSTAINABILITY

North of the Brazil border, Mexico's Pemex – or Petróleos Mexicanos – has experienced some of the same problems as Petrobras, namely: high debt levels and government interference in its commercial operations. Unlike Petrobras, it is wholly owned by the government.

Today the firm churns out about 2m barrels of oil a day, which makes it the eighth-largest producer globally. Pemex generates roughly $66bn of annual revenue but – as with Petrobras – relies heavily on international debt markets to fund its operations.

Currently, the Mexican firm has around $100bn of debt outstanding, putting it in a similar position as Petrobras. However, in contrast to its Brazilian counterpart, Pemex is experiencing a decline in production as its maturing oil fields peter out. At the same time, the Mexican producer is under pressure to reduce capex, partly to make good on its extraordinary tax obligation to the government.

In 2016, Pemex paid out about 90% of its operating profit in taxes, some of which was funded by debt. Over the last few years, too, the Mexican government has used Pemex in its initiative to constrain domestic petrol prices, resulting in operating losses for the company.

Needless to say, credit investors were not impressed. But Mexico is implementing a wide-ranging set of energy reforms that have, to a large extent, allayed the credit market's concerns.

First, the reforms introduced a higher level of competition in the Mexican oil markets, opening up new partnership opportunities for Pemex that will help it address declining production problems and capex constraints. Second, the government has committed to gradually paring back the heavy tax burden it imposes on Pemex over 2016-2019 in a move that will significantly improve free cash flow. Third, the reforms will ensure that Mexican petrol prices are set by market forces by 2018. Pemex has already begun the process, with a national petrol-price hike of 15-20% this January.

The reforms, plus the bump in oil prices from the 2016 low, has seen Pemex achieve some significant improvements in the second quarter of 2017: dropping net leverage from 5-times to 4.0-times, and dramatically reducing its free cash flow deficit from $4.4bn a year ago to $0.4bn now.

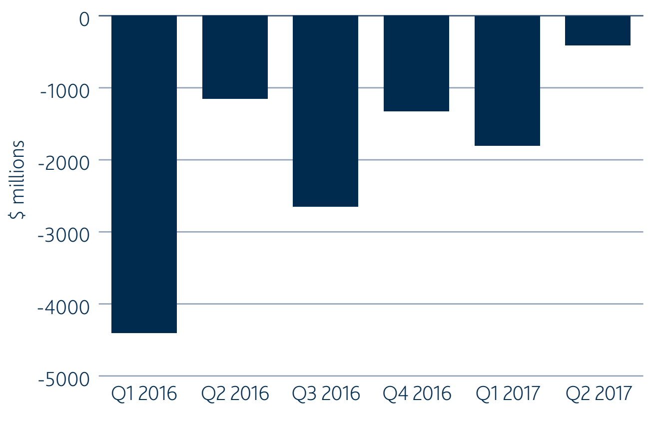
As we assessed these developments, ESG concerns also entered the frame. They included: Pemex's significantly below-par record on workers' safety, and a poor environmental management history that featured numerous oil spills and leaks. To discuss these matters, we asked Hermes EOS to initiate conversations with Pemex. To its credit, the company was keen to take up the dialogue.

In particular, our discussions with the company's sustainability team in May 2017 went some way to reassuring us about its commitment to better ESG practices. From this engagement, it was clear that Pemex was aware that it needed strong ESG performance to attract discerning investors in global debt markets. With the Mexican energy sector undergoing deregulation, Pemex can focus more on expansion and less on supporting the federal budget. Best-practice management of its operations will enable it to become more competitive.

The company has made some progress in lifting workforce health record to industry standard, citing a recent workplace safety campaign that mandated 'zero tolerance' for risky behaviour. And labour safety and carbon-emission-reduction targets have been published in its five-year business plan ending in 2021.

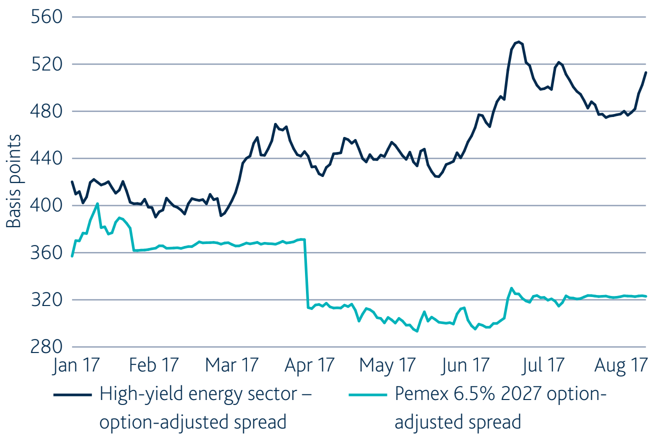
These actions to date augur well for Pemex, but we will continue to monitor the company against its stated ESG targets. We would certainly consider moving to an above-benchmark position in Pemex debt if it reduces ESG risks as planned – assuming, of course, the group's credit profile remains stable and valuation sensible.

Figure 5: Pemex: Benefiting from a declining free cash flow deficit



Source: Pemex company filings as at 11 August 2017.

Figure 6. Pemex: Ahead of the market in 2017



Source: Barclays Live as at 11 August 2017.

THE GOOD OIL

Oil continues to be a vital resource for global society: despite the growing popularity of electric cars and the threat of fossil-fuel deposits becoming stranded assets, demand for the resource is likely to increase for the forseeable future. For credit investors, knowledge of oil companies is essential, as they are the largest debt issuers in the high-yield market.

However, understanding their credit attributes is not enough. As demonstrated by the case studies above, the performance of both Petrobras and Pemex are driven by improving ESG dynamics, strongly supported by engagement, as well as traditional credit risks. By drilling deep into these companies, we identified non-financial aspects which could be improved to benefit the bottom line and therefore investment performance. ESG integration and engagement helped fuel the change.

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Multi asset inflation

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Contact information

Business Development

United Kingdom	+44 (0)20 7680 2121	**Africa**	+44 (0)20 7680 2205	**Asia Pacific**	+65 6850 0670
Australia	+44 (0)20 7680 2121	**Canada**	+44 (0)20 7680 2205	**Europe**	+44 (0)20 7680 2121
Middle East	+44 (0)20 7680 2205	**United States**	+44 (0)20 7680 2205		

Enquiries marketing@hermes-investment.com