BRAZIL
PART 2
The Story Continues…

A Special Report From *Oil and Gas Investor* and Global Business Reports

From Boom To…Boom?

Both Petrobras and the government's contract terms adopt a more flexible stance to attract investment.

Global Business Reports' first report on Brazil (October 2008, *Oil and Gas Investor*), found an oil and gas market in full bloom. Petrobras—the mixed public/state Brazilian petroleum company founded in 1953—had just discovered the pre-salt (or subsalt) fields, the price of oil was above $100 a barrel, and both Petrobras and the Brazilian government were eager to attract E&P and service and supply companies to assist in exploiting the huge potential.

Just as importantly, the (by most accounts) excellent political leadership that Brazil had experienced since the mid-1990s had created a stable macroeconomic climate, with 6% average GDP growth over the last four years, a stable banking system, exports of $200 billion per annum and inflation at 4%. This picture meant that the attractiveness of Brazil's economic potential was now outweighing the onerous nature of the country's adherence to labor-friendly laws, promotion of national companies, high tariffs and taxation.

Then, as now and for many years to come, the key actor in hydrocarbons was Petrobras, responsible for 99.9% of production and about 95% of service contracts. Petrobras' aim had long been oil self-sufficiency for Brazil, an aim achieved in economic terms in 2008 with the country reaching production of 1.9 million barrels a day.

Petrobras is now retooling its operations in a strategy that emphasizes exportation over internal consumption. Such a move—loudly debated at the September 2008 Rio Oil and Gas Expo—would involve no less than a transformative leap forward for oil and gas activities in Brazil. Indeed, Petrobras' five-year plan (being tweaked at press time) called for 146 vessels (including anchor handling tug supply vessels (AHTSs), platform supply vessels (PSVs), tankers, 24 producing platforms, six refineries, 40 drilling rigs and the world's first "floating production, storing and offloading (FPSO) factory."

Brasbunker provided one of the largest netting enclosures ever made, in Camamu Bay, Bahia.

Of course, even then there were clouds on the horizon.

Barely weeks after the Rio Expo, Sao Paulo's Bovespa stock exchange joined the rest of the world in turning away in fear from the subprime losses that have now infected the entire global financial system. With trillions of dollars in capital wiped out of the world markets and the price of oil nose-diving, the main question for Brazilians, as for the rest of the world, was "what happens now?"

The dozens of executives and officials interviewed for this report were cautiously optimistic. Ironically, the "country first" socialism that was arguably responsible for holding back foreign investment and economic and human development for so many

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decades has to some extent insulated Brazil from the worst ravages of the credit crunch. Billion-dollar companies in Brazil may boast corporate governance structures and quality controls on a par with those found anywhere in the world, but the vast majority of these are neither listed nor have any intention of going public. Of those prepared to talk about their financial arrangements, a clear majority had Brazilian private-equity partners that, they argued, would also be less affected than most. Lastly, and perhaps most importantly, the government under the popular President Lula has set out a clear strategy for mitigating the effects of the crunch—adding extra credit to the market through its own organs, freeing up Brazilian firms' ability to seek credit abroad and accelerating the pace of the fiscal and monetary reforms it had already outlined. And, Brazil has the reserves to walk the walk.

Gaining entry

One of the wittier epithets about Brazil is Charles de Gaulle's "Brazil is the country of the future, and will remain so." He had a point: While opportunity exists, never have the words "caveat emptor" been more apt than in describing capital-intensive investment in Brazil. Most observers agree that doing business in Brazil is very difficult.

The sundry laws and regulations that determine the rules of the game are mystifying. Plinio Machado, founder of city gate and parts supplier and manufacturer Vanasa Multigas, Sao Paulo, notes with amusement that the documentation required by Petrobras for a truck-sized city gate "took up as much space as the equipment itself." It turns out he was not joking. Indeed, the bureaucracy involved in being a service and supply company to Petrobras requires the full-time dedication of a sizeable portion of staff.

Ricardo Pessoa, CEO, UTC Engenharia

Becoming a significant player also requires a significant presence on the ground. Labor restrictions and local content rules (Petrobras requires that local content make up about 65% of the equipment and labor in most contracts) are obvious reasons to have a substantial local operation.

Part of the difficulty is Petrobras' dominance. The company is legally required to negotiate a good deal from its suppliers and routinely pays some 35% less than market price. As well as being a prudent shopper, Petrobras wants the best and to understand the "hows and whats" of what it has purchased. Those who want to do business with Petrobras must provide premium technologies at a bargain price.

Can such a strategy be profitable for suppliers? Evidently, yes. An annual revenue growth rate of 15% was low for the companies interviewed for this report, and several companies had attained revenues of $200 million-plus after being in business for barely a decade. A striking example is EPC firm UTC Engenharia, which, in its 2007 annual report, set a goal of doubling revenues to $700 million by 2014; according to CEO Ricardo Pessoa, it had reached its goal by year-end 2008.

Petrobras' hard-nosed attitude toward risk in contracts, the increasing level of internal and external environmental controls on its activities, and the growth in scale and value of the contracts it issues are linked to a series of three catastrophic accidents—the most notorious being the 2001 Guarabana Bay pipeline spill. The incident created a huge scandal both inside and outside of Brazil and was integral to Petrobras' realization that the expertise, capital and risk-sharing capacities found in the oil and gas market abroad were now essential to Brazil's future. Thus the company has become more flexible when negotiating contracts, particularly when it comes to sharing risk.

UTC's Pessoa points to the difference between the tenders put out for the P-55 and P-57 FPSOs as compared to those for P-43, P-47 and P-48. "Petrobras is really making efforts to open up space for innovation. They are standardizing their specs, and being much less prescriptive with them, really letting the market influence what they do rather than the other way around."

While Petrobras is changing, Brazil's government is also making it easier for companies to enter the sector. Indeed, gaining entry to Brazil is relatively easy. That said, getting a company up and running afterwards is less so, and making it profitable on a large scale is a significant challenge. Partly, this is due to the importance of relationships. Many of the international firms that have been successful in Brazil have a long history there. Until recently, this "relationship requirement" put off many firms whose technology or services were suited to Brazil, but that preferred to sell though distributors.

Testing the water

A common mode of entry for companies such as Seacor and Norskan Offshore has been to test the water first by entering Brazil in a small way. Norskan Offshore CEO Hans Ellingsen explains that the company initially made a token $2.5-million investment into a one-line handler in order to gain access to BNDES funding (one of Brazil's principal development finance organizations). Once it had established relationships and processes and the peculiarities of Brazil's business environment had been integrated into the company's practice, it quickly upgraded to a fleet of six ships, focused primarily on premium anchor handlers built in Brazil. Norskan now has a firm base and settled strategy focused on "conducting an excellent human resource policy to retain workers while maintaining an excellent relationship with Aker Yards, the only yard in Brazil capable of building the bigger and more advanced vessels, whose capacity we have bought up until 2013," says Ellingsen.

Setting up construction operations within Brazil makes a big difference in the navigation sector, and firms such as Norskan, Edison Chouest Offshore, Seacor and Brasbunker are just a few examples of firms that have already or are actively considering setting up construction premises. It is also a strong driver in most other sectors, such as pipe manufacturing and adaptation, city-gate construction and manufacturing of less capital- and technology-intensive products.

As well as meeting technical requirements, manufacturing in Brazil helps companies establish themselves as core suppliers to Petrobras. Even firms that cannot manufacture their more complex solutions in Brazil, such as Aggreko and Roxar, are actively considering manufacturing at least some of their parts or more simple solutions in the country.

For those whose solutions are specific and both technology and capital intensive, the road to selling involves a complex and time-consuming process that Ed Riley of Mount Engenharia describes as "multidimensional chess." Petrobras is a large and complex entity, and its relevant divisions—for example, engineering, exploration and production, procurement, CENPES (its highly respected research center), and those charged with specific projects—all have separate processes, as well as changing levels of "pull," which must be navigated before a given solution can even be officially considered for a contract.


Norskan Offshore CEO Hans Ellingsen

Of course, Petrobras is not the only factor in doing business in Brazil. Clovis Galdino, Subsea 7's operations manager, says it was "our work with Shell which really created a paradigm shift for us here." Independents are more ready to use new solutions, as well as proven solutions new to Brazil. Their increasing footprint means that there is more space for establishing a given solution in the market.

Further, while the long process of being approved to work with Petrobras trundles on, it is possible to pick up contracts that mitigate the question marks over short-term profitability for new entrants. Mario Gibson, Latin America vice president for award-winning wireline firm Welltec, explains that the work that the company has "been able to pick up with Shell, alongside 'standard' logging jobs for Petrobras, has been instrumental in sustaining our interest in being a long-term player in Brazil."

The challenges of the Brazilian market are: regulation and licensing, sourcing quality human resources, sourcing quality partners, and ensuring that one's finances remain healthy despite the pressures of working predominantly for a state company. While daunting, these challenges are not insurmountable, as many Brazilian and international firms have proved.

The entrance strategy

On the software side and in other specific areas, such as highly sophisticated ultradeep-sea solutions, qualified firms do pick up contracts. Heitor Tozzi of environmental consultancy GSI Brooks says, "Petrobras is very keen to avoid being 'locked in' to a given supplier in any area. It likes splitting work and—while this might be frustrating for some—it is very good in terms of encouraging new entrants and ensuring that the technology used in Brazil is constantly improving."

Firms such as CGG Veritas, Paradigm, Roxar, Beicip Franlab and others have been direct beneficiaries of this approach; the flip side, however, is that Petrobras retains a larger project-management role. Some observers believe that Petrobras is moving away from this project-management role, however, and is increasingly attracted to the idea of giving out larger and larger contracts. Multinationals that can spread costs believe this gives them a definite advantage.

Additionally, multinationals can acquire companies whose solutions would add to their existing portfolios. One independent E&P that has acquired an exploration portfolio is Canadian-financed newcomer Brasoil. Entering the market in 2006, the firm used Canadian private-equity funds to buy into assets held by Quieroz Galvao before successfully bidding for an exploratory block in the ninth bidding round. "Yes, there are challenges in Brazil, but we aim to become a major independent in the country, which is possible with the right funding," says Brasoil CEO Don Parker.

Brasoil has complemented its strong financial backing with strategic alliances that have provided a diverse exploration portfolio. It partnered with fellow independent Norse Energy to win the rights to three deepwater blocks in the ninth bidding round. The blocks — S-M-1035, S-M-1036 and S-M-1100 — are adjacent to each other in 200 meters of water some 100 kilometers northeast of Coral Field.

Brasoil's portfolio also contains a mix of shallow-water and onshore holdings, ranging from mature, producing blocks to potential prospects, and including a 10% interest in Petrobras-operated Manati, Brazil's largest nonassociated gas field.

Capital trends

The question of whether Brazilian companies can compete is an open one that Petrobras, the Brazilian government and Brazilian firms themselves have been striving to answer in the affirmative. One of the key limitations has always been capital. Brazilian banks and funding bodies are notoriously stingy with their loans, hobbling local companies' growth.

But while capital remains a problem, the situation has eased. Jose Augusto Pereira of PipeWay, which developed the award-winning "Feeler Pig," says his company has benefited from support from Petrobras' CENPES research center and the Studies and Projects Finance Agency, which receives government money to invest either in universities or companies to develop innovative products. "We have received about $1.5 million over the past 10 years to invest in research. This funding is very difficult to get. You need to be a solid company with a solid business plan and a solid technical team in order to re-

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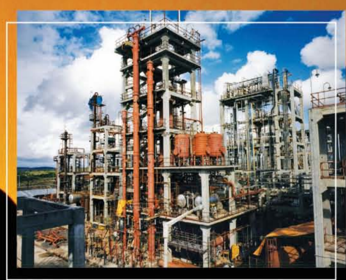
Along its history of over 30 years providing technology, work and experience to Brazil's development, UTC Engenharia believes that this is the best way of contributing with the sustainable development and quality of life improvement. Our works are generating power, work, expertise and riches for the country, in addition to training professionals who are qualified and highly committed to the quality of our services.



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ceive it, but it's there."

Another welcome development has been the emergence of Brazilian private-equity and venture-capital firms eager to combine their knowledge of the Brazilian market with their knowledge of modern finance. Fortunately, due to the restrictive nature of Brazil's financial regulation, most of these firms were prevented from becoming involved in some of the more arcane financial products at the root of the current global financial crisis.

A third model for success is "marriage" between Brazilian and international firms, such as the union between Fluke Engenharia and Acteon. The latter is primarily a services company, while Fluke is primarily a manufacturing firm, although it also provides services. The reason for a mixed marriage? "Acteon was interested in us firstly because of our strong relationship with Petrobras and secondly because of our significant infrastructure, both physical and human," says Antonio Manuel F. dos Santos Filho, general director of Fluke Engenharia, Acteon.

Fluke holds the contract for 100% of Petrobras' moorings and torpedoes and owns two 80,000-square-meter shipyards in the Rio region. The attraction for Fluke is telling: "We wanted to start working for Petrobras outside Brazil and, outside of Brazil Petrobras tends to contract full-service third parties to manage all aspects of their mooring and foundations, rather than parcel off the work into smaller contracts. We were limited by capital and technology and Acteon supplies both," says dos Santos Filho.

Indeed, Acteon has been fortunate to acquire two shipyards. These are in short supply and in high demand given the scale of what Petrobras will need on the navigation side and its requirement that its needs be met through Brazil-constructed vessels. Some question the feasibility of that model. As Norskan Offshore's Hans Ellingsen says, "For the 24 vessels now 'on the street', only one shipyard [Aker Yards] can build the big anchor handlers and we have bought all their capacity up to 2013." The situation is less urgent on smaller vessels, as many companies now have their own shipyards—CBO, Wilson & Sons and Edison Chouest Offshore, to name just a few.

The past few years have seen domestic and foreign firms prosper in Brazil. Whether Brazil continues to host such growth in the future remains unanswered, but the signs are positive.

From risky to safe?

Petrobras is a vast company with an extremely successful recent track record of making technological advances while holding down costs. Its policy of supporting Brazilian firms is unlikely to change anytime soon, nor is its habit of putting intense cost pressure on its suppliers. On the whole, Brazilian firms are concerned but bullish.

"In the past, companies in Brazil were lucky if they could know what was going to happen the next week—five-year plans were a fiction, and 15-year plans a dream," says Setal Engenharia's CEO Alberto Padilla. "With our new-won stability, though, and the massive discoveries that keep being thrown up, this has changed. The strong pressure that Petrobras has put on its suppliers to improve and the relationships that we are forging with international players mean that Brazilian companies will be first choice in one of the most stable oil and gas markets in the world."

International firms can also take solace from Petrobras' continuing dominance of the market. Petrobras, unlike other national oil companies, is a mixture of public and private capital that is rightly a source of pride for Brazilians. It will proceed with significant investments and, according to many insiders, can remain profitable with a crude oil price as low as $20 a barrel.

Equally importantly, nearly all those interviewed expressed confidence that Petrobras would ease the financial pressures that it currently places on service and supply firms. Ricardo Pessoa of UTC echoed others in saying that "Petrobras is a huge generator of cash. It is very liquid and is aware that many of the firms it needs to complete its projects are not. I have no doubt whatsoever that it will reduce the level of capital it requires of partners, while at the same time shouldering more of the burden of risk in terms of large-scale projects."

> ***"Acteon** was interested in us firstly because of our strong relationship with Petrobras…." Antonio Manuel F. dos Santos Filho, general director of Fluke Engenharia, Acteon*

Separately, some argue that the falling price of oil means that there is actually increased opportunity for firms providing solutions that improve efficiency and increase yield. "For us the focus is improving petroleum production," says Francisco Fernandez of Champion Technologies. "The price may be going down, but that's okay as it means we're actually better off as our services are more in demand."

Similarly, Mario Gibson of Welltec argues that technologies that "fit with the complexity inherent in much of the E&P work in Petrobras' inbox will benefit over the next year or two: technologies that allow for the minimization of the use of explosives, and maximization of well isolation, facilitate horizontal drilling and manipulate the slide from well opening and closing."

Sums up Clovis Galdino, general manager of Subsea 7: "Pre-credit crisis there was a lot of worry about the services market being chronically undersupplied. I think this will now be less of a danger, and some of the new players circling about may back off, but there will still be more than enough work for the companies that have the assets and solutions that fit Brazil's needs." □

The Right Ingredients

As Fernando Schahin, chief financial officer of Grupo Schahin, puts it, "Developing what we have is a monumental task, and this was so even before the credit crunch. We need refineries, more skilled human resources, technology, research….It will be hard for the Brazilian private sector to cope with the challenge."

That the general unevenness in quality, capital and knowledge across Brazil's various sectors is recognized is a welcome note, given that previously, ambitions and reality often failed to connect.

Brazil's actual need for, and ability to finance, large-scale investments is best summed up by Paulo Vilela Ibanez, CH2M Hill's Brazil operations director. "Brazil is rich in natural resources—containing the world's largest reserves in iron ore and copper, as well as giant new offshore finds that will double oil and gas production.

"Brazil has big EPC (engineering, procurement and construction) companies and a very good standard of engineering more generally, but what it lacks is the resources to do all the work that needs to be done. This is the main bottleneck. So for an international company that has resources all around the globe and proven expertise, Brazil is a big opportunity."