

**Rating Action: Moody's downgrades Petrobras' ratings to Baa2**

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Global Credit Research - 21 Oct 2014

New York, October 21, 2014 -- Moody's Investors Service downgraded Petrobras S.A.'s (Petrobras) global foreign currency and local currency debt ratings to Baa2 from Baa1. The downgrade reflects Petrobras' high financial leverage and Moody's belief that it is only likely to decline significantly well after 2016, contrary to our original expectations, given downward pressures on oil prices and the local currency as well as high capex commitments. The outlook remains negative.

"While Petrobras has been relatively successful in executing on its ambitious capital program and has delivered on aggressive production targets, leverage continues to grow in 2014 given mainly its inability to pass through costs related to imported oil products, local currency devaluation, and an aggressive capex program", said Nymia Almeida, a Vice President-Sr. Credit Officer at Moody's.

Downgrades:

..Issuer: Petrobras Global Finance B.V.

....Subordinate Shelf (Foreign Currency), Downgraded to (P)Baa3 from (P)Baa2

....Senior Unsecured Shelf (Foreign Currency), Downgraded to (P)Baa2 from (P)Baa1

....Senior Unsecured Regular Bond/Debenture (Foreign Currency), Downgraded to Baa2 from Baa1

..Issuer: Petrobras International Finance Company

....Senior Secured Shelf (Foreign Currency), Downgraded to (P)Baa1 from (P)A3

....Subordiante Shelf (Foreign Currency), Downgraded to (P)Baa3 from (P)Baa2

....Senior Unsecured Shelf (Foreign Currency), Downgraded to (P)Baa2 from (P)Baa1

....Senior Unsecured Regular Bond/Debenture (Foreign Currency), Downgraded to Baa2 from Baa1

..Issuer: Petroleo Brasileiro S.A. - PETROBRAS

.... Issuer Rating (Local Currency), Downgraded to Baa2 from Baa1

....Preferred Shelf (Foreign Currency), Downgraded to (P)Ba1 from (P)Baa3

....Preferred Shelf (Foreign Currency), Downgraded to (P)Ba2 from (P)Ba1

....Subordinate Shelf (Foreign Currency), Downgraded to (P)Baa3 from (P)Baa2

....Senior Secured Shelf (Foreign Currency), Downgraded to (P)Baa2 from (P)Baa1

....Senior Unsecured Shelf (Foreign Currency), Downgraded to (P)Baa2 from (P)Baa1

Outlook Actions:

..Issuer: Petrobras Global Finance B.V.

....Outlook, Remains Negative

..Issuer: Petrobras International Finance Company

....Outlook, Remains Negative

..Issuer: Petroleo Brasileiro S.A. - PETROBRAS

....Outlook, Remains Negative

## RATINGS RATIONALE

Through June 30, Petrobras' debt (Moody's adjusted) reached USD 170 billion, a USD 25 billion increase from December 2013, mainly as a consequence of FX devaluation, losses in downstream related to the gap between international and local prices for gasoline and diesel and funding for capital expenditures. The company's inability to increase local prices for oil products vis-a-vis international prices has been causing major losses in downstream in the last few years; the government has prevented increases in oil products in order to control inflation.

The current lower international prices for oil products, if sustained in the medium term, will be beneficial to Petrobras' downstream business; however, lower crude oil prices will negatively affect the upstream operation. In turn, although capex may decline in 2015 based on what the company submitted to the federal government for Congress' approval (about R\$ 87.6 billion, equivalent to about USD 37.9 billion in capex expected for 2015, down from approximately USD 41 billion expected in 2014), Moody's believes that it will not be enough to allow for an accelerated reduction in debt in a context of higher foreign exchange rate, which places pressure on debt and interest metrics. In this market environment, deleveraging will take longer than anticipated.

In the last twelve months ended in June 2014, leverage metrics have increased steadily and are elevated, with adjusted total debt/EBITDA of 5.3x, debt/proved and developed reserves of \$21.88/BOE, and debt/daily production approaching \$74,000/BOE, the highest among its peer group of integrated and national oil companies.

Petrobras continues to increase oil production and so far in 2014 its pre-salt production in particular reached 532 thousand bpd in September, from 344 thousand bpd in December 2013; total crude oil production reached 2.1 million bpd in September, from 1.9 million bpd in December 2013.

It is also positive that, in the medium term, Petrobras' refining capacity will increase with the start of RNEST and Comperj refineries, expected for 2015 and 2016, respectively, reducing the need for product imports in about 395 mbbbl. However, funding the capex necessary to reach a target of about 4 million bpd by 2020 has become more difficult given elevated leverage, which adds to the already high execution risk related to timely delivery of oil drilling and production equipment given the need to meet local content requirements.

Petrobras' Baa2 ratings are supported by its large-scale reserve base and dominance in the Brazilian oil industry with a leading position in one of the industry's most prospective offshore areas; by its sizeable new pre-salt discoveries and renown technological expertise; and by its growing production. In addition, the company's continuous focus on project execution and cost reduction should ease some of the cost overrun issues and delays it has experienced in the past.

Petrobras' Baa2 ratings also reflects government support and the impact of joint-default analysis. Underlying the ratings downgrade, Moody's has lowered Petrobras' baseline credit assessment to baa3 from baa2, reflecting its high leverage profile. We are maintaining assumptions of high support from the government of Brazil (rated Baa2 with a negative outlook) and moderate dependence/default correlation between Petrobras and the government.

While government support continues to provide one notch of uplift on the BCA, we note increasing linkages between Petrobras and the sovereign. The government has been playing a larger oversight role in Petrobras' operations, strategic direction and offshore development.

We are maintaining a negative outlook on Petrobras' ratings given the probability that the company's leverage may increase further due to lower international oil prices and limited flexibility to reduce cost, with negative impact on margins. In this environment, execution on the company's capital program and achievement of targeted production growth could be negatively impacted.

Petrobras' ratings could be downgraded if financial leverage increases and is sustained with debt/EBITDA above 5x or if production growth falls short of targets. A downgrade of Brazil could also pressure the Petrobras' ratings.

We do not see momentum for an upgrade of Petrobras' ratings in the near-to-medium term. In the longer-term it could be upgraded as the company lowers its debt leverage and delivers on rising and profitable production and reserves growth, in conjunction with a higher rating on Brazil's government debt.

The principal methodology used in these ratings was Global Integrated Oil & Gas Industry published in April 2014. Other methodologies used include Government-Related Issuers: Methodology Update published in July 2010. Please see the Credit Policy page on [www.moody.com](http://www.moody.com) for a copy of these methodologies.

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