FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades 3R's Ratings to 'BB-'/'AA-(bra)'; Outlook Stable

Fri 02 Aug, 2024 - 14:29 ET

Fitch Ratings - São Paulo - 02 Aug 2024: Fitch Ratings has removed from Rating Watch Positive and upgraded 3R Petroleum Oleo e Gas S.A.'s (3R) Long-term Local and Foreign Currency Issuer Default Ratings (IDRs) to 'BB-' from 'B+' and its long-term National Scale Rating to 'AA-(bra)' from 'A(bra)'. Fitch has also removed the Rating Watch Positive and upgraded the rating of 3R Lux S.à.r.l's (3R Lux) USD500 million notes due 2031 to 'BB-' from 'B+'/'RR4'.

The upgrade follows the closing of 3R's merger with Enauta Participações S.A. (Enauta) and Maha Energy Brasil Ltda. The all-stock transaction not only strengthens 3R's scale and operating efficiency, but also materially reduces its financial leverage, in addition to broadening its already diversified asset base. Fitch believes the merger will bring tangible synergies in the offshore operations and better position 3R to develop growth opportunities. The ratings should continue to benefit from 3R's low exploration risk and capex flexibility that are reflective of its comfortable reserve life.

KEY RATING DRIVERS

Higher Scale, Better Efficiency: The merger increases 3R's scale to levels compatible with the 'BB' category and broadens its asset base, further diluting operating risks that are typically high in the sector. 3R's proven reserves (1P) and production should increase to 511 million boe and 90 kboe/d, proforma for 2024, and 110 kboe/d in 2025. The larger scale and potential operating synergies should contribute to capex and opex optimization in the offshore business. Fitch believes 3R will be able to contract services and equipment at better terms and use shared workover and drilling rigs, as well as logistical support. It should also be able to improve on the pricing of exports, with Papa Terra field's greater storage capacity and the low-Sulphur, better-quality oil from Atlanta field.

Robust Reserves: 3R should maintain a comfortable reserve life, which provides capex flexibility during downward market cycles. This is especially positive now that most of the production will come from offshore fields, where opex and capex are less flexible.

Fitch estimates 12 years of 1P reserves through 2026, assuming no reserve replacement. Offshore revenues should increase to around 55% of total revenues on average for 2024-2026, from 32% before the merger. Undeveloped reserves now represent 60% of the proved reserve base, from 40%, reflecting higher growth prospects with lower capex predictability.

Strong Growth: Fitch estimates 3R's production to increase 11% per year on 2024-2028, on average (proforma for 2024), driven by facilities improvements in Potiguar cluster and the gradual increase in Papa Terra's efficiency, after heavy maintenance works. The startup of the new FPSO in Atlanta, expected for 3Q24 should also bring significant growth.

Atlanta's heavy oil production faces above-average depletion rate, but capex included in the base-case scenario includes new drillings that should significantly increase production by 2028. Fitch expects the relevant environmental licenses to be issued in 2024. The merger better positions 3R for further consolidation and enhances organic growth prospects with Enauta's contingent, adjacent resources and exploratory fields.

Improving Cost Profile: Production ramp-up and operational synergies should contribute to diluting high fixed costs, despite the upcoming challenges on asset integration. Fitch estimates 3R's lifting cost around USD20/boe in 2024, still in line with 2023, reflecting the consolidation of Enauta's currently higher costs, and around USD17/boe in 2025, with a downward trend going forward. Most of the reduction should come from Papa Terra and Atlanta, following the production increase. Half-cycle costs (operating costs plus interest payments) should reach around USD30/boe in 2024-2025 on average, which compare unfavorably with 'BB-' onshore peers in the Permian basin.

Quick Deleverage: The merger accelerates 3R's deleverage trend. Fitch estimates EBITDA net leverage to reduce to 1.6x in 2024 and 0.6x in 2025, from 2.8x in June 2024, and debt/1P reserves to decrease to around USD4.1/boe in 2024-2025, on average, from USD 5.2/boe in June 2024. These ratios incorporate into debt M&A payables due to Petrobras (BRL1.8 billion in June 2024) and derivatives (asset balance of BRL2.8 billion).

Fitch's projections do not consider financial synergies related to maximization of regional fiscal benefits, monetization of tax credits or goodwill amortization, but considers a lower funding cost leading to higher EBITDA Interest Coverage at around 7.0x in 2024-2025.

Substantial Capex Limits FCFs: Absent potential synergies arising from the merger, Fitch projects 3R`s consolidated EBITDA increasing to BRL5.1 billion in 2024 and BRL7.7 billion in 2025, from BRL2.4 billion in the last twelve months (LTM) March 2024. Around 70% of EBITDA should convert into cash flow from operations (CFFO) as of 2025, but investments should consume around 90% of the total CFFO to be generated through 2027.

Capex projections average BRL3.7 billion in 2024-2026, including half the investments expected for developing unproved reserves, based on reserves certificates. FCF should turn positive in 2025, after negative BRL1.2 billion in 2024. Projections also include dividends of BRL93 million in 2024 and close to BRL900 million in 2025-2026, on annual average, equivalent to 25% of net income.

DERIVATION SUMMARY

3R's diversified asset base is a key differentiation factor in comparison with North American E&P, oil-weighted producers in the onshore Permian basin (Texas/New Mexico), such as CrownRock, L.P. (CrownRock; IDR BB-/Watch Positive), Matador Resources Company (Matador; IDR BB-/Outlook Positive) and SM Energy Company, L.P. (SM; IDR BB-/Watch Positive).

3R stands out for its long 1P reserve life of 12 years, compared to the four year to nine years range for the others, but these companies are larger and more efficient than 3R, with production size between 150 kboe/d and 190 kboe/d, based on Fitch's projections, and production costs between USD10/boe and USD13/boe, below the USD28/boe level that Fitch estimates for 3R. These factors compensate the credit risk of the Permian producers for the lower diversification of their asset base, although the concentration favors efficiency.

All these companies operate in regulatory friendly hydrocarbon environments, even for unconventional production in the Permian basin, and should present low financial leverage in the coming years, with net debt/EBITDA below or close to 1.5x, especially CrownRock (close to 0.5x) and 3R (close to 0.5x as of 2025).

Among Latin America peers, Prio S.A. (IDR BB/Stable) benefits from larger scale, significantly higher operating efficiency and lower financial leverage, while SierraCol Energy Limited and Geopark Limited, both rated 'B+'/Stable, are smaller and must deal with the pressure from a shorter reserve life, below seven years. Geopark and SierraCol's production costs are currently more efficient, but 3R is well positioned to close the gap in the coming years and generate more operating cash per boe than the Colombian peers, after accounting for royalties, taxes and interest costs.

Fitch estimates similar leverage ratios for these companies, with net debt/EBITDA averaging between 0.8x and 1.2x in 2024-2026, although 3R's debt/1P reserves ratio (USD3/boe) should be much lower than the peers' (close to USD9/boe).

KEY ASSUMPTIONS

--Average Brent prices from 2024 to 2027 (USD/bbl): 80; 70; 65; 60;

--Atlanta's first oil in 3Q24;

--Acquisition of 23% stake in Parque da Conchas closing in 3Q24 for USD140 million (subject to regulatory approval);

--Farm-out of 20% stake in Atlanta/Oliva closing in 3Q24 for USD302 million (subject to regulatory approval);

--Average daily production from 2024 to 2027 (kboe/d): 69; 111; 112; 121;

--Oil sales consider discount to Brent of USD5/bbl in 2024 and around USD4/bbl in 2025;

--No payment related to the arbitration process in Papa Terra;

--Lifting cost from 2024 to 2027 (USD/boe): 20; 17; 16; 15;

--Annual capex averaging BRL3.7 billion through 2026, with no significant investments in or divestments from mid & downstream;

--Effective tax rate around 26%, benefitted by regional tax incentives (base-case does not consider tax efficiencies arising from the merger);

--Dividend payout ratio of 25%.

RATING SENSITIVITIES

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Increasing production to more than 125 kboe/d, while maintaining 1P reserve life of at least seven years;

--Reducing half-cycle costs to below USD20/boe on a sustained basis.

Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Debt/EBITDA and net debt/EBITDA ratios above 3.5x and 2.5x, respectively;

--Weakening of the liquidity profile;

--Major operational disruptions at key assets, resulting in a significant reduction in production.

LIQUIDITY AND DEBT STRUCTURE

Comfortable Liquidity: Fitch expects the merger to strengthen 3R's ability to access local and foreign capital markets, reducing its cost of funding. Post-merger liquidity is comfortable, with combined cash balance at June 2024 (BRL6.6 billion, excluding Enauta's equity investments) covering all debt maturing through 2026.

Fitch's projections consider that the company will prepay a significant amount of debt in the short-term, given the strong cash balance at hand. In case of liquidity pressure, Fitch considers that 3R would be able to securitize FPSO Atlanta's long-term receivables or sell and leaseback Papa Terra's FPSO. Combined with Enauta, total debt at June 2024 was BRL15.9 billion, comprised of debentures (60% of the total amount after derivatives), secured notes due 2031 (18%), payables due to Petrobras (11%) and loans from local banks (11%).

ISSUER PROFILE

3R is a small, partially integrated, well-diversified O&G producer, focused on revitalizing mature fields in Brazil, onshore and offshore. It is a corporation with no controlling shareholder and its capital is listed on B3 - Brasil, Bolsa, Balcão.

SUMMARY OF FINANCIAL ADJUSTMENTS

Acquisition payables were incorporated into debt; debt-related restricted cash was incorporated into cash; debt-related derivatives were excluded from debt.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
3R Lux S.a.r.l.				
senior secured	LT	BB-	Upgrade	B+ Rating Watch Positive
3R Petroleum Oleo e Gas S.A.	LT IDR	BB- Rating Outlook Stable	Upgrade	B+ Rating Watch Positive
	LC LT IDR	BB- Rating Outlook Stable	Upgrade	B+ Rating Watch Positive
	Natl LT	AA-(bra) Rating Outlook Stable	Upgrade	A(bra) Rating Watch Positive

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Lucas Rios, CFA
Associate Director
Primary Rating Analyst
+55 11 4504 2205
lucas.rios@fitchratings.com

Fitch Ratings Brasil Ltda.
Alameda Santos, nº 700 – 7º andar Edifício Trianon Corporate - Cerqueira César São Paulo, SP SP Cep 01.418-100

Adriana Eraso
Director
Secondary Rating Analyst
+1 646 582 4572
adriana.eraso@fitchratings.com

Mauro Storino
Senior Director
Committee Chairperson
+55 21 4503 2625
mauro.storino@fitchratings.com

MEDIA CONTACTS

Elizabeth Fogerty
New York
+1 212 908 0526
elizabeth.fogerty@thefitchgroup.com

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

National Scale Rating Criteria (pub. 22 Dec 2020)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 21 Jun 2024)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

3R Lux S.a.r.l.	EU Endorsed, UK Endorsed
3R Petroleum Oleo e Gas S.A.	EU Endorsed, UK Endorsed

DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers. Please read these limitations and disclaimers by following this link: https://www.fitchratings.com/understandingcreditratings. In addition, the following https://www.fitchratings.com/rating-definitions-document details Fitch's rating definitions for each rating scale and rating categories, including definitions relating to default. ESMA and the FCA are required to publish historical default rates in a central repository in accordance with Articles 11(2) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

Published ratings, criteria, and methodologies are available from this site at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance, and other relevant policies and procedures are also available from the Code of Conduct section of this site. Directors and shareholders' relevant interests are available at https://www.fitchratings.com/site/regulatory. Fitch may have provided another permissible or ancillary service to the rated entity or its related third parties. Details of permissible or ancillary service(s) for which the lead analyst is based in an ESMA- or FCA-registered Fitch Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed. Fitch Ratings makes routine, commonly-accepted adjustments to reported financial data in accordance with the relevant criteria and/or industry standards to provide financial metric consistency for entities in the same sector or asset class.

The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. For more details on sector-specific best- and worst-case scenario credit ratings, please see Best- and Worst-Case Measures under the Rating Performance page on Fitch's website.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001.Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

dv01, a Fitch Solutions company, and an affiliate of Fitch Ratings, may from time to time serve as loan data agent on certain structured finance transactions rated by Fitch Ratings.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.