McDep Associates
Independent Stock Ideas
August 7, 2002

Buy/Sell Rating: 2-Buy
S&P 500: 860

Petroleo Brasileiro S.A.
Buy For Rich Resources Despite Uncertain Politics

Symbol	*Price ($/sh) 6-Aug 2002*	*Shares (mm)*	*Market Cap ($mm)*	*Net Present Value ($/sh)*	*Debt/ Present Value*	*McDep Ratio*	*EV/ Sales NTM*	*EV/ Ebitda NTM*	*P/E NTM*	*Div'd NTM (%)*	*PV/ Ebitda NTM*
PBR	14.25	1,086	15,500	30.00	0.27	0.62	1.3	3.5	4	9.5	5.6

McDep Ratio = **M**arket **c**ap and **De**bt to **p**resent value of oil and gas and other businesses		
EV = Enterprise Value = Market Cap and Debt:	US$mm	27,800
Ebitda = Earnings before interest, tax, depreciation and amortization:	US$mm	8,030
NTM = Next Twelve Months Ended June 30, 2003; P/E = Stock Price to Earnings		
PV = Present Value of energy businesses:	US$mm	44,800
Present Value of Equity:	US$mm	32,600

Summary and Recommendation

We recommend current purchase of the shares of Petroleo Brasileiro (Petrobras) for rich energy resources priced at a steep discount in the face of political uncertainty. Analyzing the stock for the first time in several years, we are encouraged that price controls are no longer in effect as of just a few months ago. The stock has also declined sharply to a price that gets our attention. Though we have not visited the company’s home country and we have had minimal contact with management, we can see a strongly financed, resource rich position behind the thorough financial disclosures including Form 20-F filed with the U.S. Securities and Exchange Commission. Yet we also realize that Brazil is in turmoil with a sharp decline in the value of its currency and facing an election where the leading candidate may not be business-friendly. The history of energy tells us that strong companies can weather political storms and prosper in uncertainty. In our opinion, conservatively positioned investors can justify stepping up at this time to start or add to a position in what we hope will be a leading non-U.S. energy stock of the future.

Nine Billion Barrels of Oil and Gas

Offshore Brazil has been one of the most prospective areas of the world for new discoveries in recent decades. In our Northern Hemisphere centric world some of us might be surprised that a Southern Hemisphere company can be a technological leader in deep water oil exploration and development as Petrobras is. The fruits of the effort are in a reserve position that backs current production with an adjusted life index of more than ten years. The company is setting new production records regularly.

The company reports cash flow and financial results much as if it were a well-known mega cap oil company. We used our template for analyzing peer companies and inserted the Petrobras numbers (see Table). We could not do that in the past because the balance sheet had a huge receivable related to price controls and the other data was not in a format we were accustomed to seeing.

On a reasonably comparable basis as best we can tell, Petrobras appears to be valued at a multiple of enterprise value to cash flow (EV/Ebitda) less than half that of our recently published mega cap median. Reserve life, one of the most important differentiating factors for assessing present value is longer than for the mega cap median. Yet as we allow for political uncertainty we assess present value at three-fifths the multiple of cash flow as for industry giants. That produces a McDep Ratio that is still at the low end of the range for all stocks in our coverage.

Downstream Margins May Be Volatile

Like other major oil companies most of the value that we identify is in oil and gas reserves and production. A wide profit margin in that functional area dampens changes in profits with changes in commodity price. The opposite is true in the products business. Meanwhile we would be surprised if the recent currency weakness in Brazil did not impair near term profits compared to our projection. The company may no longer be subject to price controls, but it still might decide not to raise product prices as fast as the local currency declines. Here the absence of price controls may help a great deal. None of the company's marketing competitors have much oil production in Brazil that might absorb short-term profit pressure. Competitors are more likely to be importing crude and products whose costs must be recovered soon or the oil will not be imported.

Debt Level Moderate

Petrobras' ratio of Debt/Present Value is in line with Large Cap peer companies. Most of the obligations are denominated in world currencies. That matches the nature of energy assets that have world commodity value.

Even a moderate debt level could be a concern in the most adverse circumstances. Yet the excesses of debt in energy now appear to be more in the power and infrastructure area rather than with the producers. Over leveraged producers had their problems about a decade ago and many have learned the lesson. Meanwhile power and infrastructure companies are finding out that the highly leveraged capital structures that worked in an insulated regulated environment are proving too risky to withstand global competition.

Dividends Encouraged

Perhaps reflecting the historic inflation of the Brazilian currency, Petrobras has a policy to encourage payment of a high dividend if profits are earned. The dollar equivalent of the amount distributed in the past twelve months amounts to 9.5% of the current stock price. Should that amount be trimmed in the next year, shareholders would still have a claim on valuable assets and future payments. One well-known information service with the same name as that of the mayor of New York lists Petrobras' dividend yield nearer 6%. That appears to anticipate the amount paid year to date in 2002 is all that will be paid on an annual basis.

U.S. Likely To Stand By Brazil

Investors should be tough about not taking on too much debt in the current environment. In that context, the U.S. Secretary of the Treasury was warning against complacency when he quipped something like more aid to South America would just end up in Swiss bank accounts. At the same time, our system is not perfect either. Economic resources went to misguided investment and excess compensation in the U.S. in the past decade.

When push comes to shove, Brazil is too important for the U.S. not to go to extra lengths to lend economic understanding and support. Meanwhile Petrobras is one of the economic jewels of its country. The government still owns about 40% of the oil company and thereby has a strong incentive to avoid damaging that value.

Some Diversifiable Risks Worth Taking

There is nothing like a bear market to test our character and judgment. Oil, stocks and bonds can be volatile. Yet at no time have oil, stocks and bonds been at a low extreme or a high extreme concurrently. Nor have any of the extremes been sustained for long. Diversification among the three investment media protects investors from extreme circumstances.

More than likely the world will continue to score economic growth. The greater growth is likely to come from outside the U.S. and Western Europe. Responsible use of energy resources will help fuel that growth. Petrobras is one of the strongest non-U.S., non-Western European companies that is likely to be a leader in that effort.

Of course we cannot say how long the current downward momentum in stocks and upward momentum in bond prices will continue. We have proceeded far enough in our opinion to act on the low price in Petrobras stock. We recommend that diversified investors begin a new position in Petrobras stock or add to an existing position if it is moderate size.

Kurt H. Wulff, CFA

Petrobras
Next Twelve Months Operating and Financial Estimates

	Q1 3/31/02	*Q2E 6/30/02*	*Q3E 9/30/02*	*Q4E 12/31/02*	***Year 2002E***	*Q1E 3/31/03*	*Q2E 6/30/03*	***Next Twelve** Months 6/30/03*
Volume								
Natural Gas (mmcfd)								
Total	1,686	1,686	1,686	1,686	**1,686**	1,686	1,686	**1,686**
Oil (mbd)	1,526	1,526	1,526	1,526	**4,619**	1,526	1,526	**1,526**
Total gas & oil (mmb)	163	164	166	166	**660**	163	164	**660**
Price								
Natural gas ($/mcf)								
Henry Hub ($/mmbtu)	2.53	3.38	2.99	3.37	**3.07**	3.73	3.65	**3.44**
Total	1.47	1.79	1.87	1.83	**1.74**	1.78	1.74	**1.81**
Oil ($/bbl)								
WTI Cushing	21.60	26.27	27.44	26.96	**25.57**	26.19	25.48	**26.52**
Worldwide	17.46	21.23	22.17	21.79	**20.68**	21.17	20.59	**21.43**
Total gas & oil ($/bbl)	16.12	19.60	20.47	20.11	**19.09**	19.54	19.01	**19.79**
NY Harbor 3-2-1 ($/bbl)	3.63	4.71	5.16	3.98	**4.37**	4.35	6.14	**4.91**
Revenue ($mm)								
Natural Gas								
Total	223	274	290	284	**1,071**	271	266	**1,111**
Oil	2,398	2,948	3,113	3,058	**11,517**	2,907	2,860	**11,938**
Other	2,108	2,108	2,108	2,108	**8,432**	2,108	2,108	**8,432**
Total	4,729	5,330	5,510	5,451	**21,021**	5,286	5,234	**21,481**
Expense								
Production	1,311	1,432	1,468	1,456	**5,667**	1,423	1,413	**5,759**
Other	1,913	1,884	1,874	1,900	**7,572**	1,891	1,846	**7,511**
Ebitda ($mm)								
Exploration and Production	1,310	1,791	1,935	1,887	**6,922**	1,755	1,714	**7,290**
Other	195	224	234	208	**860**	217	262	**921**
Total Ebitda	1,504	2,014	2,169	2,095	**7,782**	1,972	1,976	**8,211**
Exploration	99	99	99	99	**396**	99	99	**396**
Deprec., Deplet., & Amort.	402	402	402	402	**1,608**	402	402	**1,608**
Other non cash	38	38	38	38	**152**	38	38	**152**
Ebit	965	1,475	1,630	1,556	**5,626**	1,433	1,437	**6,055**
Interest		-	-	-	**-**	-	-	**-**
Ebt	965	1,475	1,630	1,556	**5,626**	1,433	1,437	**6,055**
Income Tax	357	516	570	544	**1,988**	502	503	**2,119**
Net Income ($mm)								
Exploration and Production	617							
Other	156							
Unallocated	(165)							
Total	608	959	1,059	1,011	**3,638**	932	934	**3,936**
Shares (millions)	1,086	1,086	1,086	1,086	**1,086**	1,086	1,086	**1,086**
Per share ($)	0.56	0.88	0.98	0.93	**3.35**	0.86	0.86	**3.62**
Ebitda Margin (E&P)	50%	56%	57%	56%	**55%**	55%	55%	**56%**
Tax Rate	37%	35%	35%	35%	**35%**	35%	35%	**35%**