



Insigneo Weekly Dispatch

# Stocks in Focus: Petrobras (PBR) and Mercado Libre (MELI)

As earnings season winds down, we thought it might be helpful to convey our thoughts on some stocks that are of interest to many of our clients. Below we explore Petrobras (PBR) and Mercado Libre (MELI) in more detail.

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## Stocks in Focus: Petrobras (PBR) and Mercado Libre (MELI)

As earnings season winds down, we thought it might be helpful to convey our thoughts on some stocks that are of interest to many of our clients. We often get inquiries on Petrobras (PBR) and Mercado Libre (MELI) so we will delve into each in more detail below.

### **Petroleo Brasileiro – Petrobras (PBR) ADR**

Price (as of 8/10/2023): \$13.68

Dividend Yield: 11%

Market Cap: \$86 Billion USD

Petrobras is an integrated energy producer. Through a vertically integrated business model, the company has operations in the exploration, production, transportation, and refining of oil and natural gas, as well as energy generation. With a business model much like Exxon Mobil or Chevron, Petrobras is the largest energy producer in Brazil and a dominant player in Latin America's energy industry. Approximately 75% of the company's revenues stem from Brazil. The company operates in three business segments, mainly: 1) Refining, Transportation and Marketing, 2) Exploration and Production, and 3) Gas and Power Generation. From a revenue perspective, as of the end of last year, approximately 85% of gross sales stemmed from its Refining, Transportation, and Marketing Segment, with Gas & Power Generation comprising 10%, and Exploration and Production 5%. However, looks can be deceiving. Many investors tend to focus on gross sales and net income when

evaluating a company. Sounds simple, looking at a company's sales and figuring out its profit. But gross sales tend to be very general in nature and net income can be influenced to appear better than it actually is. As a result, in our opinion, operating income is the metric to focus on, as it is the lifeblood of any company, representing the income that is truly generated by a company's actual operations. Based on this metric, if we focus on PBR's operating income, we find a different hierarchy in its business lines, with Exploration and Production generating 79% of operating income, followed by Refining, Transportation, and Marketing at 18%, and Gas & Power Generation at 3%. What this means is that although most of the company's sales are generated from its refining operations, most of its profits are generated by its exploration and production business. This makes sense, as E&P business lines tend to be cash-producers, while refining business lines tend to be cash-users.

The good news is that as a dominant player in the Pre-Salt formation off the coast of Brazil, Petrobras has very strong exploration and production operations. Over the past few years, the company focused on developing this business line, resulting in strong cash flows, which led to a high dividend payout. However, let's remember that Petrobras is, in its majority, a state-owned enterprise. The Bolsonaro administration had largely let the company run itself, allowing it to focus more on profitability and returns to shareholders. However, when the Lula administration came to power, the emphasis shifted from profitability towards using the company's diesel and gasoline refining operations to subsidize prices for these end products in the local markets. As we said before,

refining operations tend to consume, not produce, cash as these have higher costs of operation. As a result of this recent shift in focus, PBR's cash flow is likely to decrease in the near future, an expectation that added a high degree of uncertainty to the stock's dividend yield. Given the shift to higher cash consumption, we believed that the stock's dividend was likely to be reduced, although we were never in the camp that it would be suspended or suffer a large cut. Our expectations proved true when the company recently announced a relatively benign "new dividend policy". In this new policy, management maintained its quarterly dividend, but reduced the dividend payout from 60% of cash flow from operations to 45% of the same metric. Even though it is a lower payout, it is in fact at a more sustainable level, and mostly in line with some of the company's global energy peers.

Given the importance of operating income for the company, and operating cash flow for its dividend yield, remaining vigilant over these metrics is paramount. As we said before, given the company's shift from exploration and production to refining operations, its operating income will likely decrease in coming years. However, although lower than in previous years, the company's cash flow generation will likely remain strong and able to support its new dividend policy. Management is looking to increase returns through more efficient operations in its Tupi and Buzios oil fields. At the same time, a focus on capital discipline aimed at sustaining cash flow generation, as well as a commitment to increasing exposure to low carbon projects, could help sustain cash flow generation in the future. From a profitability standpoint, operating margins and Return on Equity ratios also remain strong,

higher than the industry average, although these are likely to retreat to more normal levels in the near future. It is important to note that the company does have higher levels of debt than peers, such as Exxon Mobil and Chevron. Although management has stated that it wants to continue repairing the company's balance sheet, it is likely that the focus will be on maintaining cash flow generation to cover its interest and dividend payments. Strong cash flow generation metrics, such as an industry high free cash flow yield near 20%, lead us to believe that, barring any unforeseen events, the company will be able to maintain its interest and dividend payments. From a valuation perspective, PBR trades at a discount to its peer averages. Given the high levels of debt and fixed assets normally held by companies in the energy sector, EV/EBITDA is a better metric to assess the valuation of a stock such as this one. Based on this metric, the stock trades near 2.5x, compared to the integrated energy company peer average near 4x.

Bottom line, we retain a neutral view on Petrobras stock. We believe that given our positive view on the overall energy sector, the company's competitive advantage due to its strong exploration and production profile, coupled with sustainable cash flow generation and a discounted valuation, could make this a fruitful holding for an investor with a long-term horizon and relatively high tolerance for risk. However, the company's shift to less profitable refining operations used to subsidize artificially lower diesel and gasoline prices in its domestic market limit its earnings growth potential over the short to medium term. It is important to keep in mind that both share classes of Petrobras stock combine to form near 15% of the iShares

MSCI Brazil ETF (EWZ). As a result, the company's share price could potentially be artificially boosted by investors looking to get general country exposure through the ETF. In the interest of full disclosure, Insigneo's Latin American Equity SMA Portfolio has exposure to Petrobras stock. However, given our neutral view of the stock, the portfolio holds a combined weight of both share classes equal to the combined weight of these in its benchmark.

#### **Mercado Libre Inc. (MELI)**

Price (as of 8/10/2023): \$1,387.06

Dividend Yield: N/A

Market Cap: \$69.5 Billion USD

With dominant e-commerce and fintech operations throughout Latin America, Mercado Libre is labeled by some as the eBay of the region and others as the Amazon of Latin America. The company operates a business model consisting of an integrated platform of diversified business lines, providing consumers in the region with one of the most complete ecosystems through which to conduct transactions. Mercado Libre is comprised of a portfolio of complementary businesses including Mercado Libre Marketplace, Mercado Pago, Mercado Crédito, Mercado Envios, Mercado Libre Ads, Mercado Libre Classifieds, and Mercado Shops. Through this portfolio, the company can offer services ranging from e-commerce, fintech, credit and financing, to logistics and online store fronts.

As of the end of the last quarter, approximately 57% of the company's revenue stemmed from Commerce business lines, with 43% originating

from Fintech. With more than 650 million users across 20 countries, Mercado Libre has a wide geographic reach in the Latin American region. Currently, the three major countries for the company's operations are Brazil, Argentina, and Mexico, with Brazil representing approximately 55% of sales, Argentina 24%, Mexico 18%, with the rest spread across various countries in the region.

Benefiting from increased consumption from an emerging middle class, Commerce has traditionally been the bread and butter of the company. This segment continues to experience growth, seeing nearly 40% revenue growth at the end of the second quarter, on a year-over-year basis. The value of all merchandise transacted through the company, also known as Gross Merchandise Value or GMV, rose by nearly 35% in Mexico and close to 25% in Brazil on a year-on-year basis. Countries like Uruguay and Chile also saw their consumption rates increase. These numbers could potentially increase even further as lower interest rates in the region could spur consumption growth. Surprisingly, offline spending is also growing at relatively high levels, as marketplace encounters driven by platforms such as Mercado Libre Classifieds gain popularity.

Fintech is also becoming an important growth engine for MELI. Evidence of this trend lies in the increasing volume of payments processed by the company. As of the end of the second quarter, the total value of payments processed, or TPV, increased by close to 100% on a year over year basis. Transactions carried out through the payment platform Mercado Pago are driving numbers higher, as well as increased fintech use through the company's Mercado Crédito platform.

In fact, these two businesses, which include Mercado Pago's online payment and Mobile Point of Sale systems, are largely responsible for the company's recent growth rates. MELI has now become a disruptor in Latin America, providing financial services to previously unbanked sectors of the region's population through its Mercado Crédito platform. Credit profiles for this sector of the population were at first largely unknown, but the company is starting to see a decrease in the number of Non-Performing Loans, as more people become aware of the use of credit. Credit quality could potentially improve even more, as interest fall in the region.

High revenue growth rates, coupled with prudent expense management, have led to increased profitability for Mercado Libre. Operating Margins and ROE ratios continue to strengthen, leading to rising operating cash flow and free cash flow metrics. In fact, its strong profitability is, in our opinion, one of the main qualities that make Mercado Libre an attractive investment. This quality is likely to strengthen even further, as the company expands its Advertising business, a segment that traditionally carries high margin returns. Currently, MELI's operating profit margins sit near 13%, higher than the average of those of its closest peers, including Amazon, Ebay, Alibaba, Sea Ltd, and JD.Com. At the same time, the company appears to be well capitalized, with its cash equivalents position representing 85% of its total debt and interest coverage metrics that far exceed many of its industry peers.

Additionally, a proven management team at the helm of Mercado Libre has successfully positioned the company as a leader in its industry niche. That

being said, the company is currently undergoing changes in management, seeing Pedro Arnt, its long-time CFO, step down just a few days ago. Martin De Los Santos, Senior VP at the company's successful credit division, will step in as CFO, a testament to the firm's deep pool of experienced leaders.

As we can imagine, a well-capitalized, regionally dominant e-commerce and fintech player with high profitability, a proven management team, and promising growth prospects cannot trade a discounted valuation. Reflecting this is the fact that, on a 2-year forward P/E basis, MELI trades near 50x earnings, representing a 45% premium to its closest peer and biggest rival, Amazon. However, with a free cash flow yield near 6%, meaningfully higher than that of its closest peer, MELI appears more reasonably valued at 16x on a P/FCF basis.

Bottom line, we have had and continue to maintain an overweight view on MELI stock. We believe that the company's dominant competitive position in the e-commerce and fintech industries in Latin America, integrated and highly profitable businesses model, strong financial position, and capable management team make this stock a

potentially fruitful long-term investment. However, the company's premium valuation does increase its level of risk. As a result, this stock would be better suited for a client with a relatively high tolerance for risk and a long-term investment horizon. In the interest of full disclosure, given our positive view on this stock, Insigneo's Latin American Equity SMA Portfolio maintains an overweight exposure to MELI.

It is important to keep in mind that the individual equities referenced here can exhibit high degrees of volatility and are not suitable for every investor. These investments are best considered on a case-by-case basis, based on a particular investor's willingness and ability to tolerate risk. If you need more information or would like to discuss these potential ideas in more detail, please do not hesitate to contact the Insigneo Research Team.



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