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Oil, Gas & Petrochemicals

Brava Energia

Ecopetrol's bid in Brazil – Acquisition of control in Brava

Ecopetrol signs SPA and launches partial tender offer to reach a 51% controlling stake in Brava

This Thursday (23), during market hours, Brava and Ecopetrol announced that Ecopetrol has entered into a Share Purchase Agreement (SPA) with certain Brava shareholders to acquire a c.26% stake in Brava's share capital. Completion of the transaction is conditional upon Ecopetrol securing control of 51% of Brava's voting share capital through subsequent transactions. To that end, Ecopetrol will launch a voluntary partial tender offer (OPA) at BRL23/BRAV3, a c.+8% premium to the pre-announcement price. However, Brava's shares closed at BRL20.17/BRAV3, implying a c.-6% decline versus the pre-announcement price of BRL21.35/BRAV3. In our view, shares are pricing in the risk of lower post-tender prices, as well as execution risk around deal completion. Of note, the announcement was not entirely unexpected as the transaction had been partially anticipated by a news article earlier this Thursday (23).

SPA details. Ecopetrol entered into the SPA with Jive, Yellowstone, and Queiroz Galvão's vehicle, Somah Printemps Quantum Group (all signatories to Brava's shareholders' agreement), as well as with other shareholders holding individual stakes below 5%. Completion of the transaction is subject to approval by Brazil's antitrust authority (CADE), the granting of waivers and consents under Brava's financing instruments and relevant commercial agreements, and the acquisition of a 51% controlling stake via the tender offer. In our interpretation, the press release does not explicitly state whether the SPA price is the same BRL23/BRAV3 offered in the tender.

The tender offer and how to value Brava shares. Ecopetrol intends to launch a voluntary partial tender offer to acquire control of Brava. The tender price is set at BRL23/BRAV3, with no monetary adjustments. The offer will be limited to the number of shares required for Ecopetrol to reach 51% of the voting capital – i.e., the acquisition of an additional 25% of Brava's share capital on top of the 26% already bound under the SPA. If demand from the remaining 74% of the capital exceeds the 25% tender limit, sales will be prorated. Should all eligible shareholders tender their full stakes, acceptances would be prorated to 33.8% (i.e., 25%/74%), leaving investors with 66.2% of their original holdings. These remaining shares would continue to trade freely in the market, potentially at prices below the BRL23/BRAV3 tender level.

Shouldn't Ecopetrol tender 100% of Brava shares? This has been a common investor question since the announcement. Our understanding is that the parties involved – namely Ecopetrol and the selling Brava shareholders – have adopted the interpretation and structured the transaction as the formation of control, rather than a transfer of control. While the sellers are signatories to Brava's shareholders' agreement, they do not formally elect a majority of the Board. Under this interpretation, a mandatory tender for 100% of the shares would not be required. Ecopetrol is nonetheless launching a voluntary tender offer to acquire additional shares, but has limited its intention to 51% of the voting capital, which is sufficient to consolidate control. We expect Brava to remain listed in Brazil, albeit with a clear controlling shareholder in Ecopetrol (itself listed in Colombia). A similar structure exists today at ISA Brasil, which is listed in Brazil and indirectly controlled by Ecopetrol.

Brava Energia (BRAV3)	Buy
Target Price (R$/sh)	R$ 22.00
Current Price (R$/sh)	R$ 20.17
Upside (%)	9%
Market Cap (R$ million)	9,370
# of shares (million)	293
Free Float (%)	100%
ADTV (R$ million)	309

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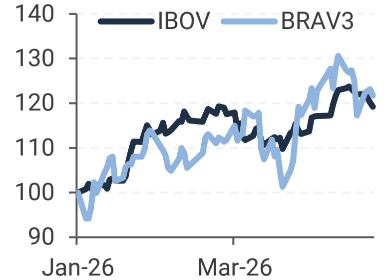
Performance vs. IBOV



Source: Brava Energia and XP Research.

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Why would shares trade down? This has been another common investor question, given that the tender price is above prevailing market prices, yet shares have declined following the announcement. In our view, Brava's post-announcement share price is driven by three main factors: (i) execution risk, i.e., the possibility that the transaction does not reach completion; (ii) the time value of money until the tender at BRL23/share; and (iii) most importantly, the market value of the remaining stake after the tender. On the latter, once the tender is completed, remaining investors will become minority shareholders in a company whose strategic orientation may change materially under a new controlling shareholder – particularly a Colombian state-owned entity (SOE) seeking to add production and reserves. This could imply a shift away from Brava's current portfolio-optimization focus toward a more growth-oriented and capex-intensive strategy, although details will only become clear once Ecopetrol outlines its plans. In this context of uncertainty, investors appear to be assigning a lower value to Brava's post-tender free-float shares.

Working out scenarios. In the figures below, we estimate the post-tender share value implied under different scenarios for Brava's current share price, varying assumptions for time to completion (Figure 01), and different percentages of free float tendered (Figure 02). Assuming most investors tender their shares at BRL23.00 (i.e., 90 - 100% demand) and a transaction timeline of roughly 90 days, this Thursday's closing price of BRL20.20 appears to price-in a post-deal share value of around BRL19.70. It is up to individual investors to assess whether this level is too conservative (implying upside) or too optimistic (implying downside). As a reference point, our twelve-month forward target price of BRL22.00 is based on the production profile embedded in the current business plan and a Brent price assumption of USD65/bbl. At current price levels, we see valuation more favorably, but prefer to remain on the sidelines while waiting for greater clarity on Ecopetrol's plans for the company.

Figure 01. Post-tender implied share value under 100% tender participation (BRL/BRAV3)

Current share price	Time to completion: 60	90	120	150
19.0	17.62	17.95	18.29	18.63
20.0	19.16	19.51	19.87	20.23
21.0	20.71	21.07	21.45	21.82
22.0	22.25	22.64	23.03	23.42
23.0	23.79	24.20	24.61	25.02

Figure 02. Post-tender implied share value under a 90-day closing scenario (BRL/BRAV3)

Current share price	Percentage of free float tendered: 100%	90%	80%	70%
19.0	17.95	17.65	17.21	16.54
20.0	19.51	19.30	19.00	18.54
21.0	21.07	20.96	20.79	20.53
22.0	22.64	22.61	22.58	22.53
23.0	24.20	24.27	24.37	24.53

More on Ecopetrol. Ecopetrol's total production currently stands at c.750kboed. Like Brava, the company is vertically integrated, with operations across upstream, midstream, and downstream segments. In Brazil, Ecopetrol's presence is relatively limited, most notably through a 30% non-operating stake in the Gato do Mato project (operated by Shell) and its controlling stake in the utilities company ISA. The acquisition of Brava would provide a multi-platform growth opportunity while increasing exposure to offshore assets – an area where Brava has stronger positioning, whereas Ecopetrol's expertise is primarily onshore. Upon completion of the transaction, Ecopetrol would add pro-rata 1P reserves of c.234 mn boe (at a 51% stake) and c.40kboed of average annual production.

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