

The Premier Investment Platform between China and Latin America

China and Brazil in the Context of the Pre-Salt Discoveries

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Nowadays it is difficult to open a newspaper and not see China as a protagonist in the headlines. Regardless of the content of the story, the underlying message speaks of the tremendous importance that China now has to individuals, corporations and Governments around the World.

The following pages will give a brief overview of the forces that are shaping modern China, and that are prompting this Country to actively seek natural resource opportunities in foreign jurisdictions. The pages will ponder on the crucial importance that oil & gas has in China's growth model, and particularly, on the eyes with which the Chinese Government and firms will evaluate the Brazilian Pre-Salt opportunity, one of the largest finds of oil in the World's recent memory.

Preliminary figures speak of an astonishing US\$400 billion in capital expenditures that will be needed to develop the Pre-Salt opportunity, creating one of the most robust portfolios of business opportunities that exist today.

With the development of the Pre-Salt discoveries, Brazil is about to embark on a life-changing decade. The Chinese on the other end of the World will stand eager to participate, as investors, co-developers, financial sponsors, off-takers of future production, providers of equipment, developers of infrastructure and logistical solutions, etc.

¹ Jorge J. Barreda is a partner at SinoLatin Capital, a Shanghai-based advisory and private equity platform dedicated exclusively to the investment flow between China and Latin America. This white paper was presented in Rio de Janeiro, Brazil in April 2010 in the context of the "Oil & Gas Outlook: Brasil 2010" conference produced by Terrapin.
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Overview

Nowadays it is difficult to open a newspaper and not see China as a protagonist in the leading story. Whether the story is related to the negotiations that are reshaping the World iron-ore market, the alleged undervaluation of the Renminbi, or a high-profile international acquisition by a Chinese firm, the underlying message speaks of the tremendous importance that China now has to individuals, corporations and Governments around the World. China has rapidly become aware of its role in the post – financial crisis World order, and China Inc. (meaning its Government, State-Owned and privately owned enterprises) seems ready and eager to go outbound in search for investment opportunities.

There are those who see in China a threat, and those who see in China a promise. We associate ourselves with the latter group, and believe that the dynamics that are making of China the increasingly important Nation that it is now, will make of this economy the pre-eminent economic force in the coming decades. We believe there will be tremendous opportunities for those that do not fear and that appropriately prepare.

China Inc. is looking abroad, and has bridged out to a large number of parties around the World. And this has been particularly noticed in Latin America.

The following pages will give a brief overview of the forces that are shaping modern China, and that are prompting this Country to actively seek natural resource opportunities in foreign jurisdictions. The pages will ponder on the crucial importance that the oil & gas sector has in China's growth model, and particularly, on the eyes with which the Chinese Government and firms will evaluate the Brazilian Pre-Salt opportunity, one of the largest finds of oil in the World's recent memory. Towards the end, the paper will provide an overview of the many ways in which Chinese parties are likely to participate in the process.

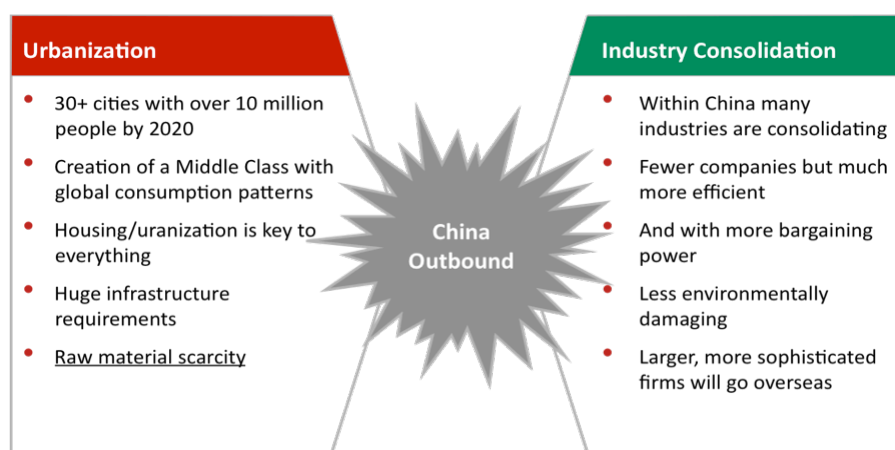
The life changing opportunities that the Brazilian oil & gas sector is offering, in the context of the pressing need for resources and the strong financial muscle that China has, can result in outstanding business opportunities for large and small firms alike in both, Brazil and China.

Two Forces Shaping the Chinese Economy

China's 30 years of sustainable economic growth, the emergence of a vibrant middle class and massive spending in infrastructure has resulted in a significant increase in the total and per capita consumption of virtually every product consumed on a daily basis.

What is going on in China is remarkable. Like tectonic plates moving resolutely and massively, two forces are shaping the role of China Inc. as an investor in international markets. On one side, urbanization, fostered by the Chinese Government as a way to bring the majority of the 800 million rural Chinese above the poverty line. If only half of those are brought into modernity, China would have 'created' a new consumer base that in terms of population is comparable to Latin America or Europe. And we are not counting the 600 million Chinese that already live in cities and whose purchasing power will continue to grow. Statisticians are daring to predict that in 15 years China will have nearly 30 cities the size of Sao Paulo in Brazil. Food for thought.

Two forces shaping the Chinese economy



Having 22% of the world's population but less than 1% of the world's oil resources, China is forced to rely on resource-rich regions

The second 'tectonic plate' is industry consolidation. The Chinese Government is fostering the consolidation of players across industries into larger, more efficient and more sophisticated conglomerates with more bargaining power. The Chinese auto and steel industries are two of the many that are going through this process.

And if urbanization and industry consolidation have the effect of plates moving on a course to collision, China's lack of own natural resources, coupled with its ownership of one of the World's largest pools of savings, have the effect of triggers of a major seismic event.

China is an important producer of a number of commodities, but with the probable exception of coal, Chinese consumption of commodities, most notably oil, gas, copper, and iron ore among others, stands at a multiple of what that country can produce on its own.

On the financial front, only at the Government level, China sits on a war chest of nearly \$2.5 trillion of foreign exchange reserves that is able and willing to put to work in strategic uses. The vast majority of China's reserves are denominated in US Dollars, and China has made no secret of its concern about the future of this currency. The Chinese Government has been very vocal about its need to diversify away from the greenback, and on the other hand, on the need to secure investments in hard assets. It has prepared itself by expediting regulatory

procedures and by instructing its policy banks and other financial institutions to support Chinese companies in their international forays.

Put all these factors in a blender and what you get is a giant economy that will play an increasingly important role in almost every natural resource opportunity the World has to offer. China is going outbound, and in our opinion, what we are seeing are the first few months of a process that will last for two generations, or more.

The Chinese Government and private sector are preparing to fully embrace their increasingly present role in the international arena. At the Government level, the Ministry of Commerce (MOFCOM) has relaxed the approval requirements for Chinese firms seeking to acquire overseas assets, while SAFE, the foreign exchange regulator, has eased capital controls on firms requesting an appropriation in the foreign exchange quota earmarked for foreign investment.

Also, not long ago, Chinese commercial banks have been allowed to lend money for overseas acquisition opportunities. In this way, the Chinese are setting the foundations of a leveraged buy-out market for overseas investment activity, a market that counts with very deep pockets: China boasts one of the highest savings rates in the World (more than 50% of GDP), and more than US\$7 trillion sit in the coffers of state-owned and private Chinese commercial banks.

On the other hand, Chinese firms have also undertaken a number of preparatory steps. Many corporations have recruited scores of internationally educated Chinese professionals from international banks and firms hit by the recent financial crisis. The Chinese corporate sector is rapidly departing from an insular mentality and a business model geared at supplying the domestic and export markets, and becoming more comfortable with the idea of developing full fledged operations in foreign jurisdictions.

And at the individual level, tens of millions of young Chinese are learning English to further their opportunities. The day in which we will see more English speakers in China than in the USA is almost here.

China Inc. as an International Investor

In 2008, China had 19.6 billion bbl of proven oil reserves. Hence, the country had to import 55% of the crude oil consumed domestically

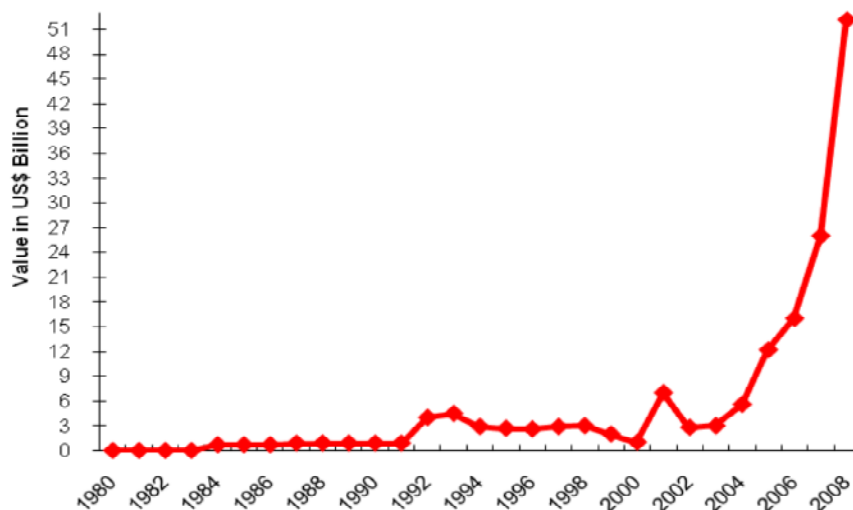
With the exception of few sporadic attempts prior to 2005, the bulk of Chinese outbound M&A activity has taken place in the last 5 years. In this period, nearly 100 different Chinese firms have acquired stakes in international assets in nearly 250 transactions worth more than US\$350 billion.

And this buying spree has gathered momentum in the last two years. While the industrialized World was licking on the wounds inflicted by the global financial crisis, Chinese companies traveled the World with the checkbook at hand. More than half of this buying activity has taken place in the last 24 months.

With the exception of a few but notable examples (the Chinalco – Rio Tinto episode), most of the approaches made by Chinese companies have resulted in successfully closed transactions. Moreover, Chinese approaches have been invariably friendly, their acquisitions have involved premiums that range from 30 to 80% in some instances, and in the vast majority of cases, have counted with the support of the boards of directors of the target companies.

Also noteworthy, if one takes into account that most, if not all, of the very few failed international forays have taken place in developed markets, Chinese companies have become increasingly interested in opportunities in Emerging Markets.

Chinese Outbound Investments – a fairly recent process



Chinese international investment is a phenomenon of its own kind, and there are a number of differentiating factors in the way Chinese companies have undertaken these international adventures. But perhaps two are worth mentioning. First, Chinese overseas investment has been politically agnostic. Chinese State capitalism has found a way to deal and transact with parties of all political colors.

Second, we have found that the rate of return on an investment is not the only variable by which the Chinese measure success, and perhaps not even the most important one. The strategic fit of an opportunity is of crucial importance, and Chinese firms will be forceful and creative contenders for the right asset.

China and Latin America

Latin America is not only a sustainable source of commodities but one of the largest and most promising emerging markets for Chinese investment

In a Policy Paper on Latin America published in 2008, the Chinese Government set out the framework that will guide its interaction with the region. Far from hiding or understating the importance that Latin America has for the Chinese economy, the Policy Paper reads “The Chinese Government views its relations with Latin America and the Caribbean from a strategic plane and seeks to build and develop a comprehensive and cooperative partnership featuring equality, mutual benefit and common development...”.

Furthermore, the Paper goes on and states the specific goals that, with respect to Latin America, it has on a number of areas. On the financial front, the Paper states that “the Chinese Government encourages and supports qualified Chinese companies with good reputation in investing in manufacturing, agriculture, forestry, fishing, energy, mineral resources, infrastructure and the service sector in Latin

America and the Caribbean to promote the economic and social development of both sides”.

And these guidelines have been implemented with decision. Only in the last few weeks, nearly US\$6 billion of transactions involving a Chinese firm and a Latin American asset have taken place. While Latin America has received only 7% of total Chinese overseas investment over the last 5 years, the Chinese are paying an increasing attention to opportunities in the region. The mining and the energy sectors stand at the core of China’s attention. These two sectors make the lion’s share of Chinese overseas M&A activity.

But it is not only through acquisitions that Chinese firms have implemented their go-outbound strategies. Lately, an increasing number of transactions involving Chinese firms have taken the form of joint ventures at the asset level, where Chinese firms have entered as co-investors and/or co-developers. The China National Offshore Oil Co. – Bidas US\$3.1 billion joint venture in Argentina is one of the most recent examples.

In the project finance arena, an increasing number of Chinese firms are being awarded EPC and similar contracts around the world. With the backing of strong financial sponsors, Chinese developers, service providers, construction companies and equipment manufacturers are competing and winning sought after contracts.

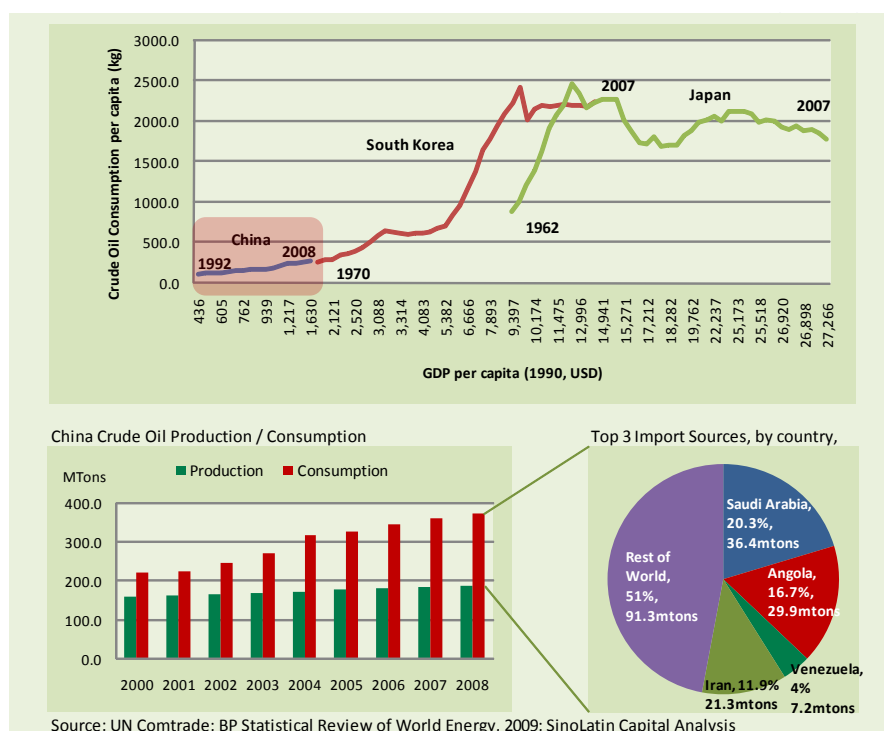
Unsatisfied Chinese Demand for Oil & Gas

Oil is integral to the Chinese growth story. As in the case with many other commodities; China consumes a multiple of the oil it produces within its borders. In 2009, China consumed nearly 8.3 million barrels per day, more than twice its production of 3.9 million barrels per day. The deficit was met with imports from Saudi Arabia, Iran, Angola and other jurisdictions. Less than 10% of China’s imported oil was supplied from Latin American sources, most notably Venezuela and Brazil.

Pulled by China’s rapid urbanization process, its massive infrastructure build out, the rapidly increasing purchasing power of its 600 million middle-class citizens, and by a rapidly expanding industrial capacity, among other factors, China’s consumption of oil is poised to grow at neck breaking speeds. The 2009 daily deficit of 4.4 million barrels is projected to increase to 6.4 million barrels by 2014. According to Goldman Sachs, by year 2020 there will be nearly 200 million car owners in China. This is more than the projected car ownership in Brazil, India and Russia combined.

Most of China's imports of oil come from Africa and the Middle East, but shipments from Latin American countries are rapidly increasing

Chinese consumption of oil has a long way to go



The graph above ²depicts the Chinese consumption of oil on a per-capita basis, and suggests the tremendous room for growth if the country further advances in its urbanization process. Today, the average Chinese consumes only a small fraction of the energy that industrialized countries consume.

The Brazil Pre-Salt Opportunity

Brazil has struck gold, black gold. And in huge quantities.

In 2006-07, Brazil discovered massive reservoirs of gas and oil in the Tupi field, in Brazil's Santos Basin. The reservoir, located at depths of 5 kilometers and at 180 kilometers from the coast, is so vast that if confirmed, could imply fresh reserves for Brazil in the tune of 50 billion barrels, multiplying Brazil's oil reserve base by up to 4 times. In a few years, Brazil could be sitting comfortably as one of the most oil-rich economies in the World.

The discovery is so important that it has eclipsed other finds in the World, even Anadarko's Jubilee discovery in the coast of Ghana, deemed one of Africa's largest finds in recent memory.

With the Pre-Salt discoveries, Brazil has created an extremely robust exploration portfolio and one of the strongest pipelines of new business opportunities in recent memory. Preliminary estimates speak of an astonishing US\$400 billion to be spent

² Graph borrowed from a white paper published in November 2009 by Rafael Valdez Mingramm (China – Latin America Commodity & Investment: Enduring Trends Towards 2027). The white paper is available in SinoLatin Capital's website (www.sinolatincapital.com)

in exploration and related investments over the course of the next two decades. The opportunity is so large that the current World installed capacity of exploration assets and tools is deemed as insufficient. Carrying this huge exploration and exploitation program will call for the concerted effort from World players along the E&P value chain.

On the financial front, the implementation of the Pre-Salt exploration and exploitation program will call for the orchestration of enormous financing packages in a number of different markets. The financing exercises may be so large that capacity constraints may be reached in a number of different ways.

In the international and domestic bond, money markets, and securitized debt markets, capacities are likely to be maxed out by those (led by Petrobras) looking to finance the required capex and infrastructure build out.

The capacity in the public equity market is also likely to be put to test. When you realize that the required capex is more than twice the market capitalization of Petrobras, and 1/3 of the market capitalization of the entire Bovespa, you can only wonder how will all this get financed.

Naturally, there will be more players than Petrobras, and the capital of the oil majors and other foreign companies will have to come into play. One thing is certain, the financing of one of the most ambitious capital expenditures programs in recent memory will call for the concerted effort of many parties, Brazilian and foreign, State and privately owned.

China Inc. in the Brazil Pre-Salt Picture

The proximity between China and Brazil is not new. In 2005, Petrobras and China's Sinochem International Oil signed a long-term supply by which 12 million barrels (valued at US\$600 million) would be shipped to Beijing. In spite of the natural disadvantages of sourcing oil from Latin America (it takes 35 days to transport crude from Brazil to China), this initial transaction demonstrated China's need to diversify from the Middle East, and revealed China's real preferences when considering these types of transactions: China wants to become the off-taker of the production, and not merely a return driven financial investor.

Going forward, the Brazilian Pre-Salt assets will represent to the Chinese an opportunity too good to be missed. Brazil is being courted by Governments and large international players, and China Inc. is no exception. I have no doubt that the discussion of this opportunity is at the top of President Hu Jintao's agenda during his April 2010 visit to Brazil.

To begin, Chinese interest is likely to manifest itself at the Government to Government level, via the granting of loans, most likely under the framework of Loan-for-Production or Loan and Off-take Agreements. The vehicles used to channel these monies will continue to be the oil conglomerates (CNOOC, CNPC, Sinopec, Petrochina) and/or the financial sponsors the Government uses for these purposes (China Development Bank, CIC, etc.)

Chinese oil conglomerates will also seek to become players in the upcoming auction process for oil lots, contributing their own equity in addition to their experience and expertise. Of the 120,000 sq. kms. that comprise the Pre-Salt assets, 71,000 sq. kms. are yet to be granted. As way of example, we understand that Chinese oil

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conglomerates are already preparing to take part in the upcoming auction for Colombian oil fields ("Rondas Colombia"). Chinese interest in the Brazilian fields will be clear, provided that the lots are of a size that is generally considered minimum to entice the interest of these Chinese conglomerates (2P reserves of at least 100 million barrels)

However, Chinese interest in the sector will go beyond that of the Government and the large conglomerates, and this is where the opportunities lie for players that are not the size of Petrobras or Lupatech.

China is home to a number of important manufacturers of drilling rigs, pumps, control systems, and in general, all the oil field equipment that is needed for the drilling, extraction and operation. China is also home to providers of technical services, such as seismic, engineering and construction services, marine support and shipping, as well as geophysical services. And a few of these companies rank among the largest in the World.

Backed by the very deep pockets of the Chinese financial sector, these providers of equipment and services are also likely to become a source of financing. Part of the overwhelming need for financing that will take place in Brazil over the course of the next decade can perfectly take place at the vendor level, and through this channel, Chinese financial sponsors are also likely to chip in.

Conclusion

With the development of the Pre-Salt discoveries, Brazil is about to embark on a life-changing decade. The Chinese on the other end of the World will stand eager to participate, as investors, co-developers, financial sponsors, off-takers of future production, providers of equipment, developers of infrastructure and logistical solutions, etc.

The momentums in both China and Brazil coincide for companies in both economies, large and small, State-owned and private, to reap the benefits of mutual cooperation. The World will look very different in 20 years, and in this futuristic picture we foresee Brazil and China having attained a higher level of economic integration, and jointly consolidating their leading role in a World led by emerging market economies. And the Brazilian oil sector is poised to become the catalyst of a new era of Sino-Brazilian integration.