MOODY'S
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Credit Opinion: Petroleos Mexicanos

Global Credit Research - 16 Dec 2015

Mexico, Mexico

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	Baa1
Senior Unsecured	Baa1
NSR Senior Unsecured	Aaa.mx
NSR Commercial Paper	MX-1
NSR BACKED Senior Unsecured	Aaa.mx

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Key Indicators

[1]**Petroleos Mexicanos**

	9/30/2015(L)	12/31/2014	12/31/2013	12/31/2012	12/31/2011
Average Daily Production (Mboe/d)	3,249.2	3,432.4	3,543.8	3,587.4	3,607.8
Proved Reserves (Million boe)	12,056.8	12,056.8	13,124.5	13,542.8	13,484.3
Total Crude Distillation Capacity (mbbl/day)	1,249.0	1,602.0	1,690.0	1,690.0	1,690.0
EBIT/Average Book Capitalisation	15.6%	36.4%	40.0%	42.8%	48.8%
Downstream EBIT/Total Throughput Barrels ($/bbl)	-$7.4	-$17.7	-$19.1	-$14.9	-$55.0
EBIT / Interest Expense	2.4x	7.2x	8.4x	9.6x	9.8x
Retained Cash Flow/Net Debt	-0.6%	3.2%	5.4%	9.2%	10.3%
Total Debt/Capital	160.1%	141.9%	108.9%	113.5%	92.8%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Robust sizes of reserves and production

- New energy law that benefits the company in the medium term, although also accompanied with execution risk

- High fiscal burden and elevated financial leverage

- Government related issuer with very high implied government support

Corporate Profile

Founded in 1938, PEMEX is Mexico's productive state-owned oil company. Its monopoly status will change with the continued implementation of the new energy law, although, in the foreseeable future, the company will remain the dominant energy player in the country, with fully integrated operations in oil and gas exploration and production, refining, distribution and retail marketing, and petrochemicals. PEMEX is also a leading crude oil exporter, with approximately 50% of its crude exported to various countries, mainly the US. As of September 2015, PEMEX posted USD 93.2 billion in last twelve month (LTM) revenues and its tax payments amounted to about 20% of the government's annual budget. As of September 2015, its total assets amounted to USD 126 billion.

Rating Rationale

PEMEX's Baa1/Aaa.mx/MX-1 ratings as well as its ba3 baseline credit assessment (BCA) are based on the company's weak credit metrics and our view that they will deteriorate further during 2016 as oil prices remain depressed, production continues to drop, taxes remain high, and the company's capex needs are financed with debt. In addition, the lack of a clear financial policy with regards to target debt leverage also constrains PEMEX's ratings.

In the last three years, PEMEX has increased debt to fund large outflows for taxes, duties and capital spending, without achieving sustained increases in production or operating efficiencies. Even when oil prices were at a peak level in 2014, cash flow from operating activities of USD 9.1 billion fell well short of covering USD 15.1 billion in capital spending outlays. Unless the government provides substantial injections of equity capital or reduces taxes and duties in a material way, we expect PEMEX to have greater borrowing needs in 2016 and 2017, which will push debt balances far above historic levels at a time when production is stagnant, at best, and profitability and cash flow are very weak.

PEMEX's ratings also reflect the company's sizable proved hydrocarbon reserves, which in 2014 amounted to about 11,380.2 million boe, equivalent to 10.1 years of life; its oil production averaging 2,429 mbd in 2014; its dominant role and integrated operations in the energy industry in Mexico; and its position as a leading crude oil exporter to the U.S.

PEMEX's ratings consider the impact of our joint-default analysis, which include assumptions of very high support from the government of Mexico (A3 stable) and very high dependence between PEMEX and the government. This analysis provides 5 notches of uplift to PEMEX's ba3 BCA. Our assumptions reflect the view that, despite recent changes derived from the energy reform, PEMEX will remain closely linked to the government of Mexico, which will continue to provide very high support given its status as state-owned company and its importance to the government's budget, to the energy sector and to the country's exports.

DETAILED RATING CONSIDERATIONS

HIGH FISCAL BURDEN AND ELEVATED FINANCIAL LEVERAGE

In the last three years, PEMEX's leverage has increased to fund large outflows for taxes, duties and capital spending, without achieving sustained increases in production or operating efficiencies. In addition, since the sharp decline in oil prices that began in late 2014, PEMEX's operating expenses have been resilient, with negative effect on credit metrics.

PEMEX's pre-tax cash flow is abundant and could support high levels of investment, but capital retention and investment have been stymied by its heavy tax burden. The company has the lowest production costs in Latin America, of roughly USD 8/bbl; however, its tax burden was roughly USD 57/bbl over the last 12 months. PEMEX has traditionally paid out all of its EBITDA in the form of taxes, leaving it with the need to incrementally raise debt to finance fixed charges and capex.

Tax transfers to the government from PEMEX declined materially in 2015 from 2014 and will remain low in 2016, based on Moody's oil prices assumptions. However, we believe that PEMEX will continue to provide most of its operating cash to fund well-above 20% of the government's annual budget in the next 4 to 5 years. In the longer term, as the share of new oil exploration and productions projects increase in the company's portfolio of projects, PEMEX's tax burden should gradually decline, based on the new tax regime for the oil industry, as established in the new energy law. When this happens, we would re-assess our assumptions for support and dependence under the our joint-default analysis.

With capital spending exceeding cash flow from operations, we expect negative free cash flow in the USD 20

billion range in 2016, with the Mexican crude basket trading at roughly USD 35/bbl - USD 40/bbl. PEMEX has taken actions to lessen the impact of lower crude realizations by renegotiating subcontractor relationships, which will improve margins slightly. However, the company has raised more than USD 29 billion of debt since the end of the third quarter of 2014 and we expect debt-to-capital to increase to 149% in 2015, up from 142% in 2014.

We recognize that in November 2015 PEMEX was able to negotiate a major change in its labor pension benefit plan, whose liability in December 2014 amounted to close to USD 100 billion. This change would improve PEMEX's capital structure starting most probably in mid-2016, as estimated by the company. As a consequence of the deal, the government should grant a similar amount to PEMEX in the form of short-term non-negotiable government bonds, which, however, will not immediately strengthen the company's liquidity position but will serve to reduce the pension liability going forward.

STABLE RESERVES BUT MILD PRODUCTION GROWTH PROSPECTS

Despite its massive proved hydrocarbon reserves and resources, PEMEX is burdened by high taxation and a legacy of under-investment that has hurt reserves and production growth.

Crude oil production has gradually declined over the past years, averaging roughly 2.27 million bpd in 3Q15. The company's original expectation of production of 2.4 million bpd in 2015 was affected by accidents in two platforms in 1H15 and reduction in 2015 capex from originally-planned USD 19 billion to USD 15 billion, as requested by the federal government in early 2015.

In the remainder of 2015 and in 2016, we estimate that production will decline 6% and 3%, respectively, as a consequence of many factors, including limited ability to invest in exploration and production given lower cash generation derived from lower oil prices but also high duties and taxes. The pressure on PEMEX to increase capex to boost production could decline in 2016 and probably in 2017 as well if the process to farmout existing production contracts accelerates and the company's partners take a significant share of investments in the oil fields instead of PEMEX. The company may also choose to sell some non-strategic assets or use Fibra E (MLP-type of financial instruments) to raise capital to fund capex. However, these funding alternatives could prove hard to execute under a relatively new energy law.

The deep water Gulf of Mexico and unconventional shale resources provide the greatest prospects for long-term reserves and production growth in Mexico, but they also present major capital, development and technology challenges. While PEMEX was planning to increase its deep water exploration spending and has had several significant oil and gas discoveries, much of its future success will hinge on the new energy law and its impact on attracting third parties' investment to the energy sector. We expect PEMEX's core Southeastern Basin to remain its most important producing area for the foreseeable future.

CAPITAL SPENDING ON INCREASING TREND IN THE MEDIUM TO LONG TERM

PEMEX's legacy of underinvestment was changed during 2012-14, when there was a significant step up in capital spending and government approvals of increasing budgets. However, given lower cash flows derived from lower oil prices, the company expects to spend roughly USD15 billion of capex in 2015 and USD 13 billion in 2016, down from USD17.5 billion in 2014.

The largest portion of capex will be directed to upstream, mostly in the Southeastern basins where Cantarell and KMZ are located. Downstream investment is driven by the mismatch between PEMEX's lighter refining capacity and an increasingly heavy crude barrel, and by a need to reduce dependence on product imports. Due to the aforementioned recent reduction in capex in 2015, final allocation of capex to downstream should be limited to maintenance only.

Going forward, PEMEX should have more autonomy and further de-link it from the annual state budget process, but the extent to which fiscal reform will leave more capital available to PEMEX remains unclear.

EVOLVING CORPORATE GOVERNANCE AND RELATIONSHIP WITH THE GOVERNMENT

Since October 2014 and as a result of the energy law reform, passed by Congress in late 2013, PEMEX is a productive state-owned company, with more autonomy with regards to investment allocation. Also, the company's board is now 50% independent. However, the government continues to exert outright influence on the company's decisions. For instance, PEMEX's net financial balance as well as its maximum borrowing threshold must follow the government's guidance and are approved by Congress on an annual basis. In turn, government support to PEMEX is exemplified by the MXN 20 billion and MXN 10 billion injected as equity contribution in 2014 and so far in 2015, respectively. The government is free to transfer cash to PEMEX at any time provided that it generates

income surplus.

However, PEMEX's corporate governance should improve as its board composition was enhanced by a higher participation of independent, experienced members of the business community. We expect transparency and effectiveness to increase going forward. As a productive state-owned company, PEMEX' Chief Executive Officer is appointed by the President of Mexico and its Board of Directors consists of five representatives of the Mexican Government, including the Secretary of Energy (who serves as Chairperson of the Board), and five independent members.

PEMEX's has an Audit Committee, Human Resources and Compensation Committee, a Strategy and Investment Committee, and an Acquisitions, Leasing, Public Works and Services Committee.

BENEFITS FROM THE NEW ENERGY LAW BUT WITH EXECUTION RISK

During 2014, Mexico completed a major energy reform that will help transform PEMEX as well as the energy sector over time. The most important change under the new law is the end of PEMEX's monopoly, to its current status as "productive state-owned enterprise". The new law also 1) triggered changes in the company's board of directors, which became more independent, 2) established a range of contract structures to attract private investment in the entire O&G value chain, and 3) opened up PEMEX to a more standard corporate and tax structure. The new upstream contract structures will have provisions to allow private companies to book reserves (even though they remain assets of the state), removing a major impediment to earlier attempts to spur private investment in oil development in Mexico.

The new law will broaden the range of models for investment in Mexico, from the pre-existing service contracts to profit sharing contracts, production sharing contracts and licenses. Production sharing or other licensing arrangements between the state and private oil companies, where the companies can be paid in cash and oil, are likely to be more attractive to international oil companies, particularly in higher risk areas such as the deep water Gulf, unconventional shale, or even the complex Chicontepec field. In some cases PEMEX could enter into the contracts and bid jointly with private partners. The new structures will be a key step in attracting major oil companies and their technology.

It is positive for PEMEX that the company will be able to participate in joint-ventures with third parties that will provide additional access to technologies used in exploration and production of a wide variety of fields, such as deep water, shale, and mature fields, among others, which should improve the company's business prospects in the long term. Moreover, the possibility of collaboration with third parties in downstream and midstream activities could generate economic benefits to PEMEX.

During so-called round zero, occurred in the second half of 2014, PEMEX obtained 100% of its request for 2P and 68% of its request of prospective resources. In the next few quarters, the company will migrate some of its current exploration and production service contracts into exploration and extraction contracts. In addition, selected fields assigned to PEMEX in round zero will be farmed out. Going forward, PEMEX will look for alliances with partners that have capital and operational expertise, are strategic suppliers of materials and can enter into Joint Ventures in its entire value chain, including cogeneration and transportation. These changes and opportunities promise value creation but raise execution risk.

On September30 , 2015, the government of Mexico held a successful second phase of its first-round auction of oil assets, attracting bids for three of five open blocks. We believe Mexico will attract USD 3 billion in investment from the second phase of the auction --a better result than the first phase in July 2015, a critical step in Mexico's effort to open its oil production to foreign companies for the first time since 1938. The new auction also bodes well for the next phase, involving mature, onshore basins, now set for December 2015, and for further bidding in 2016 for offshore properties that the government hopes will attract some of the world's biggest private oil companies.

Liquidity Profile

PEMEX's liquidity is tight. As of September 2015, debt maturing in 4Q15 and 2016 are USD 6.7 billion and USD 5.1 billion, respectively. This compares with management's goal to hold USD 4.5 billion in cash at the end of 2015. However, PEMEX has maintained good access to domestic and international markets, raising funds in US dollars, Australian dollars, Euros, Japanese yen, British pounds and Swiss francs, and through domestic issuance and export credit agencies. So far in 2015, PEMEX tapped both the international and domestic markets for about USD 21 billion in global and local bonds as well as bank loans, of which USD 9.6 billion was directed to refinance upcoming debt amortizations. PEMEX is the number one issuer in the local market.

Rating Outlook

The negative outlook on PEMEX's ratings is based on Moody's view that the company's credit metrics, particularly its financial leverage, will deteriorate further as debt is used to fund capex and taxes remain high.

What Could Change the Rating - Up

An upgrade of Mexico's sovereign rating would not necessarily lead to an upgrade of PEMEX's rating. However, for an upgrade or stabilization of the outlook to be considered, sovereign considerations with regards to support and dependence would have to be accompanied by a fundamental improvement of the company's operations and credit metrics. A reduction in PEMEX's tax burden that supports higher levels of internal funding for capital spending and demonstrates a solid trend of increase in production and reserves could benefit the company's baseline credit assessment. These conditions would help reduce PEMEX's dependence on debt funding, with a favorable impact on its leverage profile.

What Could Change the Rating - Down

Further material increase in debt that leads adjusted debt/EBITDA to be above 7 times despite the reduction in pension liability or a significant deterioration in production beyond the expected 3% decline in 2016 could put pressure on PEMEX's BCA and debt ratings. In addition, because PEMEX's ratings benefit from implicit support from the government of Mexico, a downgrade of the government's rating could lead to a downgrade of PEMEX's ratings.

Other Considerations

The integrated oil methodology yields an indicated rating of B1 (LTM 9/30/2015), versus PEMEX's BCA of ba3. The methodology outcome reflects its large-scale operations, but also high financial leverage and the negative impact of the government's fiscal reliance and influence on PEMEX.

Rating Factors

Petroleos Mexicanos

Integrated Oil & Gas Industry Grid [1][2]	**Current LTM 9/30/2015**		[3]**Moody's 12-18 Month Forward ViewAs of 12/15/2015**	
Factor 1 : Scale (25%)	**Measure**	**Score**	**Measure**	**Score**
a) Average Daily Production (Mboe/d)	3249	Aaa	2679	Aa
b)Proved Reserves (Million boe)	12057	Aaa	9263	Aa
c) Total Crude Distillation Capacity (mbbl/day)	1249	A	1602	A
Factor 2 : Business Position (20%)				
a) Business Position	Baa	Baa	Baa	Baa
Factor 3 : Profitability and Returns (10%)				
a)EBIT/Average Book Capitalisation	15.6%	A	14.9%	Baa
b) Downstream EBIT/Total Throughput Barrels ($/bbl)	-$7.4	Ca	-$6	Ca
Factor 4 : Financial Policy (20%)				
a) Financial Policy	Ba	Ba	Ba	Ba
Factor 5 : Leverage and Coverage(25%)				
a)EBIT / Interest Expense	2.4x	Ba	2.5x	Ba
b)Retained Cash Flow/Net Debt	-0.6%	Ca	-5%	Ca
c)Total Debt/Capital	160.1%	Ca	139%	Ca
Rating:				
Indicated Rating from Grid Factor 1-5	Baa3	Baa3		Ba1
Rating Drag	4	4	4	4
a) Indicated Rating from Grid		B1		B2
b) Actual Rating Assigned		Baa1		Baa1

Government-Related Issuer	Factor
a) Baseline Credit Assessment	ba3
b) Government Local Currency Rating	A3
c) Default Dependence	Very High
d) Support	Very High
e) Final Rating Outcome	Baa1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 9/30/2015(L); Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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