MOODY'S
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Credit Opinion: Petroleos Mexicanos

Global Credit Research - 03 Nov 2015

Mexico, Mexico

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Issuer Rating	*A3
Senior Unsecured	*A3
NSR Senior Unsecured	*Aaa.mx
NSR Commercial Paper	*MX-1
NSR BACKED Senior Unsecured	*Aaa.mx

* Placed under review for possible downgrade on August 25, 2015

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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

- Rising capital spending trend

- High fiscal burden and elevated financial leverage

- Government related issuer with strong 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 USD93.2 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 USD126 billion.

Rating Rationale

PEMEX's A3/Aaa.mx ratings as well as its ba1 baseline credit assessment (BCA) are currently under review for possible downgrade. The ratings review was triggered by our expectation that depressed oil prices will further undercut Pemex's cash flow generation and result in rising balance sheet leverage over the next several years. The company has increased debt for a number of years to fund large outflows for taxes, duties and capital spending, without achieving any sustained increases in production or operating efficiencies. Even when oil prices were at a peak level in 2014, cash flow from operating activities of $9.1 billion fell well short of covering $15.1 billion in capital spending outlays. The company will have much larger borrowing needs to fund negative free cash flow now that oil prices have fallen more than 60% compared to a year ago. Unless the government provides substantial injections of equity capital or reduces taxes and duties in a material way, we expect PEMEX to have much greater borrowing needs in 2016 and 2017, which will push debt balances far above historic levels at a time when production is stagnant and profitability and cash flow are very weak. Our review will consider the degree to which PEMEX can improve its cost structure and adjust capital spending without significantly affecting production and reserves. We will also consider if the company has material funding alternatives other than debt. In addition, we will take into consideration the likely mechanisms, timeliness, and size of support from the government of Mexico (A3 stable), in case of need.

Currently PEMEX's ratings reflect the company's sizable proved hydrocarbon reserves, which in 2014 amounted to about 12,380.2 million boe, equivalent to 10.1 years of life; its oil production averaging 2,266 mbd in 3Q15; 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. However, the ratings also factor in the company's heavy tax burden and increasing financial leverage. PEMEX's ratings also consider challenges related to production, which has been falling gradually in the last several years due to the company's limited ability to invest and share upside and downside risk with third parties. In addition, the lack of a clear financial policy with regards to target debt leverage also constrains PEMEX's ratings.

The A3/Aaa.mx ratings of PEMEX also factor in very high implied support from and dependence on the government of Mexico (A3 stable), using our joint default analysis. Despite the significant changes arising from the new energy law, in our view PEMEX will remain linked to the Mexican government, which will continue to provide strong support, given the company's importance to the government's budget, to the oil sector and to the country's exports and economy. However, we believe that given the company's worsening credit profile and the government's tight budget, a full equalization of both issuers' ratings may no longer apply.

DETAILED RATING CONSIDERATIONS

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 USD3 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.

HIGH FISCAL BURDEN AND ELEVATED FINANCIAL LEVERAGE

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 and the prohibition on third parties' equity ownership of reserves and production. PEMEX has the lowest production costs in Latin America, of roughly USD8/bbl; however, its tax burden was roughly USD57/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.

With capital spending on an increasing trend and exceeding cash flow from operations, we expect negative free cash flow in the USD20 billion range, with the Mexican crude basket trading at roughly USD35/bbl - USD40/bbl. PEMEX has taken actions to lessen the impact of lower crude realizations by renegotiating subcontractor relationships, which will improve margins slightly. However, PEMEX has raised more than USD29 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.

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. However, the company has been increasing upstream spending to try to grow reserves and stabilize production, focusing on its traditional core offshore and onshore Southeastern Basins, which can be developed and produced at competitive costs.

However, 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 were affected by accidents in two platforms in 1H15 and reduction in 2015 capex from originally-planned USD19 billion to USD15 billion, as requested by the federal government in early 2015.

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 has changed in recent years, with a significant step up in capital spending since 2012 and government approvals of increasing budgets. 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.

PEMEX's capital spending is typically back-end loaded during the year. The company expects to spend roughly USD15 billion of capex in 2015, 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.

CORPORATE GOVERNANCE

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.

Liquidity Profile

PEMEX faces substantial scheduled debt amortizations - USD6.7 billion in the remainder of 2015 and USD5 billion in 2016. Its high debt levels and amortizations entail significant refinancing risk, though both domestic and international markets remain receptive to the company. PEMEX typically keeps a minimal amount of cash on its balance sheet; as of September 30, 2015, cash and cash equivalents totaled USD6.5 billion. In the same period, it held syndicated revolving credit lines in the amount of USD4.5 billion and MXN23.5 billion, of which USD130 million were available.

On Dec 26th, 2014, the Mexican government withdrew USD3.5 billion from PEMEX's cash balances. This level of government interference highlights the governments reliance on its national oil company.

So far in 2015, PEMEX tapped both the international and domestic markets for about USD21 billion in global and local bonds as well as bank loans, of which USD9.6 billion was directed to refinance upcoming debt amortizations. 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, through domestic issuance and export credit agencies. But, given the large amount of debt PEMEX needs to issue, it could face increased financing risk if market resistance ever grows.

Rating Outlook

The ratings of PEMEX are on review for possible downgrade. We expect to complete the ratings review before the end of November 2015.

What Could Change the Rating - Up

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 reserves and production could benefit the company's baseline credit assessment. These conditions would help reduce PEMEX's dependence on debt funding, with a favorable effect on its leverage profile.

An upgrade of Mexico's sovereign rating would put positive pressure on PEMEX's rating. However, for an upgrade

to be considered, sovereign considerations would have to be accompanied by a fundamental improvement of the company's operations and credit metrics.

What Could Change the Rating - Down

A material increase in financial leverage or significant declines in production could put pressure on PEMEX's BCA and debt ratings. We expect PEMEX's debt ratings to remain closely linked to the those of Mexico thus 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 baa3 (LTM 9/30/2015), versus PEMEX's BCA of ba1. The methodology outcome reflects its large-scale operations, but also high financial leverage. PEMEX's BCA and debt ratings reflect the negative impact of the government's fiscal reliance on PEMEX, with an outcome of B1.

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 11/3/2015**	
Factor 1 : Scale (25%)	**Measure**	**Score**	**Measure**	**Score**
a) Average Daily Production (Mboe/d)	3,249.2	Aaa	3128	Aaa
b)Proved Reserves (Million boe)	12,056.8	Aaa	9930	Aa
c) Total Crude Distillation Capacity (mbbl/day)	1,249.0	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		A
b) Downstream EBIT/Total Throughput Barrels ($/bbl)	-$7.4	Ca	$0.1	Caa
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	2.7x	Ba
b)Retained Cash Flow/Net Debt	-0.6%	Ca	-4%	Ca
c)Total Debt/Capital	160.1%	Ca	141%	Ca
Rating:				
Indicated Rating from Grid Factor 1-5	Baa3	Baa3		Ba1
Rating Drag	4	4	4	4
a) Indicated Rating from Grid	B1	B1		B2
b) Actual Rating Assigned				A3

Government-Related Issuer	**Factor**
a) Baseline Credit Assessment	ba1
b) Government Local Currency Rating	A3
c) Default Dependence	Very High
d) Support	Very High
e) Final Rating Outcome	A3

[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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