FITCH AFFIRMS PEMEX'S FOREIGN & LOCAL IDRS AT 'BBB+'/'A-' & NATIONAL SCALE AT 'AAA(MEX)'/'F1+(MEX)'

Fitch Ratings-Chicago-01 July 2016: Fitch Ratings has affirmed Petroleos Mexicanos S.A.'s (Pemex) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB+' and 'A-', respectively. The rating affirmation applies to approximately USD40 billion of notes outstanding. Fitch has also affirmed Pemex's National Long- and Short-Term ratings and all related nationally rated debt securities at 'AAA(mex)' and 'F1+(mex)', respectively. The Rating Outlook is Stable.

KEY RATING DRIVERS

Pemex's ratings reflect its close linkage to the government of Mexico and the company's fiscal importance to the sovereign and strategic importance to the country. Pemex's ratings also reflect the company's competitive pre-tax cost structure, national and export-oriented profile, sizable hydrocarbon reserves and its strong domestic market position. The ratings are constrained by Pemex's substantial tax burden, significant unfunded pension liabilities, large capital investment requirements, negative equity and exposure to political interference risk.

Strong Linkage to the Government

Pemex is the nation's largest company and one of the Mexican central government's major sources of funds. During the past five years, Pemex's transfers to the government have averaged 49.0% of sales, or 126.0% of operating income. These contributions, through royalties, exploration taxes and production duties have averaged between 25% and 35% of government revenues. As a result, Pemex's balance sheet has weakened, which is illustrated by its significant increase in debt and negative equity balance sheet account since the end of 2009. Pemex's debt lacks an explicit guarantee from the government.

Strategically Importance for Energy Security

Pemex's linkage to the sovereign also arises from the company's strategic importance for the supply of liquid fuels to Mexico. A financial distress situation at Pemex holds the potential to disrupt the supply of liquid fuels in the entire country, which could have material social and economic consequences for Mexico, as it is a fundamental input into the production of almost all goods, as well as the mobility of goods and labor. Although Mexico is a net exporter of crude oil, the company relies on the imports of both crude oil and basic oil products in order to supply local demand.

Historically, the company was the only entity allowed by the constitution to explore and produce crude or to own and operate downstream infrastructure. The industry was open to private participation at the end of 2013 and so far there has been modest interest in upstream investments. Interest in Pemex's downstream businesses does not appear imminent and over the short to medium term the country will continue relying on Pemex's operations for its domestic liquid fuel supply. Mexico could see an increase of private participation in the supply and distribution of liquid fuels after 2018, when price regulations are expected to decrease materially or disappear and fuel prices will be determined by a competitive market.

Symbolic Government Support

Mexico's support of Pemex has been evidenced in recent months by the Ministry of Finance's public statements of support, as well as announced modest capital injections and marginal tax reductions. This support has been so far more symbolic than material and Fitch expects the Mexican government to execute more meaningful support actions when the company needs them. In April of 2016, the Mexican government injected approximately USD1.5 billion of new capital into Pemex. This action follows the USD2.9 billion injected in the form of no-tradable government securities during December 2015; USD2.7 billion of the notes received are expected to be exchange for short-term tradable government securities in 2016 and the proceeds will be used to cover pension liabilities payments.

In addition to these actions, the Mexican government established a USD6.5/boe average cost deduction floor for tax purposes, which could represent MXN50 billion of tax savings for Pemex during 2016 if the company's realization price averages USD25/bbl. The tax savings from this reform will approach zero if realization price for Pemex is above USD57/bbl. Pemex also received credit lines for an aggregate amount of MXN15 billion from the country's development banks; Banco Nacional de Obras y Servicios Publicos, S.N.C. (Banobras), Nacional Financiera, S.N.C. (Nafinsa) and Banco Nacional de Comercio Exterior, S.N.C. (Bancomext).

Weak Stand-Alone Credit Quality

Pemex's stand-alone credit quality is in line with a 'B-' Long-Term Rating, should the company not be owned by the state and the government were not to provide financial support should Pemex's require it. This stand alone view also assumes that the Mexican government continues extracting a large amount of funds from Pemex in the form of taxes, resulting in feeble FFO. Pemex's stand-alone credit profile has been weakened in recent years by the significant increase in debt the company has issued primarily in order to cover its large transfers to Mexico in the form of taxes, duties and royalties. Pemex's debt trajectory could continue pressuring the company's stand alone credit quality, which could reach an unsustainable level, should the Mexican government continue issuing debt at Pemex's level to transfer funds to the central government. Pemex made transfer payments in the form of taxes and royalties to the government equal to 1.3x its EBITDA during 2015. The company covered its 2015 negative FCF of USD13.8 billion mostly with debt issuances; Pemex's debt trajectory indicates it could surpass USD100 billion of debt by 2017.

As of the last twelve months ended March 31, 2016, Pemex's EBITDA (operating income plus depreciation plus other income) was approximately USD14 billion after adjusting for asset impairments and pension liabilities' associated gains; FFO for the same period was negative USD1.7 billion, mainly as a result of transfers to the government. Pemex cash flow metrics are weak due to the company's high cash transfers to the government in the form of taxes and production duties. Leverage as measured by total debt-to-EBITDA was 6.6x. As of March 31, 2016, total debt was USD93.3 billion. Pemex's total debt-to-proved reserves has grown to USD9.9/boe as of March 2016 from USD6.3/boe as of yearend 2014. Pemex's leverage could reach an unsustainable level over the next two to three years absent further changes to reduce Pemex's tax burden.

Capex Cuts to Reduce Production

Fitch expects Pemex's production to continue declining over the next few years as a result of the significant capex cuts in exploration and development in order to counter the decline in oil prices while maintaining relatively high transfers to Mexico. The diversification of the oil production asset base, with Cantarell representing less than 15% of oil production, reduces the risk of large production declines in the future. The company's previous goal was to increase total crude production to three million bpd in the medium to long term, which in Fitch's view, has proven challenging. Pemex's current goal for 2016 is to have a crude production of approximately 2.1 million bpd.

Currently at approximately 2.2 million barrels per day (bb/d), crude oil production has continued to marginally decline in recent years. Natural gas production excluding nitrogen has been relatively stable during recent years at approximately 5.5 billion cubic feet per day (bcf/d). Pemex was able to stem the steep production decline through more intensive use of technology, improvements in operations, and increased production from a diversified number of fields.

KEY ASSUMPTIONS

Fitch's key assumptions within the agency's ratings case for the issuer include:
--WTI crude prices average USD35 per bbl in 2016, increasing to USD65 per bbl by 2019.
--The company continues to face difficulties increasing its production over the next four years.
-- Pemex will receive support from the sovereign.

RATING SENSITIVITIES

Although not expected in the short-term, an upgrade of Pemex could result from an upgrade of the sovereign coupled with a strong operating and financial performance and/or a material reduction in Pemex's tax burden. Negative rating action could be triggered by a downgrade of the sovereign's rating, the perception of a lower degree of linkage between Pemex and the sovereign, and/or a substantial deterioration in Pemex's credit metrics.

LIQUIDITY

Pemex has moderate liquidity of USD8.1 billion as of March 31, 2016. The company has committed revolving credit lines for USD4.5 billion and MXN23.5 billion; as of April 28, 2016, USD1.63 billion and MXN9.1 billion were available. The company's debt is well structured, with somewhat manageable short-term debt maturities. The company's liquidity is further bolstered by its pre-tax cash flow generation supportive by its competitive operational cost structure. Fitch estimates Pemex's operating cash cost to be less than USD24 per barrel of oil equivalent, including interest costs and full allocation of administrative expenses to the upstream business.

FULL LIST OF RATING ACTIONS

Fitch has affirmed Pemex's ratings as follows:

--Long-Term IDR at 'BBB+'; Outlook Stable;
--Long-Term Local-Currency IDR at 'A-'; Outlook Stable;
--National Long-Term Rating at 'AAA(mex)'; Outlook Stable;
--National Short-Term Rating at 'F1+(mex)';
--Notes outstanding in foreign currency at 'BBB+';
--Notes outstanding in local currency at 'A-';
--National scale debt issuances at 'AAA(mex)';
--Short-Term Certificados Bursatiles Program at 'F1+(mex)'.

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Applicable Criteria
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362

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