What Investors Want to Know: Pemex

Government Demands Leading to Insolvency

Special Report

Taxes Will Lead to Insolvency: The Mexican government's continued demands for dividends from Petroleos Mexicanos (Pemex; BBB+/Negative), in the form of taxes, duties and royalties will force Pemex to borrow indefinitely and lead to insolvency. This path will significantly increase the need for a large government rescue in the medium term. In 2015, the company transferred about 1.3x EBITDA to Mexico and is expected to have transferred all of its EBITDA in 2016. Pemex's taxes make it improbable the company will have positive FCF in the future.

Debt Weakens Credit Quality: Debt as of year-end 2016 likely surpassed USD100 billion. Without more adjustments to Pemex's tax program, debt could surpass USD125 billion in two to three years, or more than USD15.0/barrel (bbl) of proven reserves, up from USD9.9/bbl in 2015. Fitch Ratings considers this ratio unsustainable. Leverage may improve in line with Fitch's oil price recovery expectations, but the company's reserve life of 8.1 years may not materially recover from the decline reported in 2015 without an increase in investment.

Cost Cuts Are Insufficient: Although Pemex is striving to lower production costs and increase operational and investment efficiencies, these efforts may not be sufficient to avoid insolvency without lowering the government's take. Pemex's production costs are competitive and room for improvement is limited as MXN24 billion in costs and procurements was reportedly saved in 2016.

This amount is comparable to USD1/barrels of oil equivalent (boe) in full-cycle cost savings, if all costs were applied to upstream costs. Pemex would need to lower pretax, full-cycle oil costs by USD14/bbl and oil prices would need to reach USD100/bbl to have break-even cash flow.

Capex Reduction Risks Long Term: Pemex's production stands to decrease at a pace close to its depletion rate of 5%–10% per year in the medium term as a result of significant capex curtailment. In recent years, capital investments were below implied replacement costs and not enough to stem a decrease in production. The announced investment cuts will likely reignite production declines while proven reserves and reserve life could fall as well.

FCF Negative at Any Price: Pemex's FCF will be negative under any oil price scenario if reserves are replenished as oil is produced. Fitch estimates after-tax break-even prices for 2014 and 2015 were USD82/boe and USD57/boe, respectively. Divestitures could ease pressure, but will yield no long-term benefits if proceeds fund dividends instead of being reinvested in profitable assets. Joint ventures are beneficial only in the very long term and Pemex could run into financial trouble before the benefits of partnerships kick in.

In this report, Fitch addresses the following frequently asked questions regarding Pemex:

What is Pemex's rating sensitivity?

What is Pemex's FX rate sensitivity?

What are the effects of farmouts and migrations?

What is Pemex's expected debt trajectory?

How could a potential NAFTA renegotiation affect Pemex?

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2017 Outlook: Latin American Energy (Limited Debt Growth Headroom) (December 2016)

Fitch Revises the Outlooks on Various Mexican Corporates to Negative (December 2016)

Petroleos Mexicanos (Pemex) Sensitivity Analysis (Taxes: Pemex's Path to Insolvency) (October 2016)

Petroleos Mexicanos (Pemex) (August 2016)

Latin American Oil Dashboard (May 2016)

Latin American Oil & Gas Netback Profile (Cash Costs at or Below Market Prices) (January 2016)

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What Is Pemex's Rating Sensitivity?

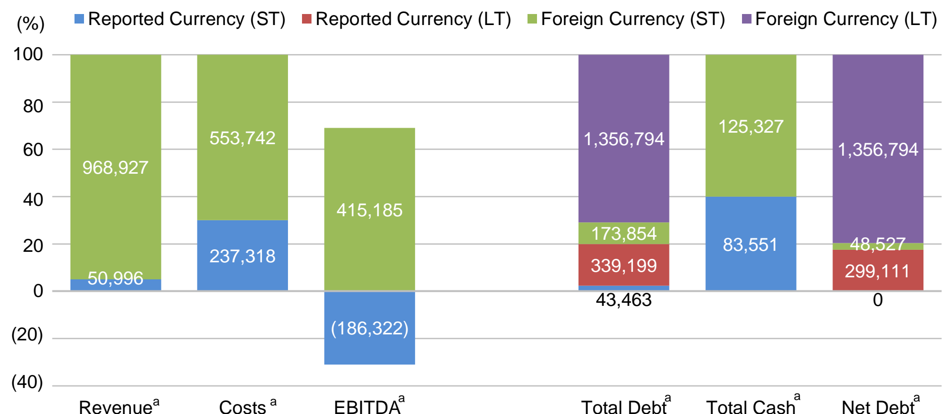
A negative rating action could be triggered by a downgrade of the sovereign's rating, the perception of a lower degree of linkage between Pemex and Mexico, and/or a substantial deterioration in Pemex's credit metrics. Negative rating actions for the company independent of the sovereign are possible to the extent credit metrics continue deteriorating and the perception of government linkage weakens. Multiple factors could lead to Fitch's perception of weakening government support. These factors include, but are not limited to, continued high taxation, reimplementation of price subsidies negatively affecting Pemex's cash flow generation and a negative change in messaging from the government with regards to support. So far, Mexican officials publicly expressed the government's strong determination to support Pemex.

Although not expected in the short term, an upgrade of Pemex could result from an upgrade of the sovereign, coupled with strong operating and financial performance, and/or a material reduction in Pemex's tax burden. The company is expected to remain a strategically important vehicle for Mexico in the short to medium term. This is supported by the company's supply of liquid fuels to the country. A situation of financial distress 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. Although Mexico is a net exporter of crude oil, the company relies on importing basic oil products, including dry gas, petroleum products and petrochemicals, in order to supply local demand.

What Is Pemex's FX Rate Sensitivity?

Benefits from the recent Mexican peso depreciation should be only modest as Fitch estimates approximately three-quarters of the company's costs are denominated in, or linked to, the U.S. dollar and the bulk of the company's debt is U.S dollar-denominated. The Mexican peso depreciated an average of 19% per year during the past two years. Fitch estimates for every 10% decline in the Mexican peso, compared to the U.S. dollar, Pemex's EBITDA increases by approximately 7%. This is provided the company can pass through the higher fuel costs in Mexican pesos seamlessly, which could prove challenging under a continuing sharp depreciation of the Mexican peso. Review the *Fitch FX Screener* chart below for details.

Fitch FX Screener



[a]Post hedge. ST – Short term. LT – Long term.
Source: Fitch estimates.

Recent energy reform provides for fuel price liberalization, which Mexico started implementing this year, and is aimed at eliminating subsidies and/or targets specific low-income groups. Price liberalization is key to attracting private participation in the downstream and fuel commercialization industry. Although Mexico historically implemented price controls, in the past

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few years Pemex's price realization was linked to international parity, using fuel taxes as a cushion to amortize pump price fluctuations. In January 2017, Mexico took the first steps in deregulating prices. Gasoline and diesel price increases of 15% to 20% were met with protest throughout the country, evidencing the difficulties and political tension of passing through the costs of severe Mexican peso depreciation and the effects this could have for Pemex.

What Are the Effects of Farmouts and Migrations?

Pemex's recent success with a deep-water farmout is very positive in the long term for the company, as incremental production goes online in approximately seven years with lower government expropriation and minimal cash outflows. The success of the farmout could be positive for the company as it could facilitate the execution of additional farmouts. Under its current business plan, Pemex intends to accelerate the pace of partnerships in this program, especially with assets with lower exploration to first oil timetables or existing production, cash flow generation could improve from lower government take under new contracts. The next farmout is scheduled for first-half 2017 and will include assets with shorter development timeframes.

The company could see a significant improvement in its tax regime if the Mexican government allowed migration of assignments for existing producing fields into the new profit or production sharing contracts offered under current auctions. The new profit or production sharing contracts have a cost cap deduction of up to 60.00% of the value of products and the sharing tax applies to the balance. This compares with Pemex's current cost deduction cap for tax purposes of the greatest of 11.55% or an average of USD6.5/bbl.

What Is Pemex's Expected Debt Trajectory?

Pemex's stand-alone credit profile weakened in recent years from the significant increase in debt the company issued primarily in order to cover large transfers to the Mexican government in the form of taxes, duties and royalties. The company's debt trajectory could continue to pressure 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.

As of Sept. 30, 2016, Pemex reported approximately USD99 billion of debt. During fourth-quarter 2016, the company issued approximately USD7 billion of debt, part of which was to prefund 2017 needs. This puts Pemex's total debt for year-end 2016 above USD100 billion. Without more adjustments to Pemex's tax program, debt could surpass USD125 billion in two to three years, or more than USD15/bbl of proven reserves, up from USD9.9/bbl in 2015, a level Fitch considers unsustainable.

How Could a Potential NAFTA Renegotiation Affect Pemex?

Renegotiation of NAFTA would likely have a neutral effect on Pemex. Mexican energy was not included in NAFTA and energy is a global industry and oil a global commodity. Although Mexico was historically a net oil exporter to the U.S. since year-end 2015, the U.S. is a net exporter of crude, petroleum products and natural gas to Mexico. Oil trade between the two countries averaged approximately 1.4 million barrels per day during 2016. Proximity between Mexico and the U.S. maximizes trade economics for both countries. Mexico and the U.S. both stand to lose from restrictive trade policies in oil and gas. Mexico could sell oil production elsewhere at a marginal discount to what it currently trades with its northern neighbor should the U.S. implement import taxes on crude oil.

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