What Investors Want to Know: PEMEX

Future Rating Action Scenarios to Follow Fitch Ratings' Government Related Entities Criteria

Weaker Rating Linkage Assessment to Sovereign

Standalone Credit Profile Deterioration: Petroleos Mexicanos' (PEMEX; BBB–/Negative) ratings were downgraded on Jan. 29, 2019, reflecting the deterioration of its Standalone Credit Profile (SCP) to 'CCC' from 'B–' previously. PEMEX's rating downgrade, compared to Mexico (BBB+/Negative), reflects the company's continued negative FCF generation, persistent underinvestment to replenish reserves and stabilize production, and delays in material government measures to support PEMEX financially to the levels required to materially improve its SCP.

Strong Government Linkage: Although Fitch Ratings' assessment of the strength of the linkage between PEMEX and the government was revised downward, as a result of the SCP deterioration, Fitch continues to expect the government will ensure that PEMEX maintains a robust liquidity position to service debt, which supports the material rating differential with the SCP. PEMEX's linkage to the Mexican government results from strong incentives to support the company, given the socio-political and financial consequences a PEMEX default would have for the country.

Moderate Support Track Record: Fitch's assessment of the moderate support track record for the company could increase with extraordinary measures of support from the government. This has the potential to stabilize PEMEX's Outlook or revert the rating approach to equalization with the sovereign. The government's recent announcement of potential additional extraordinary support for PEMEX could bode well. We estimate the company could see a reduction in the government take of approximately 44%–48% if Mexico were to migrate 100% of the company's production to the new royalties rates introduced in 2014, provided PEMEX has deductible expenses to take advantage of this benefit.

PEMEX's Negative Outlook: The company's Negative Outlook mirrors Mexico's Sovereign Negative Outlook and reflects the potential for further deterioration of PEMEX's SCP to below 'CCC'. Additional large fund transfers to the government could result in negative FCF generation, rising debt and prohibit sustainable capital reinvestment. FCF continues to be negative despite efforts to cut costs and capex. Should the Mexican government fail to prevent PEMEX's SCP from deteriorating below 'CCC', Fitch believes this will be a further indication the government views the company's strategic importance for the nation is less critical and could result in further negative rating actions for PEMEX's ratings.

In this report, we address the following key issues and most frequently asked investor questions:

- Under what circumstances could PEMEX's ratings be equalized with the sovereign?
- What happens if Mexico's credit rating is downgraded as a consequence of providing unequivocal financial assistance to bolster PEMEX's credit profile?
- Under what circumstances could PEMEX's rating fall below investment grade?
- What could lead Fitch to implement a bottom up or standalone rating approach?
- What is the credit effect of a material increase in downstream investments?

Under What Circumstances Could PEMEX's Ratings Be Equalized with the Sovereign?

PEMEX's SCP would need to recover to at least a 'B–' rating level in order for Fitch to equalize the ratings of the company to those of the sovereign. This will imply a reduction in leverage to an FFO-adjusted leverage of 5.0x or less and/or a reduction in total debt/proved reserves (1P) to less than USD14/barrels of oil equivalent (boe) with a credible deleveraging trajectory. In order for the company to achieve this, PEMEX would likely require a reduction in the government take by close to 75%, a material capital injection used to reduce debt or a combination of these factors.

These measures will demonstrate the Mexican government truly recognizes the strategic importance the company has for the country, which will allow Fitch to re-evaluate our assessment of incentives of support back to a "Very Strong" from the recently lowered level of "Strong". These measures could also allow us to increase our assessment of the support track record to "Strong" from the current level of "Moderate". The table below lists the current different assessments for PEMEX's strength of linkage to the sovereign. Fitch recently lowered the socio-political and financial implications of the default sub-factors to "Strong" from "Very Strong" as a result of the government inaction to prevent PEMEX's SCP from deteriorating to 'CCC'. Should Mexico ensure PEMEX's SCP returns to above the 'CCC' level, these sub-factors may return to "Very Strong", allowing again for an equalization rating approach.

Fitch's Government Related Entities Approach for PEMEX

	Previous		Current		
Factor	**Assessment**	**Score**	**Assessment**	**Score**	**Rationale**
Status, Ownership and Control	Very Strong	10	Very Strong	10	A 100% government owned company. A significant level of government control of the company's strategy, debt issuance and investments.
Support Track Record and Expectations	Moderate	2.5	Moderate	2.5	Support is present through public statements from the government, capital injections and access to funding from state-controlled financial institutions. This has been offset by elevated levels of transfers to the federal government.
Socio-Political Impact of Default	Very Strong	20	Strong	↓10	A PEMEX default could jeopardize the supply of liquid fuels for Mexico as the country is not self-sufficient and relies largely on fuel imports. Although this supports an assessment of "Very Strong", the 'CCC' SCP prevents Fitch from assessing this category at that level.
Financial Implications of a Government Related Entities Default	Very Strong	20	Strong	↓10	PEMEX's financial debt is approaching 10% of Mexico's GDP. A PEMEX default could affect the country's ability to borrow in the international markets and significantly affect the domestic financial system. Although this supports an assessment of "Very Strong", the 'CCC' SCP prevents Fitch from assessing this category at that level.
Overall Support Score		52.5		32.5	
Rating Approach		**Equalized**		**TD –2**	

PEMEX – Petroleos Mexicanos (PEMEX). SCP – Standalone Credit Profile. TD – Top Down.
Source: Fitch Ratings.

What Happens if Mexico's Credit Rating Is Downgraded as a Consequence of Providing Unequivocal Financial Assistance to Bolster PEMEX's Credit Profile?

Depending on the level of support, PEMEX's ratings could be either equalized to those of the sovereign, as previously mentioned, or experience a contraction in the notch differential to Top Down minus one (TD –1) from the current approach of the sovereign rating minus two notches (TD –2). One of Mexico's Sovereign Rating negative sensitivities is "materialization of contingent liabilities that undermine the sovereign's balance sheet". This implies that exceptional support for PEMEX could weight on the sovereign's credit quality, in which case PEMEX's rating may stabilize at 'BBB–' under a one-notch downgrade for the sovereign and a TD –1 rating approach.

Fitch estimates a reduction of 50% of the government take may be sufficient to allow the company to invest enough in its upstream business, to the extent where not a meaningful amount of the retained internal cash flow is used for other investments, such as midstream or downstream. This level of reduction in government take could lead Fitch to re-evaluate its assessment of the support track record to “Strong” from “Moderate”, which could help support a TD –1 rating approach, while the SCP remains at ‘CCC’. Although a reduction of the government take of this magnitude may not immediately result in a higher SCP than the ‘CCC’ rating, as credit metrics may remain pressured, this could improve over time as leverage metrics improve, which could then result in a equalization rating approach in the future.

Fitch estimates that if the Mexican government were to migrate 100% of the company’s production from the current tax program to one offered under the new royalty rates, PEMEX’s transfers to the government could decline to between 44%–48%. This is provided PEMEX has sufficient capex and operating expenditure (opex) to take advantage of the higher cost capital deductions under the new tax program and that there is not a material increase in income taxes and downstream investments. Currently, PEMEX is able to deduct expenses up to a level of no more than 12.5% of the value of production before applying a 65% profit-sharing duty. The new profit-sharing agreements allow for deductions before taxes up to a level of 60% and allows for opex and capex deductions. The company is also subject to a production tax with a floor of 7.5%, indexed to oil prices, increasing to as much as 14% at an oil price of USD100 per barrel (bbl).

Fitch estimates PEMEX will need to boost FCF by USD12 billion–USD17 billion per year in order to have a capital investment program in upstream that is enough to replenish 100% of reserves and stabilize production, while reporting a neutral to positive FCF. In order to replenish 100% of reserves on annual production of approximately 940 million barrels of oil equivalent per year, PEMEX would have to invest between USD13billion–USD18 billion in upstream capex, which is a material increase from the estimated upstream capex of less than USD5 billion during 2018. This is an underinvestment of between USD8 billion–USD13 billion. During 2018, the company is estimated to have had a negative FCF of approximately USD3.5 billion, which, when added to the estimated level of underinvestment results in USD12 billion–USD17 billion of a funding shortfall.

The table below illustrates three different scenarios under which Fitch may change its rating approach that could result in either a stabilization of the outlook or a positive rating action, depending on the effect this may have on Mexico’s Sovereign Rating. These scenarios are for illustration purpose only as there are other potential alternative scenarios and circumstances that could result in different outcomes from those listed below. Fitch’s focus for positive rating actions for PEMEX concentrate on the company reporting neutral to positive FCF, while maintaining a sustainable investment level that ensures the company’s viability and stability of operations in the long term and can also help improve its SCP.

Scenario Analysis

(USD Bil.)	LTM Sept. 30, 2018	50% Lower Take	75% Lower Take	75% + USD20 Billion Capitalization
EBITDA	29	29	29	29
Government Take	27	13.5	6.8	6.75
Total Debt	107	107	100	80
Capex	6	16	16	16
Total Production (kboe/d)	2,584	Stable at 2584	Stable at 2584	Stable at 2584
1P (Mil. boe)	7,000F	7,000F	7,000F	7,000F
TD/1P ($/boe)	15F	15	14	11
FFO-Adjusted Leverage (x)	12	6	5	4
Standalone Credit Profile	CCC	CCC But Improving	B Category	≥ BB Category
Rating Approach	TD –2	TD –1	Equalized	Equalized

Kboe/d – Thousand barrels of oil equivalent per day. 1P – Proved reserves. TD – Top Down. Boe – Barrels of oil equivalent. F – Forecast.
Source: Fitch Ratings, Fitch Solutions.

Under What Circumstances Could PEMEX's Rating Fall Below Investment Grade?

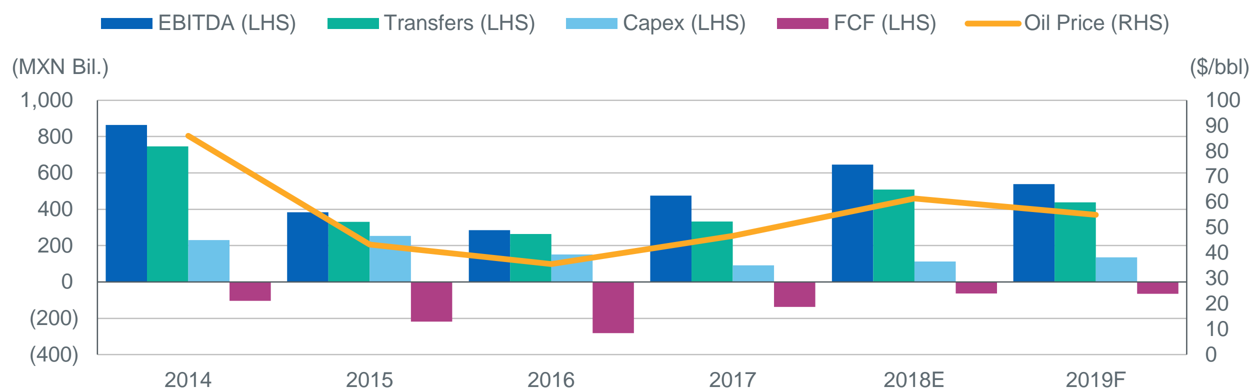
There are two main scenarios under which PEMEX's ratings may see further downward pressure: a sovereign downgrade without extraordinary support for PEMEX and/or a continued deterioration of PEMEX's SCP. The company's current SCP of 'CCC' resulted in a TD –2 rating approach in relation to the sovereign's rating. Therefore, if Mexico's Sovereign Ratings are downgraded for reasons other than a PEMEX bail out, then the ratings could potentially be downgraded following the application of Fitch's Government Related Entities methodology that continues to mirror this relationship. Additionally, further deterioration that could take Fitch's assessment of linkage for the incentives of support to 'Moderate' from the current 'Strong' designation could result in a TD –3 relationship to the sovereign rating.

PEMEX's Negative Outlook mirrors Mexico's Negative Outlook and reflects the potential for further deterioration of the company's SCP to below 'CCC'. Additional large fund transfers to the government could result in negative FCF generation, rising debt and prohibit sustainable capital reinvestment. The company's FCF continues to be negative, despite efforts to cut costs and capex. Fitch expects PEMEX's FFO-adjusted leverage to have been more than 10.0x at YE 2018 and total debt/1P reserves to have reached nearly USD15/bbl. Should the Mexican government fail to prevent the company's SCP from deteriorating below 'CCC', Fitch believes it will be a further indication the government views PEMEX's strategic importance for the nation as less important. This could result in further negative rating actions for the company's ratings.

A negative rating action could be triggered by any combination of the following factors:

- A downgrade of the sovereign's rating that is not driven by the materialization of PEMEX-related contingent liabilities;
- Sustained deterioration of PEMEX's financial flexibility coupled with government inaction to support liquidity. This could result from continued negative FCF and/or a material reduction of the company's cash on hand, credit facilities and/or restricted capital markets access;
- FFO-adjusted leverage materially above 8.0x and total debt/1P reserves significantly higher than USD15/boe;
- Continued deterioration of the company's SCP to below the current 'CCC' assessment, which could result if PEMEX fails to stabilize production and continues with unsustainable reserves replacement ratios and negative FCF.

Cash Flow Trends



Bbl – Barrel. E – Estimate. F – Forecast.
Source: Fitch Ratings, Fitch Solutions.

What Could Lead Fitch to Implement a Bottom Up or Standalone Rating Approach?

Recurrent weak financial flexibility, coupled with continued government inaction, would increase credit risk and could result in a bottom up rating approach, which will benchmark from the SCP and potentially give an up to three-notch uplift, depending on expectations of government support. Fitch assesses financial flexibility based on a company's financial discipline, fixed payments coverage and liquidity. We measure liquidity as the ratio of cash on hand plus undrawn committed credit facilities plus forecast FCF divided by upcoming maturities. PEMEX's liquidity ratio is estimated to have been marginally below 1.0x as of YE 2018.

During 2019, PEMEX has principal amortization of approximately USD6.6 billion with a material portion of bonds amortizing during the first half of the year. The company reported cash on hand of USD4.7 billion and undrawn lines of credit of approximately USD6.7 billion, as of September 2018. PEMEX is expected to report negative FCF of between USD3 billion–USD4 billion during 2019.

Notching Guideline Table

SCP of SOE Versus Rating of the Government	= or > 45	35 to 42.5	27.5 to 32.5	20 to 25	15 to 17.5	12.5	= or < 10
Same or Above	Standalone or Capped	Standalone or Capped	Standalone or Capped	Standalone or Capped	Standalone or Capped	Standalone or Capped	Standalone or Capped
Up to Three Notches from the Government	Equalized	Equalized	Equalized	TD –1[a]	Bottom Up +1 Capped at Government –1	Bottom Up +1 Capped at Government –1	Standalone
Four Notches from the Government	Equalized	TD –1	TD –1	TD –2	Bottom up +1	Bottom up +1	Standalone
More Than Four Notches from the Government or Standalone Not Assigned/Not Meaningful	Equalized	TD –1	TD –2	TD –3	Bottom up +2 or +3 Capped at Government –3[b]	Bottom up +1[b]	Standalone[b]

[a]If the SCP of the GRE is one notch below the government and the credit drivers of the GRE are largely independent from those of the government, a one-notch uplift to the same rating as the government can also be considered. [b]When the standalone is not assigned or not meaningful, entities for which the notching approach is bottom up or standalone would not be rated. [c]The SCP may be not meaningful when the issuer cannot be effectively de-linked from the government or when the GRE primarily acts on behalf of the government to perform a policy driven mission and does not generate its own cash flows or because of very tight operational and financial links with the government. SCP – Standalone Credit Profile. SOE – State Owned Enterprises. TD – Top Down. GRE – Government Related Entities.
Source: Fitch Ratings.

What Is the Credit Effect of a Material Increase in Downstream Investments?

A material increase in downstream investments could be additionally detrimental for PEMEX's credit quality, especially if done at the expense of curbing upstream investments. Under the aforementioned positive scenarios, Fitch expects government support to be directed to either improve PEMEX's capital structure by reducing debt and/or investing in the company's upstream business to stabilize production and 1P reserves. PEMEX's upstream business is the largest cash flow generation segment for the company and is the one with the potential to yield the highest return on invested capital so the company can recover its SCP.

Downstream investments are typically driven for political, social or strategic reasons more so than from a return on invested capital point of view. Countries in Latin America have typically steered the region's national oil companies to invest in downstream projects in order to either ensure energy security for the country, promote employment and/or comply with more stringent environmentally regulations. In recent history, downstream investments in Latin America have rarely been driven by competitive return on invested capital.

Fitch recognizes the need for downstream infrastructure to exist as converting crude into petroleum products is essential for usage. Today sufficient infrastructure exists in North America to supply Mexico's demand, as proven by the recent increase in gasoline and diesel imports to more than 70%, at times. Fitch would consider it beneficial for PEMEX's credit quality if the company's future investments in downstream, and potentially midstream, are funded by the government. This could occur as the company's SCP recovers, as these investments are primarily necessary for energy security and would probably only have a marginal increase in cash flow generation, when compared with upstream investments.

Related Research

Fitch Downgrades PEMEX's IDRs to 'BBB–'; Outlook Negative (January 2019)
Government-Related Entities Rating Criteria (October 2018)
Petroleos Mexicanos (PEMEX) Sensitivity Analysis (Taxes: Pemex's Path to Insolvency) (October 2016)

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