BBVA Research

Economic Analysis

The measures announced today do not solve Pemex’s structural problems

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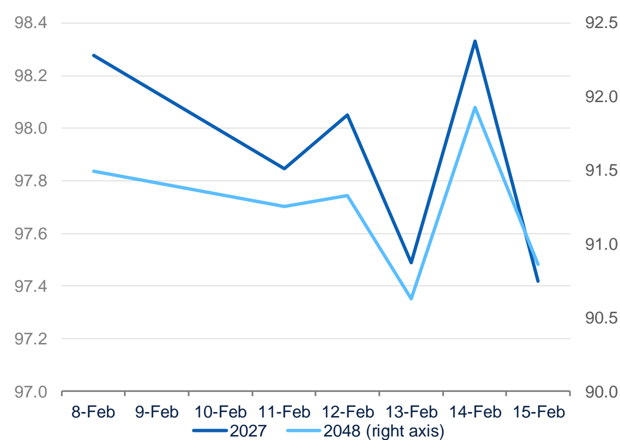
Financial support from the federal government will buy time, but Pemex's credit rating remains at risk

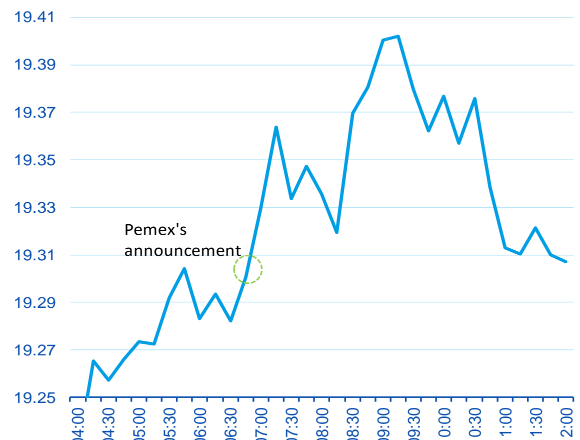
The Federal Government of Mexico has announced that Pemex will benefit from a tax reduction of MXN 15 billion for this year. This is an additional MXN 4 billion fiscal relief on top of the MXN 11 billion tax cut announced a few weeks ago by the Ministry of Finance or SHCP for its acronym in Spanish. The state productive enterprise will have the following additional resources: (i) MXN 25 billion from capital injection; (ii) MXN 35 billion in monetization of promissory notes for labor liabilities; (iii) and MXN 32 billion from the fight against fuel theft.

Figure 1: Price of Pemex bonds
(USD)



Source: BBVA Research with Bloomberg data

Figure 2: Exchange rate
(MXN per USD)



Source: BBVA Research with Bloomberg data

The market reaction to the announcement was marginally negative. Both the Mexican peso and Pemex bonds showed a slightly lower trading value in international markets. We believe that these measures are insufficient to solve Pemex's two major structural problems: its excessive debt and the decline of crude oil production. Although plans to eliminate its net borrowing for this year were also announced, the company and the federal government face a schedule of significant debt amortizations between 2020 and 2023 (see details below). The restriction of slowing the growth of financial debt in coming years will adversely affect the growth of investment resources. Consequently, without a significantly increasing rate of investment, it will be difficult to stop the slide in crude oil production.

To stabilize crude oil production and eventually increase it, the investment of MXN 273 billion approved for 2019 would need to be doubled and mainly allocated to E&P activities. But given the severe limitation for Pemex to continue borrowing, the additional resources for investment in these activities would have to come from the government budget. However, this solution could put pressure the sovereign credit rating. Although faced with this series of restrictions, the

company has the option of encouraging farmouts to boost productive investment in Pemex, thereby sharing both the exploratory risk and investment resources. In addition, greater use of this instrument would reduce the tax burden in the medium term as a result of higher deductibility of costs.

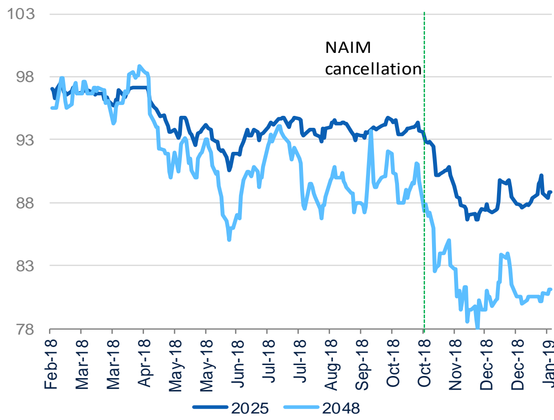
There is no doubt that the measures announced today will help Pemex retain its credit rating for the time being. However, the palliative nature of these measures does not help to significantly reduce the risk of a drop in this rating in the medium term (implying a level below investment grade). The possible and now less likely reduction in Pemex's credit rating could have a negative impact across the Mexican financial system. This is because automatic sales of bonds by investment fund administrators (who are subject to restrictions on the investment grade of bonds in their portfolios) would be triggered. To prevent this huge financial and macroeconomic risk, an increased reduction of Pemex's fiscal burden in the coming years is desirable. Nevertheless, this would strain the sovereign credit rating, although there would be some margin given its current rating of BBB+. It is worth mentioning that local government bonds are comparable in value with those of countries with a credit rating of BBB-. One last-resort option would be the explicit guarantee of Pemex's debt by the federal government, which would prevent a reduction in the Pemex bond investment grade but at the expense of greater pressure on government bonds and a relative increase in the financial cost of public debt.

Finally, we believe that the strategy of redirecting investment into shallow-water and land-based projects to the detriment of deep-water investment is problematic. The continued decline in crude oil production is enough evidence: the era of 'easy oil' in Mexico is over. Furthermore, investment in refining projects should not increase, given the historical losses in this activity.

In January, Fitch downgraded the Pemex rating from BBB+ to BBB- after the outlook was revised to negative in October last year

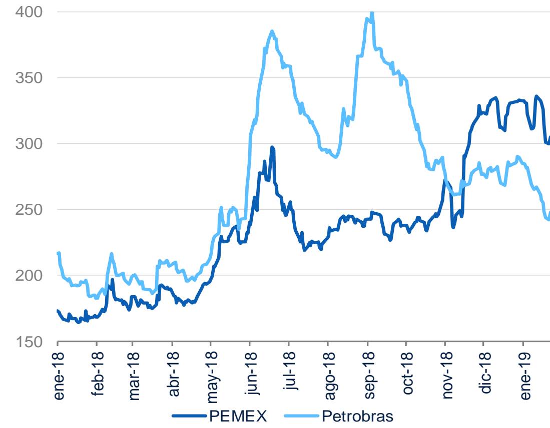
The rating agency reduced the credit rating of Pemex bonds from BBB+ to BBB- (the lowest possible investment grade). It gave two main reasons for this: the fact that not enough investment was authorized for exploration and production activities, and expected negative free cash flows of USD 3 billion and USD 4 billion for 2018 and 2019, respectively. Last October, Fitch revised its outlook from stable to negative for the oil company's credit rating. This was driven mainly by doubts generated by a possible change to Pemex's business model, with greater orientation toward refining activities. This new model would undoubtedly be detrimental to exploration and crude oil production. In October, Fitch warned of possible consequences: i) lower earnings in USD for Pemex; ii) a continued decline in crude oil production; iii) increased financial losses; and iv) problems arising from currency mismatches. As expected, risk aversion to Pemex increased in response to this announcement, which was reflected on quoted prices of bonds and Pemex's 5y CDS spread.

Figure 3. Price of Pemex bonds
(USD)



Source: BBVA Research with Bloomberg data

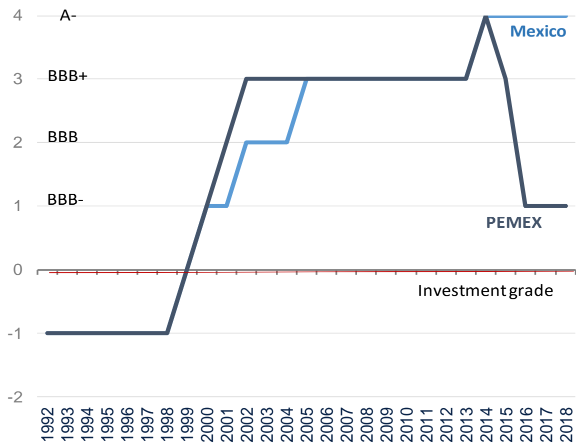
Figure 4. 5y CDS spread, oil companies
(Basis points)



Source: BBVA Research with Bloomberg data

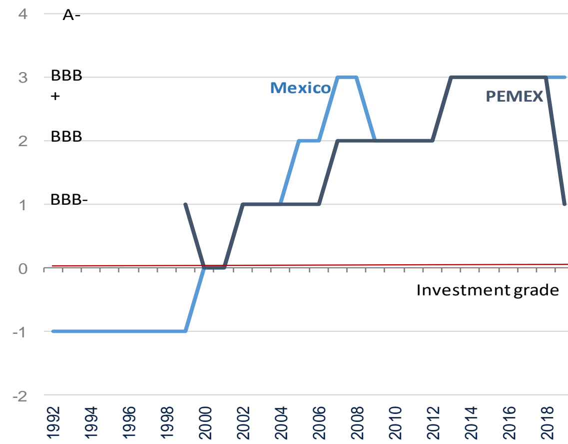
Moody's had already reduced Pemex's rating to BBB- several years ago, after keeping it at a level similar to the sovereign credit rating. In October 2018, the agency strongly criticized the government's plan to seek fuel self-sufficiency, given the increased cash-flow and currency-mismatch risks. Additionally, Moody's noted that this policy could force Pemex to import crude oil, exacerbating the abovementioned risks.

Figure 5. Long-term debt rating, Moody's
(Index)



Source: BBVA Research with Bloomberg data

Figure 6. Long-term debt rating, Fitch
(Index)



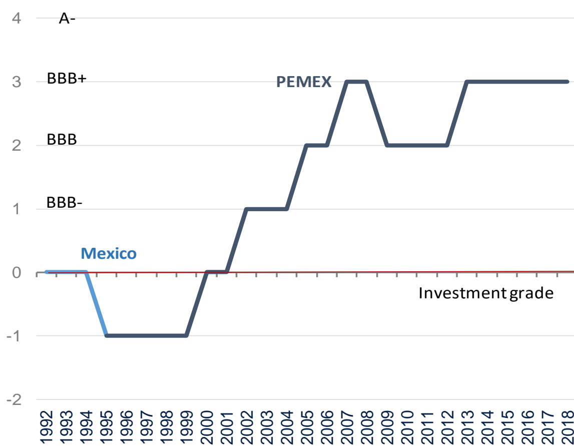
Source: BBVA Research with Bloomberg data

S&P has kept Pemex's credit rating on par with the sovereign credit rating (BBB+). We believe that this is mainly due to the implicit guarantee issued by the federal government. However, given that public finances could be affected by Pemex's future financial problems, it is likely that a Pemex's credit rating reduction by S&P could cause the sovereign rating's outlook to become negative.

The Ministry of Finance revealed that Pemex's financing needs for this year amount to around USD 10 billion. To meet these needs, the SHCP stated that debt would be issued in local currency and foreign currency (USD 4.75 billion). According to information contained in a presentation made by Pemex a few days ago, there are plans to eliminate Pemex's net debt in 2019. Before the financial support for Pemex that was announced today, the target for debt was USD 2.8 billion for this year. Financing needs are now lower and Pemex's new debt issuances will be used for refinancing purposes: USD 6.6 billion for debt rollover plus USD 1.8 billion and EUR 0.5 billion to defer other amortization payments.

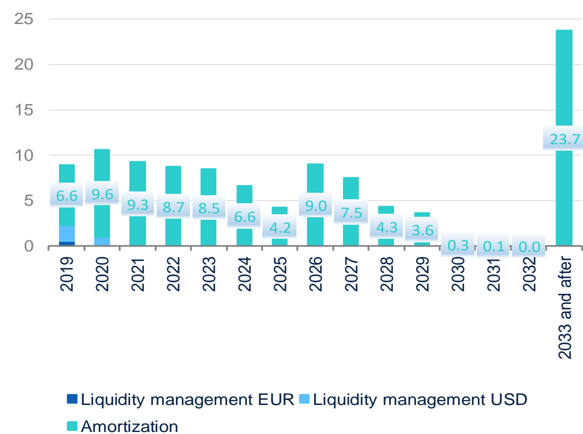
The debt maturity profile for 2020–2023 will represent a major challenge to keeping Pemex's credit rating in the investment grade. In this regard, both the federal government and Pemex will have to manage this maturity profile effectively. We anticipate that these relatively large amortization payments will affect the growth of resources for investment. The continuation of farmouts will be essential given the restrictions to be imposed by such debt maturity profile on investment growth.

Figure 7. Long-term debt rating, S&P (Index)



Source: BBVA Research with Bloomberg data

Figure 8. Maturity profile of Pemex's financial debt in the coming years* (Billions of USD)



*It does not include revolving lines of credit, which totaled USD 0.874 billion at 30 November 2018.
Source: BBVA Research with Pemex data

Given the restriction of slowing the growth of financial debt, Pemex will not be able to significantly increase investment in the coming years. Consequently, the federal government will have to significantly reduce the tax burden in order to bring Pemex's investment back to the levels achieved before the oil crisis of 2014–2015. A few weeks ago, the Ministry of Finance (SHCP) announced two measures to cut the tax burden on the oil company. The first will increase the limit for deducting costs associated with crude oil production and exploration projects, raising it annually from 2019 until 2024 for production levels of approximately 90,000 barrels per day (about 5% of Pemex's crude oil production). According to SHCP estimates, this fiscal modification will free up approximately MXN 66 billion (USD 3.3 billion) in Pemex resources during those six years. With regard to the second measure, the design of a special tax system for secondary and tertiary recovery projects is being considered. The Ministry of Finance claims that this measure will have no impact on the 2019 public budget, as it will favor a gradual increase in production in addition to the projected crude oil production for the current year.

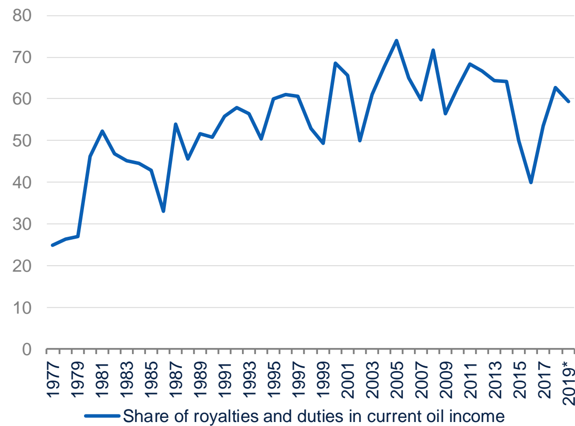
Although the new changes to Pemex's fiscal system will enable it to increase investment in E&P projects during 2019-24, the fiscal incentive will not be sufficient to take investment to the levels (USD 26.8 billion) seen before the collapse of oil prices between 2014 and 2015 (this year's approved investment for Pemex is USD 13.7 billion). Given that over

the coming years, the additional resources allocated to investment in E&P will mainly come from a reduced tax burden, the federal government must implement a more aggressive fiscal incentive policy to prevent crude oil production from falling.

Figure 9: Operating performance, investment, new net debt and royalties and duties (billions of USD)

*/ The figures for 2018 and 2019 are derived from budgetary data.
Source: BBVA Research with data from Pemex and Banxico

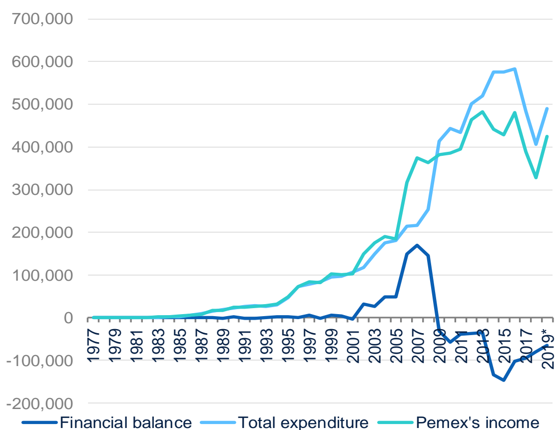
Figure 10: Royalties and duties paid by Pemex for the extraction of hydrocarbons (% of total oil revenue)



*/ The figures for 2018 and 2019 are derived from budgetary data.
Source: BBVA Research with data from Banxico, Pemex and SHCP

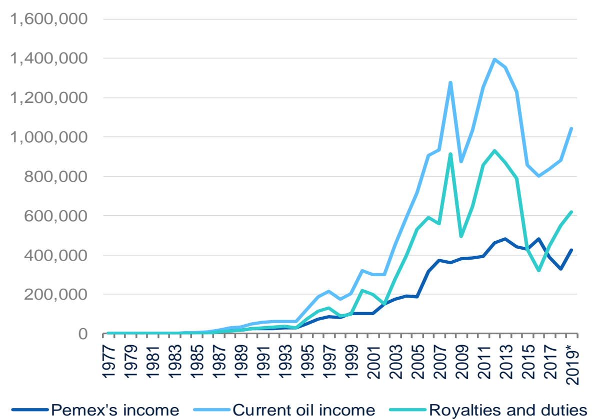
Even though projections show that the deficit in Pemex's financial balance for the current year (MXN 65.4 billion) is less than that projected for 2018 (MXN 79.4 billion), it would be desirable that the federal government decreases the tax burden on Pemex in order to allow the company to attain a positive financial balance over the next few years.

Figure 11: Pemex financial balance and components (millions of MXN)



*/ The figures for 2018 and 2019 are derived from budgetary data.
Source: BBVA Research with data from Banxico, Pemex and SHCP

Figure 12: Pemex oil revenue and total oil revenue (millions of MXN)

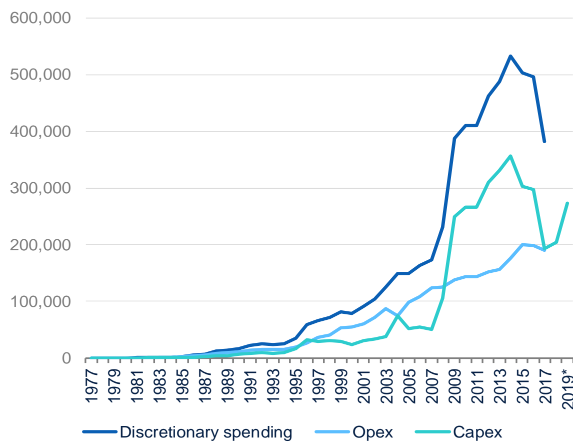


*/ The figures for 2018 and 2019 are derived from budgetary data.
Source: BBVA Research with data from Banxico, Pemex and SHCP

It is worth mentioning that Pemex's revenue has fallen in the past two years.[1] Furthermore, this reduction in revenue has occurred in spite of the increase in total oil revenue. A greater tax burden on Pemex in 2017 and 2018 explains such reduction. For Pemex's income to show a recovery in 2019, the federal government will have to reduce the tax burden with respect to 2018. This seems feasible since, according to the Mexican Hydrocarbons Revenue Law, the minimum applicable tax rate in 2019 will be 65%, which is 1.25 percentage points lower than in 2018.

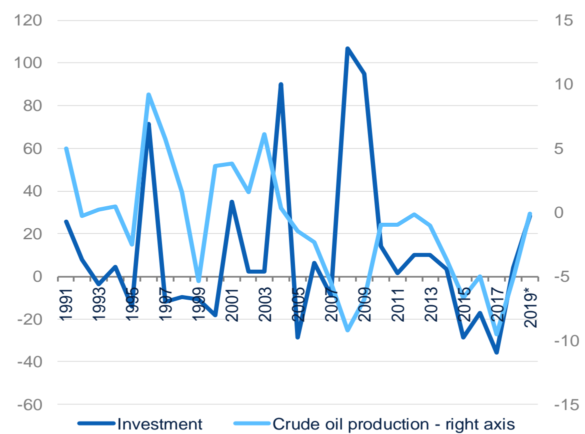
In our view, it is positive that the federal government is attempting to boost Pemex's investment in 2019. Recall that the previous federal government mainly cut Pemex's investment in response to the sharp drop in oil revenue in 2015 and 2016. To the extent that such investment is positively correlated with production, the decision to not have concentrated the fiscal consolidation on operational costs may prove costly in terms of decreased oil production over the coming years.

Figure 13: Pemex operational and investment costs (millions of MXN)



*/ The figures for 2018 and 2019 are derived from budgetary data.
Source: BBVA Research with data from Banxico and Pemex

Figure 14: Pemex's investment and production of crude oil (% YoY change)



*/ The figures for 2018 and 2019 are derived from budgetary data.
Source: BBVA Research with data from Banxico, Pemex and EIS.

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1: The figures for 2018 are taken from budgetary data. Consequently, it is possible that actual data might imply an increase in Pemex's income.