BBVA Research

Economic Analysis

Underinvestment in E&P prompts Fitch to downgrade Pemex’s bonds to junk status

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- **Fitch downgrades Pemex’s bonds to junk status as the company keeps facing serious underinvestment in E&P because of its relatively high fiscal burden**
- **Fitch also has a negative outlook on Pemex’s credit rating because the company’s current tax bill significantly pressures its cash flow generation and reinvestment capabilities**
- **Arguably, the lack of government action on several fronts to allocate more resources to E&P capex this year could have been the trigger for the downgrade decision**
- **We recommend that the government should cancel its new refinery project, reactivate the farmouts business model and accelerate the development of 20 new O&G fields**

According to the rating agency, Pemex’s cost cutting measures and the fiscal relief granted by the government are not going to be enough to solve the underinvestment problem in the upstream business, leading to further declines in crude oil production and reserves.

Fitch considers that the government's strong ownership and tight control of PEMEX is adversely affecting the support for the state-owned oil company since its excessive fiscal burden comes at the expense of investment in the upstream business. We agree that any permanent solution to Pemex’s financial fragility has to imply a sizable reduction in its fiscal burden. Some weeks ago, the government announced a fiscal relief of MXN 30,000 million for 2019. Nevertheless, these freed resources only amount to 5% of Pemex’s total fiscal burden. In addition, the government also promised to continue increasing such relief to MXN 47,100 million and MXN 91,600 million for 2020 and 2021, respectively.

Since the Fitch’s rating outlook change to negative from stable for Pemex’s bonds that occurred in October of last year, the rating agency had been insisting that Pemex required an annual capex around USD 15 billion to USD 18 billion to replenish reserves. Pemex’s estimated E&P capex for this year is around USD 10.8 billion. Given Pemex’s restriction to limit financial debt growth to zero, the oil company will not be able to significantly increase E&P capex in the coming years.

Although we consider that Fitch could have hastened its decision to downgrade Pemex’s credit rating, arguably the lack of government action on several fronts to allocate more resources to E&P capex this year could have been the trigger for such decision. We recommend that the government should cancel its new refinery project, reactivate the farmouts business model and accelerate the development of 20 new O&G fields.

In our view, the downgrade to Pemex's credit rating not only will have a negative impact on its bonds but also on sovereign bonds given markets' expectation that more government support measures for Pemex will be underway but at the expense of government finances. Meanwhile, given local banking regulations, commercial banks with exposure to Pemex's bonds will not have to increase their loan loss provisions.

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