Political Risk Alert (12 June 2019)

## Mexico: Pemex downgrades could derail AMLO's long-term economic goals

**Event**: On June 6, ratings agency Fitch downgraded the bonds issued by state-owned oil firm Pemex to BB+ from BBB-, pushing the rating into 'speculative grade' or 'junk' territory.

**Significance**: The move came a day after Fitch downgraded the bonds of the federal government by one notch, to BBB from BBB+, citing the impact of Pemex's financial prospects upon those of the government. Moody's has maintained its A3 rating for government debt but has shifted its outlook from stable to negative. The possibility of further downgrades will be a permanent shadow on the government's economic actions at least until the end of 2020, while downgrading would make it more expensive for Mexican private sector companies to borrow on international capital markets.

**Analysis**: With Pemex's debt soaring from the beginning of the century, its production falling and its generous pension scheme now a serious financial burden, the country's previous president, Enrique Pena Nieto (2012-18), became convinced that the firm would never regain its status as an industrial powerhouse. This led him to pursue an ambitious reform programme to open the energy sector to private investment.

Government investments were reduced and, as prices picked up after the 2014 oil price crash, oil exploration auctions became increasingly attractive for multinationals. At the same time, in order to stem financial losses, Pemex's refining business was allowed to dwindle. Processing heavy Mexican crude was costly, while the by-products of the process, such as asphalt and fuel oil, had extremely low prices. The more refined petrol Pemex produced, the greater the financial losses it sustained, so government has increasingly relied on fuel imports from the United States.

The Pena Nieto administration's move towards energy liberalisation ran completely counter to Andres Manuel Lopez Obrador (AMLO)'s entrenched preference for the public sector over the private, and AMLO entered office with ambitions to restore Pemex's profitability and turn it into a means of delivering economic development, as it was in the 1970s for his native region of Tabasco.

He has effectively scraped Pena Nieto's energy reforms, suspending all further auctions of areas for oil exploration for at least three years, and instead proposed a steep increase in government investment in production and refining. Among his government's targets are a 50% increase in hydrocarbons production by 2024, which would mean output of 2.65 million barrels per day, and the reduction of petrol imports to zero by 2022.

So far however, such aims look fanciful. At a roadshow in New York in January, senior Pemex officials attempted unsuccessfully to obtain support for a fresh issuing of bonds. The prospect of

a return to the financially unviable Pemex proved unpalatable for investment bankers, and the company was shut out of international bond markets.

The government's handling of its plans to construct a new refinery in Tabasco have further undermined faith its ability to turn the company's fortunes around. With capacity to refine 340,000 barrels of heavy oil per day, the planned Tabasco refinery would be Mexico's largest. However, a strict requirement that construction be completed by 2022 and within a budget of just 8 billion dollars has ruled out all of the parties that had shown initial interest in leading the project. AMLO has since announced that Pemex itself will conduct the work, on time and on budget, adding an additional burden on the company. Work formally started at the beginning of June.

AMLO’s approach to Pemex is one of part of the erratic economic policymaking that has rattled investors, with the US government's aggressive stance on trade, including the recently postponed threat to impose a blanket 5% tariff on all Mexican imports, compounding those concerns. With the fortunes of the federal government and Pemex closely intertwined, the dimmer growth prospects for the economy as a whole have fed into the changes ratings agencies have applied to the bonds issued by both.

While their specific ratings differ, all agencies are expressing pessimism. Standard and Poor's (S&P) modified the outlook for both government and Pemex debt to negative from stable in early March, while maintaining the rating for both at BBB+, three levels above junk status. It lowered its stand-alone credit (SAC) assessment of Pemex three notches to B- from BB-, deep into junk status territory.

Moody's changed the outlook for Pemex to negative from stable in early March. However, Pemex's rating, at Baa3 (just above junk level), is a full three notches below Mexico's (A3). Pemex's SAC was reduced to Caa1 from B3 (Caa1 is equivalent to one level below the B- of S&P). Both the government and Pemex ratings moved jointly and at the same level until November 2015, when Moody's decoupled them due to the plunge in oil prices.

Fitch's actions have been more dramatic this year. At the end of January, shortly after the disastrous New York roadshow, it slashed Pemex's rating two notches to BBB- from BBB+. It then lowered it to BB+ on June 6. Its SAC stands at CCC, a level equivalent to the Caa1 of Moody's. A Moody's downgrade, which is possible given the negative outlook, would also push Pemex's bonds into the junk status range. Such an action by S&P is improbable as it would require a slashing of three notches.

Two junk ratings would trigger the forced selling of Pemex bonds by funds (investment, pension and sovereign) that are contractually obliged to hold assets which enjoy investment grade quality. In that case, Pemex would become a 'fallen angel', the term for a debt issuer that has lost its investment grade status. With about 80 billion dollars in bonds, it would become the largest corporate bond issuer in history to fall into this category, easily surpassing the current

holder of the title, Petrobras, which had 41.2 billion dollars in bonds.

It is estimated that such a fall would trigger the forced selling of 16 billion dollars of Pemex bonds, plunging their price and sending yields skyrocketing. The damage to the company's credit standing -- and to Mexico's -- would be huge.

As a bond outcast, Pemex is trying to arrange a massive syndicated loan with international banks, headed by J.P. Morgan, HSBC and Mizuho Securities, that would allow it to roll over loans with banks and to pay bonds. The figure mentioned in mid-May was 8 billion dollars, but the final loan may be for more. The participants and conditions are still being negotiated, with an announcement expected at the end of June. Whatever the eventual terms, the loan, if awarded, will greatly increase the bank debt owed by the company, which at the end of 2018 stood at 5.6 billion dollars.

**Looking ahead**: The AMLO Administration is unlikely to be deterred from its mission to re-establish Mexico's 'energy sovereignty', especially given the pressure from Washintgton. Its strategy of seeking to dramatically boost oil and petrol production, which may prove valuable in the long term, first requires massive levels of investments that will push Pemex's finances deeper into the red in the nearer term.