FitchRatings

Fitch Affirms PEMEX's IDRs at 'BBB+' and National Rating at 'AAA(mex)'; Outlook Revised to Negative

Fitch Ratings-Chicago-19 October 2018: Fitch Ratings has affirmed Petroleos Mexicanos' (PEMEX) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB+' and National Long-Term ratings at 'AAA(mex)'. In addition, Fitch has revised the Rating Outlook on PEMEX's international IDRs to Negative from Stable. The rating affirmation applies to approximately USD77 billion of notes outstanding. Fitch also assigned an expected rating of 'BBB+(EXP)' to the company's 10-year, USD2 billion senior unsecured bond issuance. A complete list of rating actions follows at the end of the press release.

The Outlook revision to Negative from Stable reflects the increased uncertainty about PEMEX's future business strategy coupled with the company's deteriorating Standalone Credit Profile (SCP), which could reach 'CCC' from its current 'B-'. Future potential changes in PEMEX's business strategy could accelerate the weakening of the company's capital structure. Fitch will monitor the developments regarding the strategy for the company and whether it gives PEMEX a sustainable upstream capex level that allows the company to replenish reserves and stabilize production while maintaining a neutral to positive FCF through the cycle. The company's SCP can continue deteriorating as a result of a change in strategy that materially increases downstream capex or affects domestic sales' realization prices, especially if at the expense of lowering upstream capex and/or increasing leverage.

The Negative Rating Outlook also reflects PEMEX's SCP continued deterioration as a result of persistent high levels of fund transfers to the Mexican government, which results in negative FCF generation and rising debt. The company's FCF continues to be negative despite the company's efforts to curb costs and capex. FFO adjusted leverage is currently near 14x and total debt-to-proved reserves (1P) reached USD14/bbl as of June 2018. Should the Mexican government fail to prevent PEMEX's SCP from deteriorating into the 'CCC' rating category, the SCP at that level will prevent Fitch from assessing the government's incentives to support the company as "very strong", which could result in negative rating actions for PEMEX's IDRs.

PEMEX's ratings reflect the Mexican government's high incentives to support the company given the very strong socio-political and financial consequences that would result due to any financial distress at PEMEX. A financial distress scenario at PEMEX holds the potential to disrupt the supply of liquid fuels for the entire country, which could have material social and economic consequences for Mexico. Mexico is a net importer of liquid fuels, and PEMEX relies on the import for basic oil products, including dry gas, petroleum products and petrochemicals to supply local demand. Furthermore, a financial distress scenario at PEMEX may have implications for the government or other Government Related Entities (GREs) within the country ability to raise financing.

KEY RATING DRIVERS

Strong Government Linkage: PEMEX's linkage to the Mexican government results from the very strong incentives to support the company given the socio-political and financial consequences for the country should the company default. PEMEX is Mexico's largest company and one of the government's major sources of funds, historically contributing between 25% and 30% of government's revenues. Although

PEMEX's contributions to the government decreased to 11.3% of government revenues or an average of MXN435 billion during 2016 and 2017, from MXN850 billion per year between 2011 and 2014, transfers remain high in relation to the company's cash flow generation. During the past five years, transfers to the government averaged 45% of sales, or 83% of adjusted EBITDA. As a result, the company's balance sheet has steadily weakened, with a significant increase in debt and negative equity since year-end 2009; its current debt lacks an explicit guarantee from the Mexican government.

Strategic Importance for Energy Security: Linkage to the sovereign arises from the company's strategic importance in the supply of liquid fuels to Mexico. A financial crisis at the oil and gas company would have very strong socio-political consequences for Mexico as it may potentially disrupt the country's liquid fuel supply. Mexico is a net importer of liquid fuels as a result of continued production decline, raising demand and decrease in crude oil processing. The country relies on PEMEX for virtually all the supply of gasoline and diesel, of which approximately two thirds come from imports. A financial crisis at PEMEX also has the potential to have very strong financial consequences for the Mexican government and other Government Related Entities (GREs), especially with regards to their access to funding.

Implicit Government Support: Mexico's implicit support of PEMEX is evidenced by modest capital injections, support for pension liabilities and marginal tax reductions. This support so far has been moderate, especially when compared to the level of transfers from the company to the government. Fitch expects the government to execute more meaningful supportive actions when needed. In 2016, the government injected MXN73.5 billion in the company, of which MXN47 billion was used to fund pensions. The company also received MXN15 billion of credit lines from national development banks and MXN137 billion of government issued promissory notes to fund pension cost for the upcoming years.

Deteriorating Underlying Credit Quality: PEMEX's SCP is in line with a Long-Term IDR of 'B-' if it were not owned by the state and if the government were not to provide financial support. PEMEX's SCP is likely to continue deteriorating and potentially reach the 'CCC' rating category in the short to medium term should the Mexican government continue extracting large amounts of funds from PEMEX, resulting in weak FFO, negative FCF and increasing leverage. The company's SCP can also continue deteriorating as a result of a change in strategy that materially increases downstream capex or affects domestic realization prices, especially if at the expense of lowering upstream capex and/or increasing leverage.

PEMEX's underlying credit quality continues to weaken primarily due to the high level of transfers to the federal government despite drastic measures implemented during the past two years to minimize negative FCF. Pemex is expected to report a material improvement in decreasing net indebtedness and rate and FCF, albeit still negative, to low single digits negative FCF from close to negative USD15 billion in 2016. During the last 12 months (LTM) ended June 30, 2018, PEMEX reported an adjusted EBITDA before net pension expenses of USD25.2 billion and FFO of USD2.1 billion, while total debt amounted to USD105 billion.

Weak Post-tax Credit Metrics: Although PEMEX reports moderately solid pre-tax credit metrics, its post-tax credit protection metrics are weak as a result of high transfers to the federal government. As of the LTM ended June 30, 2018, PEMEX's reported a Fitch calculated FFO adjusted leverage near 14x. Fitch expects FFO leverage to recover moderately in 2018 under its price deck assumptions to approximately 10x and deteriorate thereafter. PEMEX's total debt-to-proved reserves (1P) have deteriorated to around USD14/boe from USD9.2/boe in 2015 and Fitch expects it could modestly recover in 2018 before continuing to deteriorate thereafter. This leverage metric could surpass USD15/boe in the medium term, a level Fitch considers commensurate with a 'CCC' rating category SCP. This weakening in leverage could occur either as a result of increasing financial debt to maintain high transfers to the federal government or from continued low capital investments to replenish reserves.

Capex Cuts Reduce Production: Fitch expects production and hydrocarbon reserves to continue declining over the medium term and to potentially stabilize after three to five years as current Capex is insufficient to replenish reserves. Fitch estimates PEMEX will require an annual capex of around USD15 billion to USD18 billion to replenish reserves, this estimating a USD15/boe to USD18/boe finding, development and acquisition cost (FD&A). PEMEX's exploration and production capex for 2017 and 2018's budget of USD4.5 billion and USD4.3 billion, respectively, is not enough to replenish annual production of approximately 1 billion boe. The current levels of farm-outs, joint ventures, tax reductions and investment are not sufficient to reverse the production decline trend. Fitch estimates production could decline 5% per year over the next two years and stabilize thereafter. Potential increases in production from farm-outs, joint ventures and lower taxes could partially offset the production decline in the medium to long term.

DERIVATION SUMMARY

PEMEX's linkage to the sovereign is similar to its peers, namely Petrobras (BB-/Stable) and Ecopetrol (BBB/Stable). It also compares with Enap (A/Stable), Petroperu (BBB+/Stable) and PDVSA (RD). These companies all have strong linkages to their respective sovereigns given their strategic importance to each country and the potentially significant negative socio-political and financial implication of any financial distress at these companies.

PEMEX's ratings reflect its close linkage to the Mexican government and the company's fiscal importance to the sovereign and strategic importance to the country. PEMEX's ratings also reflect the company's competitive pre-tax cost structure, national and export-oriented profile, sizable hydrocarbon reserves and its strong domestic market position. The ratings are constrained by PEMEX's substantial tax burden, significant unfunded pension liabilities, large capital investment requirements, negative equity and exposure to political interference risk.

Fitch views PEMEX's SCP as commensurate with a 'B-' rating, which is three notches below Petrobras' SCP of 'BB-' and six notches below Ecopetrol's SCP of 'BBB-', primarily due to PEMEX's weaker capital structure and increasing debt and leverage trajectory. PEMEX's SCP of 'B-' reflect the company's burdensome transfers to the federal government; its large and increasing financial debt balance when compared with total reserves of approximately USD14 per barrel of 1P; an FFO adjusted leverage in excess of 14x; and its decreasing production and reserves trend.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Its Rating Case for the Issuer
--Average West Texas Intermediate (WTI) crude prices of USD65/bbl in 2018, USD60/bbl in 2019 and USD55/bbl in the long term.
--Capex cuts implemented in 2017 continue for the medium term.
--Production declines by 5% over the next two years before it stabilizes.
--PEMEX will receive necessary support from the government.
--Cash taxes remain unchanged.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
Although not expected in the short term, a rating upgrade could result from an upgrade of the sovereign coupled with strong operating and financial performance. The Negative Rating Outlook could be revised back to Stable if the company's strategy is revised to allow for a sustainable upstream capex that is

sufficient to maintain a close to 100% reserve replacement ratio and stable production while reporting neutral to positive FCF through the cycle.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
A negative rating action could be triggered by a downgrade of the sovereign's rating, the perception of a lower degree of linkage between the company and the sovereign, and/or deterioration in credit metrics leading to a SCP commensurate with a rating in the 'CCC' category. A downgrade on the international scale could result if the company fails to stabilize production and it continues with unsustainable reserves replacement ratios and negative FCF. This could result in an increase in total debt to 1P reserve to USD15/boe or above and a sustained FFO Adjusted Leverage above 8x. Failure by the Mexican government to remedy PEMEX's capital structure would prevent Fitch from assessing the government's incentives to support the company as "very strong", which could result in negative rating actions.

The Stable Outlook on the national rating reflects the possibility that the 'AAA(mex)' rating remains unchanged should a one notch downgrade occur. PEMEX's national scale ratings could see downwards pressure if the international ratings are downgraded by multiple notches.

LIQUIDITY

Market Dependent Liquidity: Liquidity is supported by cash on hand of approximately USD5.5 billion as of June 30, 2018. PEMEX's liquidity is also supported by its proven track record of access to international debt capital markets. During the first half of 2018, the company raised approximately USD10 billion of debt. The proceeds of the issuances were used to finance capital investments, repay debt and for general corporate purposes, which include transfers to the federal government. The debt amortization schedule is well balanced, with somewhat manageable short-term debt maturities. During 2016, 2017, and year to date PEMEX successfully implemented several liability management operations in order to extend its amortization profile. As of June 30, 2018, short-term debt amounted to approximately USD8.5 billion.

Liquidity is further bolstered by a robust pre-tax cash flow generation supported by a competitive operational cost structure. The company's available undrawn committed revolving credit lines amounted to USD6.7 billion and MXN23.5 billion as of June 2018. Fitch estimates operating cash costs to be less than USD20 per barrels of oil equivalent (boe), including interest costs and full allocation of administrative expenses to the upstream business.

FULL LIST OF RATING ACTIONS

Fitch has affirmed Pemex's ratings and revised the Outlook as follows:
--Long-Term Foreign Currency IDR at 'BBB+'; Outlook to Negative from Stable;
--Long-Term Local-Currency IDR at 'BBB+'; Outlook to Negative from Stable;
--National Long-Term Rating at 'AAA(mex)'; Outlook Stable;
--National Short-Term Rating at 'F1+(mex)';
--Notes outstanding in foreign currency at 'BBB+';
--Notes outstanding in local currency at 'BBB+';
--National scale debt issuances at 'AAA(mex)'.

Fitch has assigned the following:
-- Senior unsecured issuance rating 'BBB+(EXP)'.

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Applicable Criteria
Corporate Rating Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023785)
Government-Related Entities Rating Criteria (pub. 07 Feb 2018) (https://www.fitchratings.com/site/re/10019302)
National Scale Ratings Criteria (pub. 18 Jul 2018) (https://www.fitchratings.com/site/re/10038626)
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