FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Pemex's IDRs to 'B+' on Rating Watch Negative

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Fitch Ratings - New York - 14 Jul 2023: Fitch Ratings has downgraded Petroleos Mexicanos' (Pemex) Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) to 'B+' from 'BB-'. Fitch has also placed the ratings on Rating Watch Negative (RWN). Fitch has also downgraded approximately USD80 billion of Pemex's international notes outstanding to 'B+'/'RR4' from 'BB-'.

The downgrades reflect Pemex's continued weak operating performance, which has resulted in Fitch lowering several of the company's ESG Relevance Scores to '5' and is expected to further limit it sources of financing from banks, investors, and suppliers. The lowering of these Relevance Scores reflects the environmental and social impact associated with multiple accidents at Pemex's operating facilities since February 2023, which resulted in casualties and injuries to its employees and damages to critical infrastructure and assets.

The RWN reflects concern about the Mexican government's ability and willingness to materially improve the company's liquidity position and capital structure in the next two years without concessions from creditors. Pemex faces international debt bond maturities of USD4.6 billion in 2023 and USD10.9 billion in 2024. The refinancing of this debt will expose the company to higher interest expense that would further stress its cash flow. An inability to refinance the capital markets debt with similar or other long-term financial instruments would exacerbate its liquidity risk by the end of 2024. Resolution of these issues driving the RWN could extend beyond six months.

If Fitch were to lower its assessment score of the financial or social implications of a default to Weak from Moderate as outlined in our Government-Related Entities (GRE) Rating Criteria, a multiple-notch downgrade would likely occur as Fitch would rate the company using a bottom-up rating approach. Fitch rates Pemex's standalone credit profile 'ccc-', which would result in a maximum rating of 'b-' using the bottom-up approach.

KEY RATING DRIVERS

Weakening Linkage to Sovereign Rating: Pemex's ratings are four notches below the sovereign. Fitch has applied a variation to its GRE criteria in order to assign a rating with a four-notch differential. The variation is explained by Fitch's view that Pemex is in financial distress, and its ESG track record further impairs its ability to raise capital. The company reported USD107 billion of debt as of 1Q23, USD73 billion in PPE, and negative equity book value of USD95 billion. Supporting Pemex to the extent that is needed given the high level of debt and the amount of investment needed to improve its capital structure and operating assets will be increasingly material to the government's finances.

Operational Track Record: Fitch believes the multiple fires at critical assets and infrastructure that resulted in numerous injuries and fatalities to its employees reflect concerns pertaining to the management of its operations and/or the lack of maintenance capital expenditures in its core assets and infrastructure. High debt service and the need for the government to finance negative cash flows have been key reasons for under investment.

Significant Funding Needs: Pemex needs material support from its shareholder and possibly its creditors to navigate through its debt maturities over the rated horizon. As of 1Q23, Pemex reported USD25 billion of short-term debt, of which USD4.6 billion are in international bonds due in 2023 and USD10.9 billion in 2024. The company is highly reliant on international capital markets to refinance its existing debt, as 85% of its total debt is in hard currency. In the event Pemex continues rolling its financial maturities into short-term debt, Fitch estimates the company will conclude 2024 with nearly 35% of its total debt being short-term. In addition, the cost of refinancing assuming its current long-term spreads in the market range between 8%-12% translates in interest expenses could reach nearly USD13 billion by 2025, compared to USD8.2 billion in 2022.

Growing Government Liability: Over the rated horizon, Fitch estimates that Pemex will be an increasing liability for the government. Contrary to previous years, where the government take exceeded Pemex's cash support needs, Fitch estimates under our rating case that the government will have to spend roughly USD20 billion more than it receives from the company in 2026 and 2027, to keep Pemex afloat. This rating case assumes accumulated government take to be roughly USD60 billion between 2023 through 2027 compared to USD80 billion in negative cash flows. The diminishing cash outflow is the result of higher interest cost that will lower cash available for government take and capex; the rating case assumes the company will need to spend at least USD10 billion per annum in capex, which is a conservatively low estimate.

ESG- GHG Emissions & Air Quality; ESG - Waste & Hazardous Materials Management and Ecological Impacts: Pemex has experienced multiple fires at its operating facilities and infrastructure that are expected to have residual impacts on the local communities and environment. Fitch is concerned that the management of its operations and/or the lack of maintenance capital expenditures in its core assets and infrastructure will further challenge its financial profile. This was a key consideration in the downgrade of the rating and reflected in the RWN, as Pemex's ESG track record can further impair its ability to raise capital.

ESG - Employee Wellbeing: The multiple fires that have occurred in 2023 have resulted in numerous injuries and fatalities of its employees. Fitch is concerned regarding the management of its operations, and regulatory oversight to ensure Pemex and other operators in the country are meeting industry standards pertaining to safety and employee wellbeing.

ESG - Management Strategy: The confluence of the company's ESG track record and its financial distress further complicates management's ability to execute on its strategy, which is exacerbated by the company's challenging debt maturity profile and limited accessibility of capital.

DERIVATION SUMMARY

Pemex's linkage to the sovereign compares unfavorably with peers Petroleos Brasileiro S.A. (Petrobras; BB-/Negative), Ecopetrol S.A. (BB+/Stable), Empresa Nacional del Petroleo (ENAP; A-/Stable) and Petroleos del Peru - Petroperu S.A. (BBB-/Negative Watch). All of Pemex's regional peers have strong linkages to their sovereigns due to strong government support. Fitch believes governments in the region, except for Mexico, implemented different measures to ensure the SCPs of their respective national oil and gas companies remain viable in the long term.

Fitch views Pemex's SCP as commensurate with a 'ccc-', which is 10 notches below Petrobras' and Ecopetrol's SCPs of 'bbb'. The differences are primarily due to Pemex's weaker capital structure and increasing debt and leverage trajectory. Pemex's SCP reflects the company's large transfers to Mexico's federal government, large and increasing financial debt balance when compared with 1P reserves and elevated EBITDA-adjusted leverage. Comparatively, Ecopetrol and Petrobras significantly strengthened their capital structures and maintained stable operating profiles.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within the Rating Case for the Issuer:

--Average West Texas Intermediate crude prices of USD75/bbl in 2023, USD70/bbl in 2024, USD65bbl in 2025, USD60bbl in 2026, and USD57bbl for the mid-cycle.

--Henry Hub prices of USD3.0/mcf in 2023, USD3.5/mcf in 2024, USD3.0mcf in 2025, USD2.75mcf in 2026 and thereafter;

--Oil Production stays flat at 1.8mmboed;

--Annual capex average of USD10 billion per annum;

--Government take to average 65% of EBITDA per annum;

--All short-term debt and debt maturities are refinanced at 11%;

--PEMEX will receive necessary support from the government to ensure adequate liquidity and debt service payments;

--Refined product volumes growth moves aligned with Fitch's Real GDP growth forecasts of 2.4% in 2023, 1.8% in 2024, and 2.0% thereafter.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--An upgrade of Mexico's sovereign ratings;

--An irrevocable guarantee from Mexico's government to sustainably cover more than 75% of Pemex's debt;

--A material capitalization, coupled with a material reduction of taxes, with a business plan that results in neutral to positive FCF through the cycle, while implementing sustainable upstream capex that is sufficient to replace 100% of reserves and stabilize production profitably.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A downgrade of Mexico's sovereign rating;

--Weakened ability and/or willingness of the government to meaningfully support Pemex;

--Weakened social and political implications or desire to support Pemex;

--Inaccessibility of financing and/or material increase in interest expense, stressing FFO to negative;

--Cash balance falling below USD3.0 billion on sustained basis.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Stressed Liquidity: Pemex's liquidity position remains weak as a result of negative FCF, which resulted in a relatively low cash position and reduced availability of its lines of credit. Pemex reported total cash and equivalents of around USD3.3 billion as of 1Q23. The company reported USD107 billion of total debt with USD25 billion in short-term debt. The company has USD4.6 billion in bonds due in 2023 and USD10.9 billion in 2024.

ISSUER PROFILE

Pemex, Mexico's state oil and gas company, is the nation's largest company and ranks among the world's largest vertically integrated petroleum enterprises.

Criteria Variation

Fitch has applied a criteria variation to the GRE criteria. Fitch has adopted a more conservative notching approach for Pemex beyond the top-down minus 3 approach suggested by the Notching Guidelines. Fitch believes that Pemex is in financial distress and that there is a lack of a willingness (but not ability) by the government to support Pemex to the extent that is fully needed. Pemex's rating is four notches below the sovereign rating at 'B+', a top-down-minus 4 approach.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Fitch has revised Pemex's ESG Relevance Score for GHG Emissions & Air Quality to '5' from '4' and Waste & Hazardous Materials Management and Ecological Impacts to '5' from '3' due to the numerous fires at its operating facilities that are expected to increase its carbon footprint and risks to polluting the environment and its impact on local communities. This has a negative impact on the credit profile and is highly relevant to today's downgrade of Pemex's rating.

Fitch has revised Pemex's Employee Wellbeing ESG Relevance Score to '5' from '2' due to the multiple fires that have occurred in 2023 that have resulted in numerous reported injuries and fatalities of its employees. Fitch is concerned regarding the management of its operations, and the regulatory oversight to ensure Pemex and other operators in the country are meeting industry standards pertaining to safety and employee wellbeing. This has a negative impact on the credit profile and is highly relevant to today's downgrade of Pemex's rating.

Fitch has revised Pemex's Management Strategy ESG Relevance Score to '5' from '3' due to the confluence of the company's ESG track record and its financial distress, which is expected to further complicate management's ability to execute on its strategy. This has a negative impact on the credit profile and is relevant to the ratings in conjunction with other factors.

Pemex has an ESG Relevance Score of '4' for Governance Structure, resulting from its nature as a majority government-owned entity and the inherent governance risk that arises with a dominant state shareholder, which has a negative impact on the credit profile and is relevant to the ratings in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING		RECOVERY	PRIOR
Petroleos Mexicanos (PEMEX)	LT IDR	B+ Rating Watch Negative Downgrade		BB- Rating Outlook Stable
	LC LT IDR	B+ Rating Watch Negative Downgrade		BB- Rating Outlook Stable
senior unsecured	LT	B+ Rating Watch Negative Downgrade	RR4	BB-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Corporate Rating Criteria (pub. 29 Oct 2022) (including rating assumption sensitivity)

Exposure Draft: Climate Vulnerability in Corporate Ratings Criteria (pub. 10 Jun 2023) (including rating assumption sensitivity)

Parent and Subsidiary Linkage Rating Criteria (pub. 17 Jun 2023)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Petroleos Mexicanos (PEMEX)	EU Endorsed, UK Endorsed

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ENTITY/SECURITY	ISIN/CUSIP	RATING TYPE	SOLICITATION STATUS
Petroleos Mexicanos (PEMEX) senior unsecured bond/note	US71654XAK37	Long Term Rating	Unsolicited
Petroleos Mexicanos	MX95PE1X00H9	Long Term Rating	Unsolicited

UNSOLICITED ISSUERS

ENTITY/SECURITY	ISIN/CUSIP	RATING TYPE	SOLICITATION STATUS
(PEMEX) PEMEX Petroleos [illegible] 2013	US71656LAX91	Long Term Rating	Unsolicited

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