Moody's

Rating Action: Moody's downgrades PEMEX's ratings to B3; negative outlook

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New York, February 09, 2024 -- Moody's Investors Service (Moody's) downgraded Petroleos Mexicanos' (PEMEX) Baseline Credit Assessment (BCA) to ca from caa3, which reflects its standalone credit strength. At the same time, Moody's downgraded PEMEX's Corporate Family Rating (CFR), the backed senior unsecured ratings on the company's existing notes, as well as the backed senior unsecured ratings of Pemex Project Funding Master Trust, to B3 from B1. Moody's also downgraded both entities' backed senior unsecured MTN program to (P)B3 from (P)B1 respectively, and maintained the negative outlook for both issuers.

RATINGS RATIONALE

The BCA downgrade to ca from caa3 reflects PEMEX's increasing liquidity requirements due to expanding capital requirements, increasing cost of capital and significant upcoming maturities over the next 2-3 years. Further, the company faces increasing business risks as it continues to expand its refining capacity and attempts to grow production. The action also takes into account that PEMEX's lack of measures to curtail its exposure to Environmental, Social, and Governance (ESG) risks has compelled some banks to limit their exposure to the company.

The downgrade to B3 incorporates PEMEX's weakening stand-alone credit quality and reflects Moody's revised assumption of government support to High from Very High. The change reflects Moody's assumption of a likely shift in the willingness to support the company's full service of its debt in the next few years in light of PEMEX's expanding cash needs and Moody's projections of the government's further deterioration in fiscal conditions in 2024. This deterioration is anticipated to stem from a material increase in the deficit, fueled by social spending, persistently high borrowing costs, and augmented expenditures in flagship projects. Moody's foresees that any support from the next administration, although forthcoming in 2024-25, will likely come at a higher cost. The downgrade also incorporates the risk that the company could pursue a transaction such as debt exchanges, repurchases or other transactions that would reduce debt at a substantial discount to par or make other changes that Moody's would consider a distressed exchange, which is a default under Moody's definition.

PEMEX's BCA of ca reflects Moody's expectation for negative free cash flow over the forthcoming three years. This trend is primarily attributed to significant debt maturities, peaking at $13.7 billion in 2026, and a decrease in operating cash flow stemming from the expansion of its loss-making refining business, which has accumulated operating losses of roughly $31.5 billion from 2019 to 2022, as reported. Despite the fact that oil and gas production growth has not met management targets, Moody's recognizes PEMEX's achievement in reversing the downward trend in production and reserves over the previous three years. Moody's, however, notes that the 2024 budget suggests a reduction in capital investments compared to 2023, a shift that could potentially hinder future production and reserve replenishment.

Moody's anticipates PEMEX will have to increase its reliance on external funding to counterbalance its negative free cash flow, influenced by multiple factors. These encompass the company's limited ability to improve its business performance due to the maturity of its oil fields; insufficient capital for adequate investment in exploration and production, potentially impacting production and reserve replacement; and the mandate to enlarge its refining business. Moody's expects that the refining sector will continue to register operational losses and remain vulnerable to medium-term trends in oil and gas demand. Governance risk is a consideration in the rating action. The company operates with aggressive financial policies reflected in weak liquidity and very high debt levels, resulting in a capital structure that is untenable.

PEMEX has weak liquidity and is highly dependent on government support. On September 30, 2023, PEMEX had $4 billion in cash to address over $10.9 billion in debt maturities in 2024, besides substantial negative free cash flow in the period, driven by insufficient operating cash generation to pay taxes and invest in capital. Moody's recognizes that the government's budget includes roughly $8.5 billion for debt maturities in 2024.

PEMEX's B3 ratings take into consideration Moody's joint default analysis, which includes the rating agency's assumptions of high government support in case of need and very high default correlation between PEMEX and the Government of Mexico (Baa2, stable), resulting in four notches of uplift from the company's ca BCA.

The negative outlook on PEMEX's B3 ratings primarily reflects Moody's expectations that, barring a structural reform in its business strategy, PEMEX's cash flow generation and credit metrics will further deteriorate over the next three years increasing the need of support. The negative outlook also acknowledges the potential for a distressed exchange over the several years as much of PEMEX's debt trades at significant discount to par.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

An upgrade of PEMEX's ratings, although unlikely at present, could arise if PEMEX puts in place a more sustainable capital structure with evidence of recovery of the operating performance and cash flow generation. Additionally, a credible plan towards addressing the Governance challenges would also support a return to stable outlook.

Factors that could lead to an upgrade of the BCA and potentially a higher rating for PEMEX would include the ability to strengthen its liquidity position and internally fund sufficient capital reinvestment to fully replace reserves, deliver modest production growth and generate free cash flow for debt reduction.

Downward pressure on the rating would arise if there is increased likelihood of a distressed debt exchange and Moody's estimates of expected losses for bondholders exceed those implied by the B3 CFR.

Even though the horizon over which these trends might materialize is uncertain, Moody's could conclude that these risks are likely to crystallize after a period of 12 - 18 months over which it will assess the potential credit consequences of these conditions.

Because PEMEX's ratings are highly dependent on support from the Government of Mexico, a change in Moody's assumptions about government support and its timeliness could lead to a downgrade of PEMEX's ratings. A downgrade of the Government of Mexico's Baa2 rating would likely result in a downgrade of PEMEX's ratings.

The methodologies used in these ratings were Integrated Oil and Gas published in September 2022 and available at https://ratings.moodys.com/rmc-documents/393389, and Government-Related Issuers methodology published in January 2024 and available at https://ratings.moodys.com/rmc-documents/406502. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of these methodologies.

Founded in 1938, PEMEX is Mexico's national oil company, with fully integrated operations in oil and gas exploration and production, refining, distribution and retail marketing, as well as petrochemicals. PEMEX is also a leading crude oil exporter, around 60% of its crude is exported to various countries, mainly to the US and Asia. In the twelve months ended September 30, 2023 the company produced an average of 1,906 thousand barrels of per day of crude oil (excluding partners).

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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