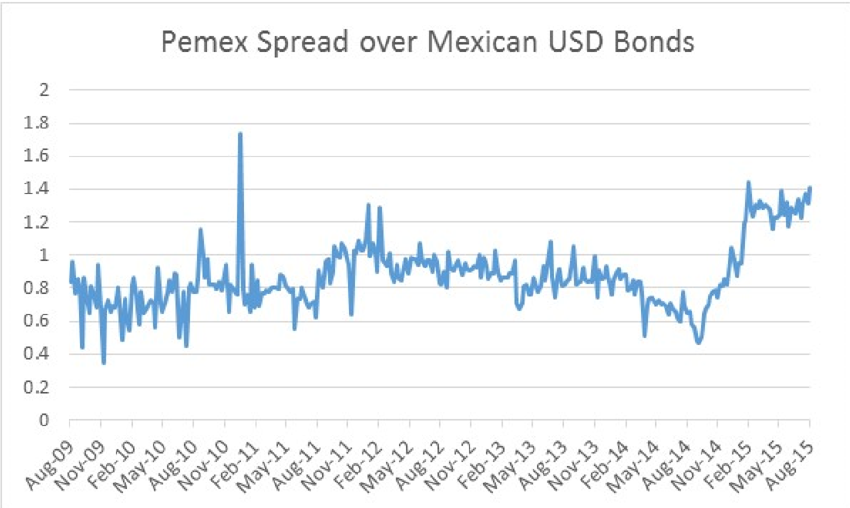
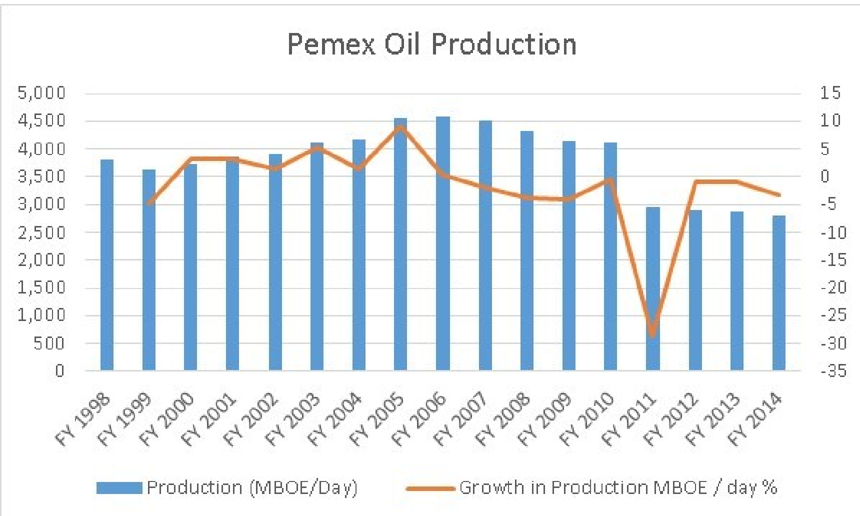
PEMEX AND THE STATE IT'S IN

I would like to thank Angel Simbaev, our summer intern, who assisted in the production of this note.

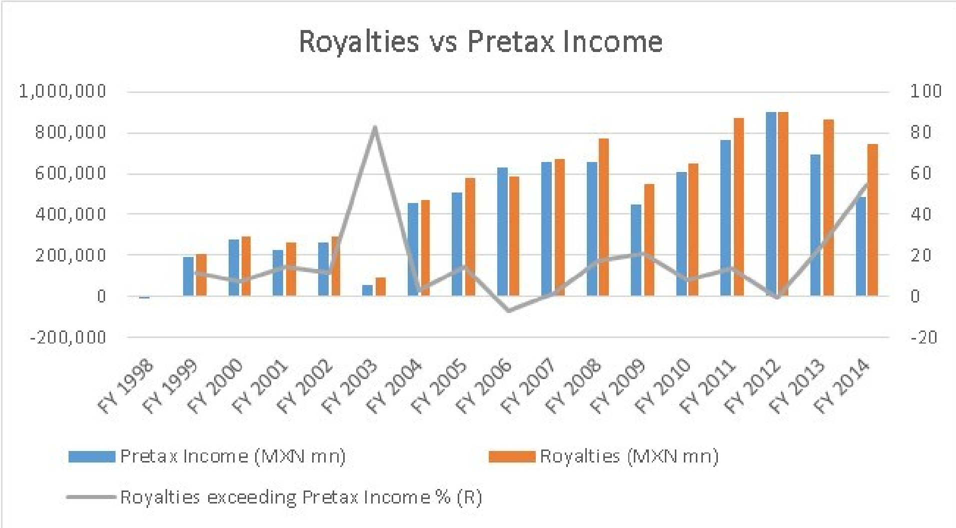
Pemex, the Mexican state owned oil producer issues bonds to raise capital. Its US Dollar denominated bonds are starting to blow-out against Mexican government US Dollar bonds of a similar maturity versus their history.



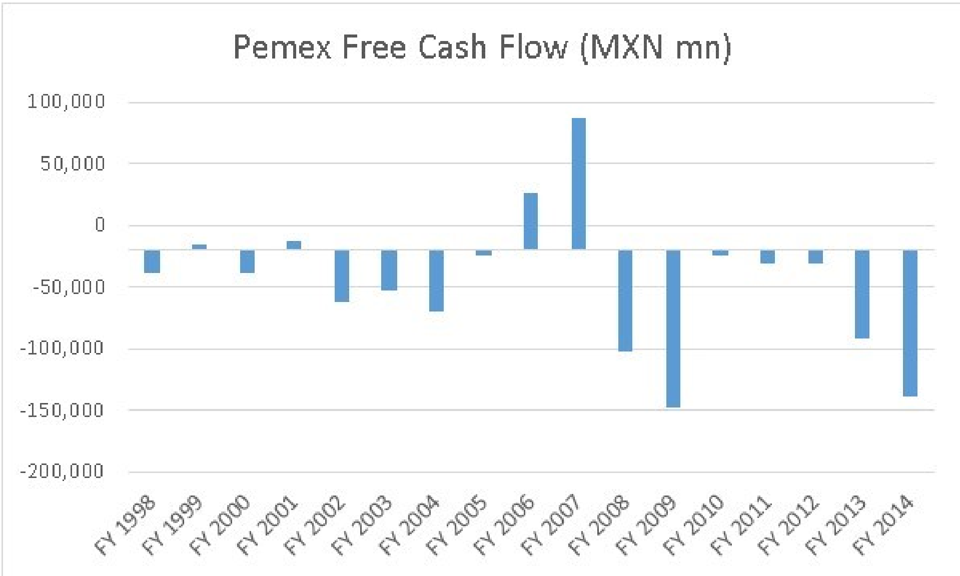
The increased spread hints that investors consider Pemex's credit to be deteriorating. It appears they are right, the published financial statements are in a woeful condition because of factors such as poor financial management and deteriorating oil production which has been in decline for a decade.



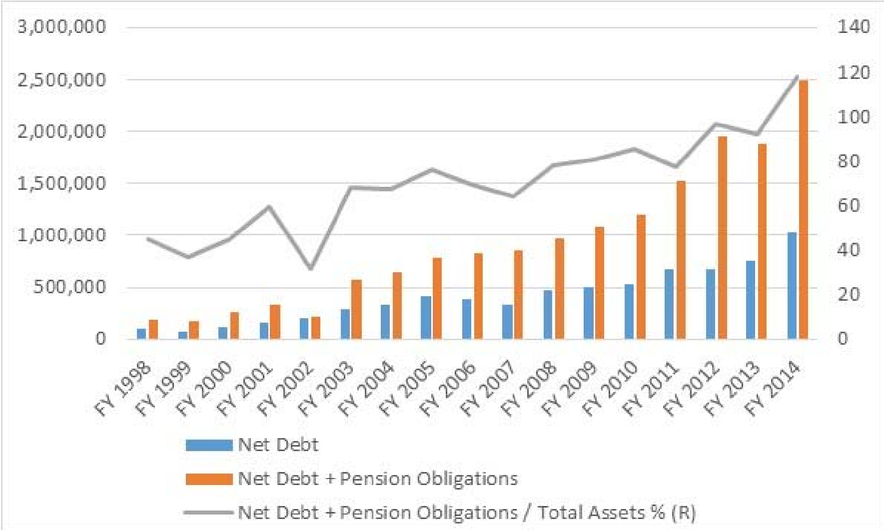
The combination of the oil price decline and falling production has resulted in Pemex's pre-tax income falling since 2012. However, because Pemex is an instrument of the state, it pays hefty royalties. The Mexican government has long taken all of the pre-tax gains, but since 2008 have exceeded them by significant amounts. In 2014 the royalty payment was greater than pre-tax income by over 50%.



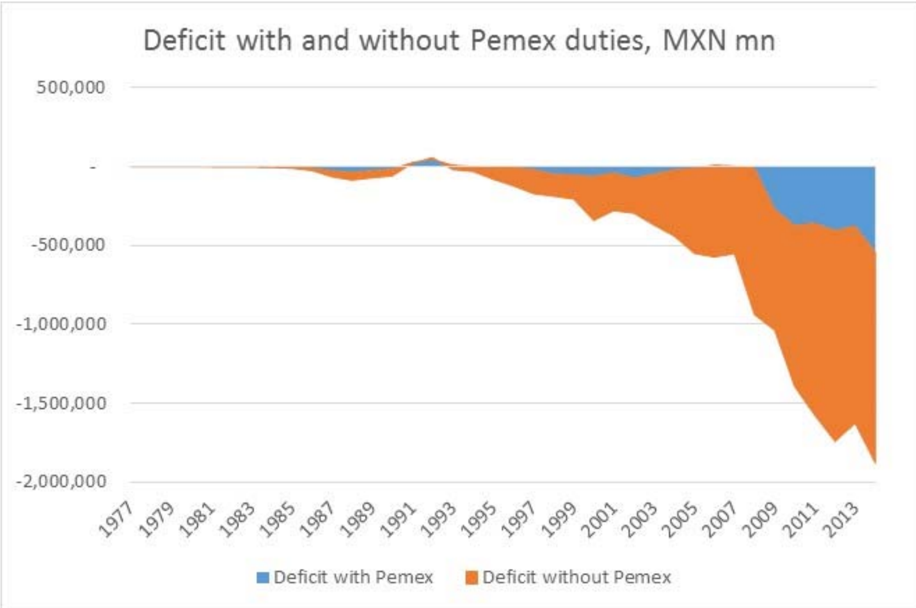
This obviously results in Pemex being loss making. Energy companies need to invest in order to maintain the life of their assets (their reserves), but due to the royalty payments and capex requirements the company has only produced a positive free cash flow twice since 1998.



If cash flow doesn't fund the company, what does? Interestingly, the scale of the losses and absence of shareholders to object, meant that Pemex had burned through all of the equity capital the company ever generated by 2004. Beyond equity, raising debt has been a frequent past-time judging by its rapid increase in recent years. However, the largest source of capital to fund the company's assets comes from pension liabilities; that is, the accumulation of pension contributions that 150,000 or so workers make for their future and are owed to them in retirement. This leaves the company in the curious position of indirectly funding government spending with its employees' pension contributions.

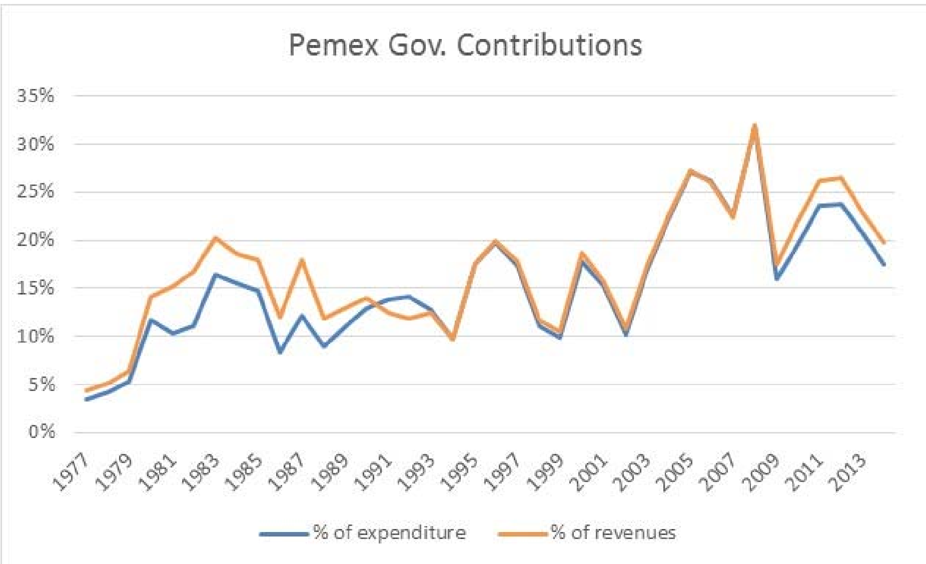


Importantly, Pemex (or its employees) are vital to the rest of Mexico. Without Pemex's contribution, and no change to expenditure, the budget deficit would be far larger. In 2013 the deficit's size would have been almost 9% of GDP, instead of 1.7%.



Source: Banco de Mexico, Bloomberg

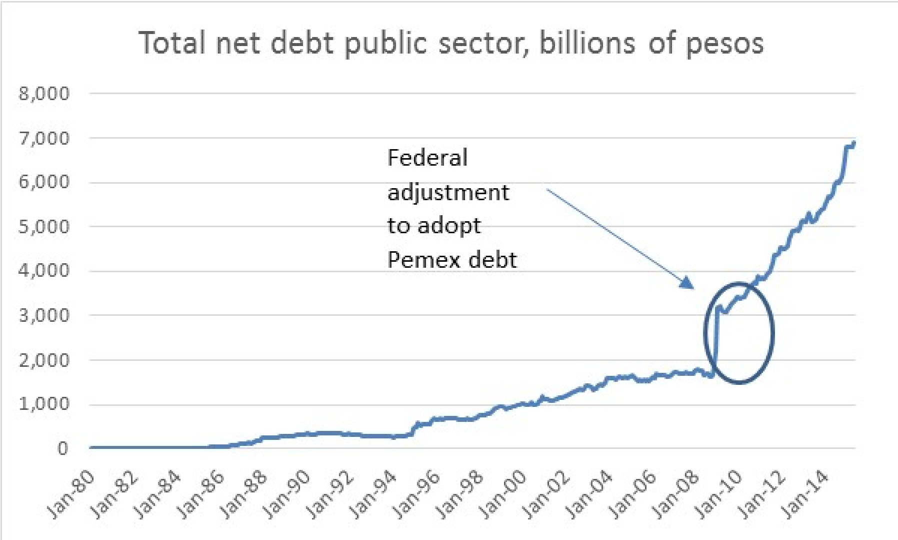
Pemex's royalty contributions make up around 20% of both government revenue and expenditure, and the trend seems to be increasing.



Source: Banco de Mexico, Bloomberg

A higher Pemex bond yield increases the cost of government spending. But a spending cut would slow GDP growth even further, which is already struggling to reach 2.5% a year.

In a falling oil price environment, Pemex and the Mexican government only have bad options. They can cut spending and suffer a serious growth slowdown, but that looks unlikely given President Enrique Nieto's approval rating dropped to a new low in July. They could try to tax elsewhere, but the Pemex burden is so great precisely because Mexico has so few other tax raising opportunities. The Mexican governement could attempt to fund spending directly through further government bond issuance or indeed through Pemex itself, but this is not a sustainable solution as total government debt has already reached over 40% of GDP and shows no signs of slowing down as the oil price declines.

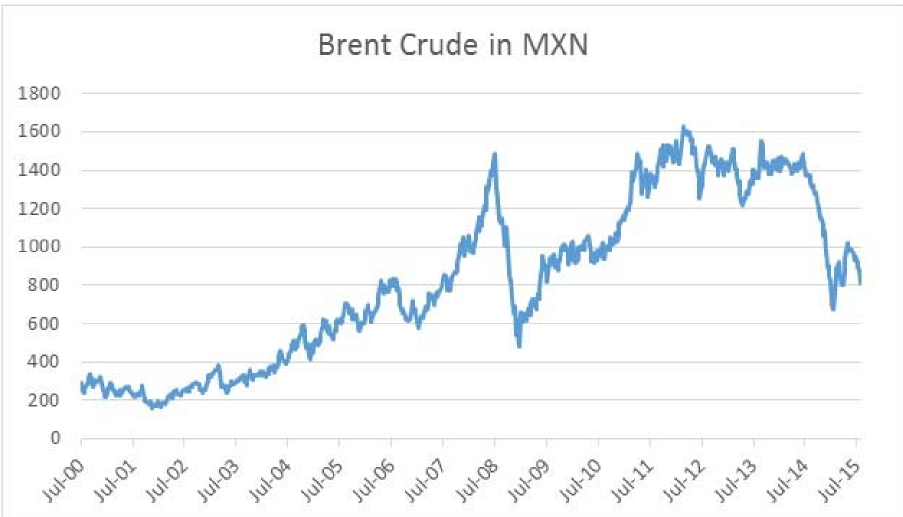


Source: Banco de Mexico, Bloomberg

Although the Mexican government do not explicitly back Pemex debt, bond yields imply some level of government support or else they would have junk-like yields. Indeed the government have made a federal adjustment to include Pemex debt in the total government debt calculation. However, Pemex is loss making and its balance sheet insolvent, if the government were to include all the company's liabilities on its own balance sheet it would increase obligations by a further 1.5 trillion Pesos or 20%, taking total government debt to 47% of GDP, an adjustment not reflected in bond yields and one the government would be loath to make.

Given the state of both the Mexican economy and Pemex, with high revenue needs, inefficient production and rising debt levels in a falling oil price environment, perhaps an adjustment will come through the Mexican Peso instead.

The Mexican government needs Pemex royalties to match pre-tax profits so as not to further its financial distress (or indeed the government's). This last happened in 2012 (see chart of Royalties v Pre-tax Income) at an oil price of around MXN 1400 / barrel. Since then the oil price in Peso terms has fallen to about MXN 800 / barrel. To achieve sufficient revenue generation given Mexico's current spending needs, the oil price would need to increase approximately 85% from here, which seems unlikely. Alternatively the Peso could fall by 70%, which although sizeable, seems the more likely of the two scenarios in this thought experiment.



Given the outlook for the oil price and its implications upon Mexico's spending and debt levels, it seems likely to me that pressure on Mexico's currency will remain firmly to the down side.

INFORMATION

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