LATIN AMERICA ECONOMICS FOCUS

Why Pemex will ultimately default

- **The latest Pemex capital injection underscores that Mexico's President López Obrador is more likely to lean towards providing a sovereign debt guarantee (either implicit or explicit) to deal with the company's financial problems. But with a less Pemex-friendly president likely to be in place next year, we think that a restructuring of the firm's debt is, ultimately, on the cards.**
- Pemex has become an increasing drag on the economy and drain on Mexico's public finances over the past 15 years. Oil production has slipped from a peak of close to 3.5mn bpd in the mid-2000s to just over 1.5mn bpd now. And, combined with rising costs, the firm has suffered persistent losses.
- Pemex did, admittedly, post a profit last year. But that came against the backdrop of very high oil prices and marked only the third annual profit in 22 years. Perennial losses have resulted in an accumulation of debt that amounts to more than $100bn (equal to 7.5% of GDP). Around 90% of this is denominated in foreign currencies. As well as a large debt burden, Pemex has significant unfunded pension liabilities.
- **The firm's ability to service its large debts (and make pension payments) through its own resources is limited**. The yield on Pemex's dollar bonds has gradually trended higher than the sovereign's own borrowing costs over the past decade or so, with the spread now at ~600bp.
- **Restoring Pemex's financial health is no easy feat**. Falling oil production has weighed on Pemex's revenues while high taxes and a bloated workforce have pushed up its costs. But there has been a lack of investment into exploring and developing new fields, and President López Obrador has refused to entertain increased private sector participation. Meanwhile, cutting Pemex's costs would require significant reform when it comes to taxes and labour relations.
- **The upshot is that the Pemex problem will continue to grow**. Indeed, we think it's plausible that support from the government to Pemex could rise further to 1.5% of GDP per annum in the coming years. As we see it, there are two main options available to the government to deal with Pemex. The first would be to guarantee its debt, either implicitly or explicitly. The second would be to restructure the firm's debt.
- **President López Obrador has been a key supporter of Pemex and, throughout his term, he has essentially provided an implicit guarantee of the company's debt**. The president's position has been reinforced by the fact that tweaks to taxes and regular transfers to Pemex have not created an immediate fiscal problem given that Mexico's public finances are strong compared with other parts of Latin America. He could go a step further and provide an *explicit* guarantee, but this would require changes to legislation.
- **Even so, elections loom in 2024 and the next president is unlikely to be as Pemex-friendly. In fact, we think they may end up being more receptive to the idea of restructuring the firms' debt**. They may feel that the public funds being used to prop up Pemex could be better used elsewhere. And a restructuring would ultimately help Pemex to become a more financially viable company. The appeal of a restructuring would be further supported by the fact that it would inflict limited damage on the domestic economy.
- Pinning down the timing at which policymakers may decide to push ahead with a Pemex debt restructuring is clearly difficult. A large and sustained slump in oil prices that creates even bigger losses would be an obvious trigger, particularly if it coincides with large debt repayments – there are sizeable repayments due in 2025. **A lot of bad news is already priced in, but the run up to such a decision is likely to be marked by a further widening of spreads on Pemex's dollar bonds vis-à-vis the sovereign.** The experience during the pandemic showed that spreads could widen by at least 250bp from their current level.

Jason Tuvey, Deputy Chief Emerging Markets Economist, +44 (0)20 7808 4065, jason.tuvey@capitaleconomics.com

Why Pemex will ultimately default

This *Focus* argues that Mexico's state oil company, Pemex, will ultimately default on its debt of more than $100bn. To make this case, we assess the dire state of Pemex's finances and argue that restoring the firm to full health will prove difficult. While President López Obrador may be more willing to guarantee the firm's debt, we think that the next president will be less Pemex-friendly and will probably seek to restructure the firm's debt.

Pemex burden on public finances mounting

Pemex has become an increasing drag on the economy and drain on Mexico's public finances over the past 15 years. Oil production has slipped from a peak of close to 3.5mn bpd in the mid-2000s to just over 1.5mn bpd now. (See Chart 1.) **Mexico was the fifth biggest oil producer in the world up until 2004, but is now just the eleventh**. We estimate that falling oil production has shaved an average of 0.2%-pts off GDP growth since 2004.

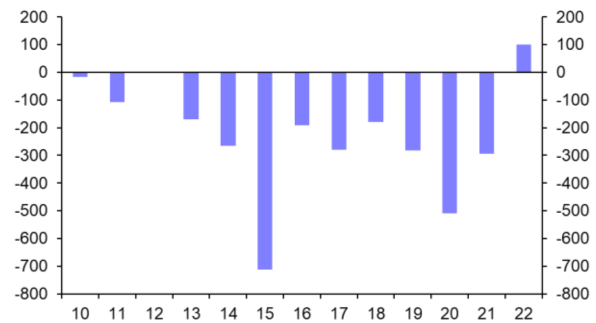
Chart 1: Crude Oil Production (mn bpd)

Sources: Refinitiv, Capital Economics

Falling oil output, as well as the cost of the new Dos Bocas refinery, have contributed to persistent losses at the state oil firm. Pemex did, admittedly, post a profit last year. But that came against the backdrop of very high oil prices and marked only the third annual profit in 22 years. **Perennial losses have resulted in an accumulation of debt that now amounts to more than $100bn (equal to 7.5% of GDP)**. (See Chart 2 and 3.) Around 90% of this is denominated in foreign currencies.

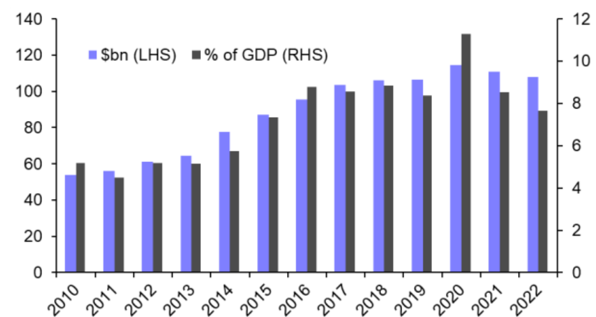
As well as a large debt burden, Pemex has significant unfunded pension liabilities – the last audit in 2022 showed that the shortfall stood at MXN1.3trn (~4.5% of GDP). That's despite an overhaul of Pemex's pension system agreed in 2015 that saw the retirement age increased and the government assume a portion of the firm's pension-related debt.

Chart 2: Pemex Net Income (MXNbn)



Sources: Refinitiv, Capital Economics

Chart 3: Pemex Total Debt

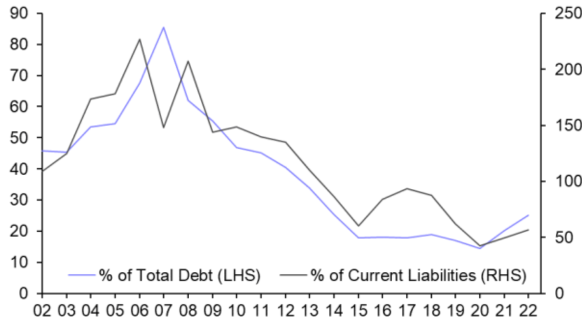


Sources: Refinitiv, Capital Economics

Pemex's ability to service its large debt burden (and make pension payments) through its own resources is limited. It's latest accounts showed that the firm held just $3.6bn in cash and cash equivalents compared with maturing debt and interest payments equal to $17.3bn over the rest of this year and next. And the coverage of total debt and current liabilities provided by the firm's current assets has steadily fallen over the past couple of decades. (See Chart 4.)

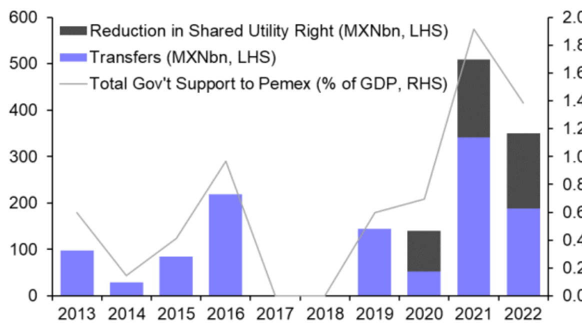
To cover its losses and service its debts, Pemex has relied on the government to make regular transfers and tweaks to tax policy. Over the past four years, transfers to Pemex as well as reductions in the Shared Utility Right (DUC, the main duty applied to Pemex) have amounted to a total of MXN1.1trn, an average of just over 1% of GDP per annum. (See Chart 5.) Further support has been provided this year, including last week's capital injection of $4.2bn.

Chart 4: Pemex Current Assets



Sources: Refinitiv, Capital Economics

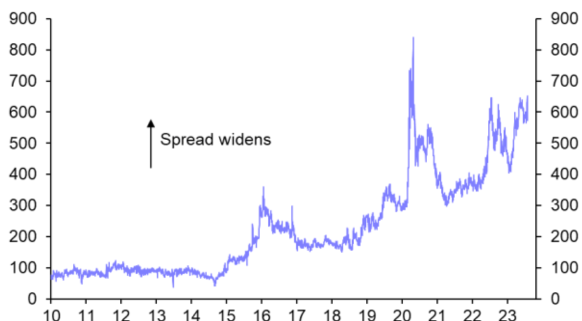
Chart 5: Government Support to Pemex



Source: Mexico Evalua

Pemex debt is not explicitly guaranteed by the government. **There is a widely-assumed implicit sovereign guarantee, as indicated by the government's drip-feed of help**. As a result, the firm's credit rating is much better than its financial metrics alone would suggest. Indeed, ratings agencies have previously suggested that the strong likelihood of continual government support is a key reason why they maintain Pemex's rating close to that of the sovereign.

Chart 6: Spread between Yields on Pemex 2035 Bond and Government 2034 Bond (bp)



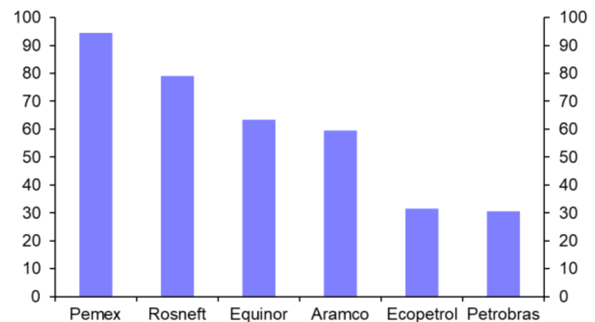
Sources: Refinitiv, Capital Economics

Even so, Pemex's borrowing costs have gradually trended higher than the sovereign's over the past decade or so. The spread between yields on Pemex's 2035 dollar bond and a similar maturity sovereign dollar bond has steadily widened, from less than 100bp to close to 600bp now. (See Chart 6.) This reflects a belief among investors that the implicit government guarantee is far from iron cast.

No quick fix

Restoring Pemex's financial health is by no means an easy feat. **One option would be to raise the firm's revenues**. Clearly, given its production only accounts for around 2% of global supply, Pemex is a price-taker in the oil market and there is little that it can do to influence prices. Therefore, any effort to raise revenues will have to rely on boosting production volumes. **Output has fallen in large part due to the fact that many of Pemex's oil fields are ageing and there has been a lack of investment into exploring and developing new fields**. President López Obrador halted and began to reverse the energy reforms implemented in 2013 under President Peña Nieto and refused to entertain increased private sector participation into the oil sector, instead preferring to promote Pemex as a state-owned national champion.

Chart 7: Effective Tax Rates on State-owned Oil Companies (%)

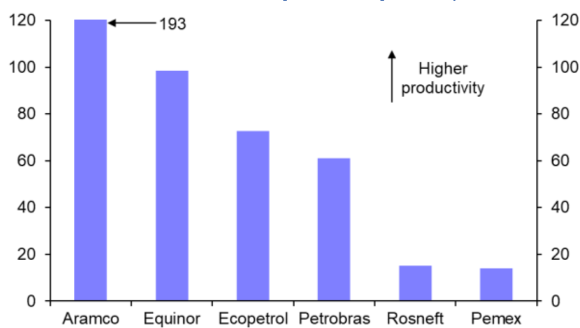


Sources: Company Annual Reports, Capital Economics

The alternative would be for Pemex to cut its costs. But this would ultimately require significant reforms when it comes to taxes and labour relations. Pemex faces a large tax burden; almost all (95%) of the firm's pre-tax profits are paid to the government. This tax burden is higher than most other state-owned oil companies. (See Chart 7.) Crucially, this has prevented Pemex from reinvesting its profits into exploration and production.

Another way for Pemex to cut its costs would be to reduce the size of its workforce. After all, Pemex's hydrocarbon production per employee is equal to just over 15 barrels of oil equivalent per day (boepd). While that is around the same level as Russia's Rosneft, it is well below productivity levels of 50-100boepd at other state-owned oil companies such as Equinor, Ecopetrol and Petrobras. Saudi Aramco is well out in front, with each employee producing close to 200boepd. (See Chart 8.)

Chart 8: Hydrocarbon Production per Employee (Barrels of Oil Equivalent per Day)



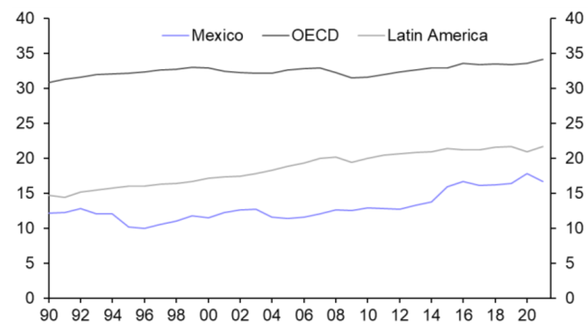
Sources: Company Annual Reports, Capital Economics

Not only is Mexico's labour productivity low, but it is falling too – oil output per worker peaked at close to 28bpd in 2004. Declining labour productivity is due partly to ageing fields and outdated technology. But it's mostly due to the company's powerful labour union, STPRM, which makes it difficult to fire workers. The company has also historically been used as a political tool to absorb labour. **While the number of employees at Pemex has fallen by 30,000 or so since the middle of the previous decade, we estimate that the workforce would need to have declined by an *additional* 50,000 (out of 120,000) to push productivity back to its peak in 2004.**

Curbing the powers of STPRM will require taking on vested interests. Meanwhile, lowering Pemex's large tax burden would reduce the need for additional government support for the company and provide scope to increase investment to raise oil output. **But the reason that Pemex's tax burden is so high in the first place is that tax collection in the wider economy is low**, reflecting a large informal sector, high tax evasion and a narrow tax base.

Reforms that took effect in 2014 under the Peña Nieto administration aimed to improve tax collection, but progress has been slow. Indeed, Mexico's tax revenues remain low at less than 20% of GDP, below that in other parts of Latin America and significantly lower than the OECD average. (See Chart 9.) **Mexico's government still relies on oil for more than a fifth of its total revenues**. And the current government under President López Obrador has not signalled that another round of significant tax reform is on the horizon with the focus, instead, on clamping down on tax avoidance.

Chart 9: Tax Revenue (% of GDP)

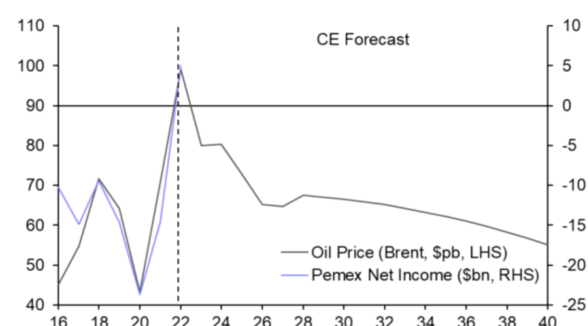


Sources: OECD, Capital Economics

Amlo leaning towards Pemex debt guarantee…

In the absence of wide-ranging tax and labour reforms, the Pemex problem will only continue to grow and the firm will become an increasing drag on Mexico's public finances. Indeed, based on our oil price forecasts alone, losses at Pemex are likely to reach $10-15bn (0.5-1.0% of GDP) per annum from the middle of this decade. (See Chart 10.) With Pemex essentially locked out of capital markets, the government will also need to step in to help the firm meet its debt repayments, **taking total support to around 1.5% of GDP per annum.**

Chart 10: Pemex Net Income & Oil Prices



Sources: Refinitiv, Capital Economics

As we see it, there are essentially two main options available to the government to deal with the Pemex

problem. The first would be for the sovereign to guarantee the firm's debt. The second would be for Pemex to seek a debt restructuring.

What route is eventually taken will, of course, depend on the politics. **President López Obrador has been a key supporter of Pemex, pledging to restore its role as a national champion. Throughout his term, he has essentially provided an implicit guarantee of Pemex's debt**. The president's position has been reinforced by the fact that tweaks to taxes and regular transfers to Pemex have not created an immediate fiscal problem given that Mexico's public finances are strong compared with other parts of Latin America – public debt stands at around 50% of GDP and the primary budget deficit (that is, excluding interest payments) was equal to just 0.5% of GDP last year.

President López Obrador could, of course, go a step further and provide an *explicit* guarantee, but this would likely require changes to legislation. At present, though, the president's Morena party only holds a simple majority in congress rather than the supermajority that is required for major legislative changes.

…but next president may prefer restructuring

However, President López Obrador is coming to the end of his term in office and elections loom next year. (Note that, in Mexico, presidents are limited to a single term.) The latest polls suggest that his Morena party is highly likely to hold on to power. At present, it is not entirely clear where the frontrunners for the Morena presidential candidacy stand on Pemex's future – which may not be a surprise given that they will be keen on President López Obrador's endorsement and so will not want to be seen to be contesting his approach to the firm. And even once the elections are out of the way, it may be that Mr. López Obrador continues to influence policymaking decisions behind the scenes.

For what it's worth, one of the frontrunners for the Morena presidential candidacy, former Mexico City mayor Claudia Sheinbaum, has suggested that she will continue with many of the incumbent's key policies. And Ms. Sheinbaum was a key opponent to plans by President Calderon in 2008 to privatise Pemex. **Equally, though, she has embellished her environment-friendly credentials**. Ms. Sheinbaum previously served on the UN's Intergovernmental Panel on Climate Change (IPCC) at the time that the group won the Nobel Peace Prize in 2007. In a recent interview with the *Financial Times,* she stated her aim is to "accelerate the energy transition to renewables" – a sharp contrast to President López Obrador who has strongly supported fossil fuel-powered electricity plants during him time in office. Meanwhile, fellow frontrunner, former foreign minister Marcelo Ebrard, has previously been receptive to tax reforms related to Pemex but has also been opposed to private involvement in the firm.

The upshot is that the next president is unlikely to be as supportive of Pemex as Mr. López Obrador. And we think that a Pemex debt restructuring will become increasingly appealing. After all, the crux of the issue is that Pemex does not currently appear to be a financially viable company. A debt restructuring would not kill Pemex off and instead help to place it on a more financially sustainable footing.

What's more, the next president may feel that the public funds being used to prop up Pemex could be better utilised elsewhere. While Mexico's public finances appear to be robust at the moment, continued large support to keep Pemex afloat would risk placing the public debt-to-GDP ratio on an upwards path. Preventing this would require policymakers to either lower spending or raise existing taxes in other areas. But maintaining a tight fiscal stance for a prolonged period of time merely to prop up Pemex will, at some point, presumably prove to be unpalatable.

The next president may also be more concerned about the possible impact of guaranteeing Pemex's debt. While doing so would help to bring down Pemex's cost of borrowing, it wouldn't necessarily place its finances on a sustainable footing. And it could even have a detrimental effect on investors' appetite to hold Mexico's sovereign debt and push up the government's own borrowing costs.

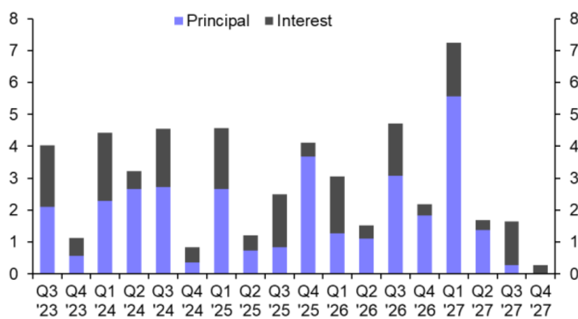
Finally, any willingness to consider a debt restructuring for Pemex will be supported by the fact that such a move would inflict limited damage on the domestic economy – after all, the vast majority of Pemex's debt is held externally and so it

will be foreign rather than domestic investors that will incur losses as a result of a restructuring.

When will a debt restructuring arrive?

Pinning down the timing at which policymakers could decide to push ahead with a Pemex debt restructuring is clearly difficult. A fresh and sustained slump in oil prices that weighs on government revenues and creates bigger losses at Pemex would be an obvious trigger, particularly if it coincides with large debt repayments. **The next president – who will be inaugurated in late-2024 – will quickly be faced with the scale of the Pemex problem when the firm faces a large debt repayment in early 2025**. Substantial payments are also due in late-2025, Q3 2026 and the start of 2027. (See Chart 11.)

Chart 11: Pemex Debt Repayments ($bn)

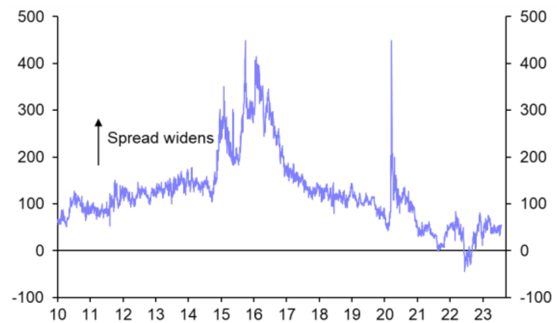


Sources: Bloomberg, Capital Economics

It's safe to say that the run up to a decision to restructure Pemex's debt is likely to be marked by a further widening of spreads on Pemex's dollar bonds vis-à-vis the sovereign. Admittedly, a lot of bad news is already priced in. Pemex's spreads (at ~600bp) are already a lot higher than those of Brazil's state-owned oil firm, Petrobras, when it saw default fears mushroom in 2015/16. (See Chart 12.)

Equally, though, Pemex's spread is still some way below the high of 840bp it reached during the pandemic when the collapse in oil prices triggered a bout of default concerns. What's more, there are probably some investors that currently anticipate the government will ultimately step in and explicitly guarantee Pemex's debt. If the government refrains from doing so and the next president shows less commitment to provide ongoing support to Pemex, expectations that Pemex will need to restructure its debt will mount and the premium that investors demand to hold the firm's debt will continue to rise.

Chart 12: Spread between Yields on Petrobras 2040 Bond and Brazilian Government 2041 Bond (bp)



Sources: Bloomberg, Capital Economics

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