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Corporates

Energy (Oil & Gas)
Mexico
Credit Analysis

Petróleos Mexicanos (PEMEX)

Ratings

Security Class	Current Rating
Foreign Currency IDR	BBB
Local Currency IDR	BBB+
National Scale	AAA(mex)

IDR – Issuer default rating.

Outlook

Stable

Financial Data

Petróleos Mexicanos
(USD Mil.)

	12/31/08	12/31/07
Revenues	119,044	103,855
EBITDA	76,936	67,192
Total Debt	42,843	45,915
Short-Term Debt	6,661	6,556
Cash and Equivalents	8,341	15,934
Debt/EBITDA (x)	0.6	0.7
Adjusted Debt/ Adj. EBITDA (x)	0.9	1.2
EBITDA/Interest (x)	13.4	12.7

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Related Research

- *Latin American Oil and Gas, March 4, 2009*
- *Oil and Gas Credit Metrics to Fall in 2009 as Commodity Bubble Bursts, Dec. 11, 2008*
- *Rating Review of Emerging Markets, Nov. 10, 2008*
- *Latin American Corporate Liquidity: Waiting for Springtime, Nov. 6, 2008*
- *Latin American Oil and Gas 2008, Jan. 30, 2008*
- *Ratings of Public-Sector Entities, Feb. 1, 2007*

Rating Rationale

- The ratings of Petróleos Mexicanos (PEMEX) reflect solid pretax financial and export-oriented operating profiles, an attractive upstream cost structure, its fiscal importance to the sovereign and its dominant domestic market position. The ratings also reflect PEMEX's significant debt levels, sizable but declining proven hydrocarbon reserves, weak net worth position, substantial tax burden, large capital investment requirements and exposure to political interference risk.
- As a state-owned oil company, PEMEX's foreign currency rating remains highly linked with the credit profile of the United Mexican States (UMS), whose foreign currency issuer default rating (IDR) is 'BBB+'. Despite pari-passu treatment with sovereign debt in the past, PEMEX's debt lacks UMS's explicit guarantee.
- The ratings also incorporate Fitch's expectation that PEMEX might increase leverage to finance its aggressive capital budget and/or delay necessary investments to reverse declining production levels given the significantly lower cash flow generation potential in the current declining oil price environment. In addition, Fitch believes that PEMEX's new fiscal regime and the Energy Reform provide limited benefits to improve the company's financial flexibility and attract private investment to the industry.

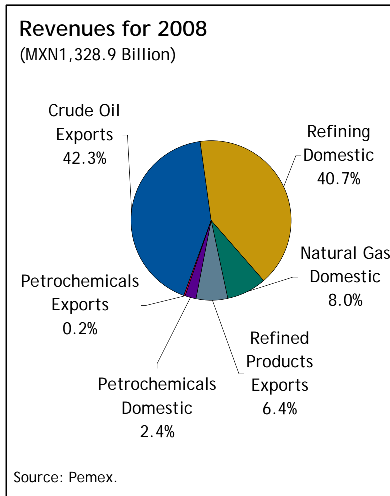
Key Rating Drivers

- Catalysts for a downgrade include UMS's ratings downgrade, a substantial increase in leverage to finance capex and/or a sharp and extended commodity price downturn.
- Catalysts for an upgrade include UMS's ratings upgrade, increased independence from the government, a tax burden in line with international standards and/or a sharp and extended commodity price upturn.

Recent Events

PEMEX posted strong results in 2008 with total revenues up 15% to USD119 billion and EBITDA up 15% to USD77 billion as price increases more than offset volume declines. Crude oil production declined by 9.2% to 2,792 thousand barrels per day (mbpd) as declines from Cantarell were only partially offset by increases at Ku-Maloob-Zaap (KMZ), while total natural gas production increased by 14% to 6,919 million cubic feet per day (mmcfd), driven exclusively by associated gas production. Debt decreased to USD42.8 billion from USD45.9 billion at the end of 2007, and cash on hand amounted to USD8.3 billion compared with USD6.7 billion in short-term maturities.

With relatively stable debt levels, PEMEX's 2008 credit metrics have improved primarily due to rising cash flow that has resulted from elevated oil prices throughout most of the year. As of Dec. 30, 2008, leverage (debt/EBITDA) was 0.6 times (x), an improvement from 0.7x during 2007. Adjusting for an underfunded pension plan and OPEB debt, PEMEX's total adjusted debt is USD81 billion, and its adjusted-leverage ratio is 0.9x. In 2008 these liabilities declined due to changes in the Mexican financial reporting standards that went into effect earlier in the year. Also, in dollar terms, PEMEX's pension and OPEB obligations are shrinking with the current MXN devaluation



and could drop even further if PEMEX reaches an accord with the union similar to the one reached by the Mexican government with public servants in 2007 (ISSTE Pension Reform). In 2009, Fitch expects credit metrics to deteriorate sharply due to depressed oil prices.

On Oct. 8, 2008, the Mexican government announced the Program to Promote Growth and Employment, which allows PEMEX to use resources from the stabilization fund for infrastructure investments and reforms PEMEX's investment framework. Also, the president of Mexico, Felipe Calderón, announced that PEMEX will use USD850 million from the fund to begin the construction of a new refinery, the first in nearly 30 years. More recently the president announced a 10% reduction in natural gas prices as well as a price freeze for gasoline. These announcements highlight the key role that PEMEX will play in the countercyclical policies of the Mexican government to mitigate the expected recession in 2009 and its linkage to the sovereign. It is not clear how the company is going to finance the remaining USD7 billion–USD8 billion required for its seventh refinery (with a capacity of 300,000 bpd), but it will likely increase leverage at the company.

Production Declines Remain a Concern

In 2008, PEMEX's crude oil production declined at an alarming rate of 9.2% to 2,792 mbpd after declining by 5.5% in 2007. A 32% decline in Cantarell was only partially offset by production increases, primarily from the KMZ fields. In January 2009 KMZ overtook Cantarell as the largest crude oil producing project in Mexico with 825 mbpd. In 2009 the company expects oil production to be between 2.7 million barrels per day (mmbpd) and 2.8 mmbpd as further double-digit production declines in Cantarell are anticipated. Natural gas production is expected to decline for the first time since 2002 to between 6,400 mmcfd and 6,500 mmcfd. Prospects at Aceite Terciario del Golfo (including Chicontepec) are encouraging. However, to meet production goals of an average of 400 mbpd over the next nine years, PEMEX needs to drill approximately 1,200 wells per year. Total hydrocarbon production had remained relatively constant since 2004 at about 4.4 million barrels of oil equivalent (boe) per day. Natural gas production increases in the Burgos and Veracruz fields had offset oil production declines, but in 2008 hydrocarbon production reached only 4.0 million boe due to oil production declines and the flaring of a significant portion of the natural gas produced.

Proven hydrocarbon reserves also continue to decline. In 2007 they fell by 5.1% to 14.7 billion boe, which represents an average life of nine years. The company expects this

Operating Metrics

Production (000 Boepd)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Crude Oil	**2,906**	**3,012**	**3,127**	**3,177**	**3,371**	**3,383**	**3,333**	**3,256**	**3,082**	**2,792**
Cantarell	1,266	1,471	1,731	1,902	2,123	2,136	2,035	1,801	1,497	1,003
Ku-Maloob-Zaap	289	292	255	249	294	304	322	404	527	702
Other	1,352	1,249	1,141	1,025	955	942	976	1,051	1,058	1,087
Natural Gas	1,022	1,012	965	953	977	1,018	1,062	1,178	1,310	1,173
Total Oil and Gas	3,928	4,024	4,092	4,130	4,348	4,401	4,395	4,434	4,392	3,965
P1 Oil and Gas Reserves (Mil. boe)	25,070	23,525	21,893	20,077	18,895	17,650	16,470	15,514	14,717	NA
P1 RRR (%)	111	(5)	(9)	(20)	26	22	26	41	50	NA
Reserve Life (Years)	17	16	15	13	12	11	10	10	9	NA
Investments (USD Mil.)	4,821	6,559	5,825	7,432	10,462	11,307	11,687	13,841	15,655	18,086

Boepd – Barrel oil equivalent per day. P1 – Proved. RRR – Reserve replacement ratio. Reserve life – Reserve/Production.
NA – Not available.
Source: PEMEX and Fitch Ratings.

negative trend to reverse in the future as the proved reserve replacement ratio (1P RRR) reaches 100% by 2012. The 1P RRR has increased to 50% in 2007 from 26% in 2005 and is expected to be even higher in 2008. PEMEX was not able to translate high international oil prices into higher production in spite of increased investment, which averaged USD16 billion in the last three years and is expected to be about USD20 billion in 2009. This highlights concerns regarding efficiency in capital expenditures allocation and the achievement of prospective long-term operating targets. Over the next nine years (2009–2017) PEMEX expects average crude oil and natural gas production per year to be 2.9 mmbpd and more than 6,000 mmcfd, respectively.

The Energy Reform and New Fiscal Regime

On Oct. 28, 2008, the Mexican Congress approved a comprehensive reform of both the energy sector and PEMEX legal frameworks, the so-called Energy Reform. Among other things, the Energy Reform improves PEMEX's corporate governance, increases management's execution capacity in investment decisions, allows the company to provide incentives or make modifications to awarded contracts and stipulates the issuance of citizen bonds (debt securities which may be acquired by small investors and whose return is linked to PEMEX's performance). The president's proposal to allow private-sector participation in storage, transportation and refining was eliminated from the final version of the Energy Reform due to opposition in Congress. These together with limited upside under contract awards might limit PEMEX's capacity to attract the necessary capital and technology for the growth of the industry, in particular for offshore drilling where most of Mexico's hydrocarbon reserves are located.

Also, in 2008 a new tax regime for PEMEX went into effect, which reduces the ordinary hydrocarbon duty to 74% from 79% and will continue to decline by 0.5% a year until it reaches 71.5% in 2012. In October 2008, PEMEX's fiscal regime was modified again to increase the deduction caps for ordinary hydrocarbon duty purposes, which gives the company additional financial flexibility. Nevertheless, PEMEX's contributions to the government continue to be the highest among the Latin American National Oil Companies and among the highest in the industry across the world. In 2008, total contributions to the government were about USD69 billion, which represent 58% of total revenues.

Fitch believes that while the Energy Reform and the change in PEMEX's fiscal regime are positive, they only represent one step in the right direction, and there are still significant changes to be made in the sector. In particular, PEMEX's ability to enter into joint ventures and partnerships determines its own budget plan without government approval and has a tax burden in line with international standards. Absent additional reforms, PEMEX may have difficulty achieving its long-term exploration, development and production targets, as well as meeting the energy needs of Mexico after years of under investing in these areas.

Liquidity and Debt Structure

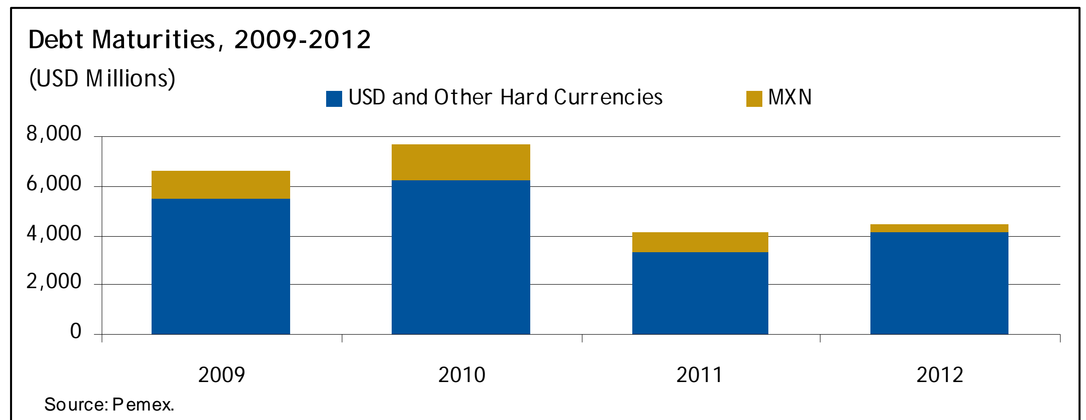
As of Dec. 31, 2008, short-term debt amounted to USD6.7 billion while cash on hand was USD8.3 billion. In addition to cash on hand, PEMEX's liquidity is supported by internally generated funds, USD2.5 billion in revolving credit facilities and access to the debt capital markets. Even during the current tight credit market PEMEX was able to issue a USD600 million Samurai bond due in 2020 at Yen Libor + 75bps in September of last year and a USD2 billon ten-year, 8% note a few weeks ago.

The recent USD2 billion issuance in the international capital markets is part of a new USD7 billion MTN program at PEMEX, which replaces the Master Trust program. By the end of 2009 all outstanding debt securities at the Master Trust will be transferred to PEMEX as one of the directives of the Program to Promote Growth and Employment, which was announced on Oct. 8, 2008, by the Mexican government. This program eliminates the PIDIREGAS financing and transforms outstanding liabilities at the trust into public debt.

PEMEX's Project Master Trust was the vehicle used to issue debt for PIDIREGAS projects. When the trust issued debt, PEMEX established that it would transfer sufficient cash to the Master Trust in order to meet its debt service. About 70% of PEMEX's total debt is currently held at the Master Trust, which is guaranteed by PEMEX and its subsidiaries.

Also, since 2004, PEMEX increased its access to the rapidly expanding Mexican debt capital market. Modeled on the PEMEX Project Funding Master Trust, the company has issued *Certificados Bursátiles* through a trust established in Mexico, the F/163. As a result of the elimination of PIDIREGAS financing PEMEX will also assume the debt issued through F/163. Debt in pesos represents about 20% of the total.

Given PEMEX's limited cash flow generation after taxes, its aggressive capital expenditure plan and declining oil prices, leverage will have to increase and/or capex will have to be cut in 2009. This would put reversing oil production declines and the possibility of reaching a 1P RRR of 100% by 2012 at risk.



Financial Summary — Petróleos de Mexico (PEMEX)

(USD Mil., Years Ended Dec. 31)

	2008	2007	2006	2005	2004
Profitability					
Operating EBITDA	76,936	67,192	64,180	51,717	45,023
Operating EBITDA Margin (%)	65	65	66	60	65
Funds from Operations (FFO) Return on Adjusted Capital (%)	17	27	17	19	13
Free Cash Flow (FCF) Margin (%)	(8)	5	(6)	(4)	(10)
Coverage (x)					
FFO Interest Coverage	1.3	3.5	2.6	2.2	1.8
Operating EBITDA/Interest Expense	13.4	12.7	15.8	10.6	16.0
Operating EBITDA/Debt-Service Coverage	6.2	5.7	6.4	6.3	6.4
FFO Fixed-Charge Coverage	1.1	2.0	1.6	1.6	1.3
FCF Debt-Service Coverage	(0.3)	0.9	(0.2)	0.2	(0.6)
(FCF + Cash and Marketable Securities)/Debt-Service Coverage	0.4	2.2	1.6	1.6	0.9
Cash Flow from Operations/Capital Expenditures	0.2	1.4	0.5	0.7	0.1
Capital Structure and Leverage (x)					
FFO Adjusted Leverage	4.7	3.5	5.7	5.6	7.6
Total Debt with Equity Credit/Operating EBITDA	0.6	0.7	0.8	1.0	0.9
Total Net Debt with Equity Credit/Operating EBITDA	0.4	0.4	0.5	0.8	0.6
Total Adjusted Debt/Adjusted EBITDA	0.9	1.2	1.4	1.6	1.5
Total Adjusted Net Debt/Adjusted EBITDA	0.8	1.0	1.1	1.4	1.3
Implied Cost of Funds (%)	13.0	10.7	7.9	10.8	7.7
Short-Term Debt/Total Debt	0.2	0.1	0.1	0.1	0.1
Balance Sheet					
Total Assets	89,591	122,023	111,356	98,032	84,888
Cash and Marketable Securities	8,341	15,934	17,440	11,361	10,534
Short-Term Debt	6,661	6,556	5,901	3,394	4,217
Long-Term Debt	36,182	39,359	46,722	47,165	35,348
Total Debt	**42,843**	**45,915**	**52,623**	**50,559**	**39,565**
Equity Credit	—	—	—	—	—
Total Debt with Equity Credit	**42,843**	**45,915**	**52,623**	**50,559**	**39,565**
Off-Balance-Sheet Debt	38,570	45,384	44,825	37,742	33,968
Total Adjusted Debt with Equity Credit	**81,413**	**91,299**	**97,448**	**88,301**	**73,533**
Total Equity	1,956	4,749	3,693	(2,527)	2,987
Total Adjusted Capital	**83,369**	**96,048**	**101,141**	**85,774**	**76,520**
Cash Flow					
Funds from Operations	1,660	13,101	6,633	5,805	2,224
Change in Operating Working Capital	1,379	3,844	(1,336)	(393)	(1,690)
Cash Flow from Operations	**3,039**	**16,945**	**5,297**	**5,412**	**534**
Total Non-Operating/Non-Recurring Cash Flow	—	—	—	—	—
Capital Expenditures	(12,628)	(11,706)	(9,642)	(7,616)	(6,550)
Dividends	—	(24)	(1,449)	(976)	(920)
Free Cash Flow	**(9,589)**	**5,216**	**(5,793)**	**(3,181)**	**(6,935)**
Net Acquisitions and Divestitures	—	(25)	—	—	—
Other Investments, Net	418	—	—	—	—
Net Debt Proceeds	909	(8,250)	(6,398)	5,603	5,254
Net Equity Proceeds	3,176	1,021	8,517	4,095	2,891
Other Financing, Net	—	29	3,089	(3,475)	(525)
Total Change in Cash	**(5,086)**	**(2,009)**	**(585)**	**3,041**	**685**
Income Statement					
Net Revenues	119,044	103,855	97,429	86,334	69,516
Revenue Growth (%)	14.6	6.6	12.9	24.2	19.4
Operating EBIT	51,151	53,948	53,309	46,871	41,312
Gross Interest Expense	5,755	5,293	4,074	4,859	2,814
Pension Expense	10,069	7,513	6,340	5,093	4,678
Net Income	(9,796)	(1,476)	4,150	(7,002)	(2,258)

Adjusted EBITDA – Operating EBITDA plus pension expense.
Source: Company reports and Fitch calculations.

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