MAKING MONEY WORK FOR YOU.

Fixed Income Analysis

PETRÓLEOS MEXICANOS

Barita Investments Limited
15 St. Lucia Way, Kingston
Tel #: 1-888-429-5333

Company Overview

Petróleos Mexicanos ("PEMEX") is a state-owned Mexican company that produces, refines, and distributes crude oil, natural gas, and petroleum products. PEMEX is Mexico's largest Company and is one of the largest producers of oil and gas in the Americas.

Given its size, PEMEX is a major source of government revenue with the Company's consolidated annual budget and financing program being incorporated into the government budget. It is considered a strategic asset by the Mexican state.

Sector:	Energy
Bond Name	PEMEX 6.70% 2032
Credit Rating/Outlook (S&P)	BBB/Negative
Maturity	February 16, 2032
Issue Size	US$ 6.78 Bn
Rank	Senior Unsecured
Current Price (April 8, 2022)	US$91.880 / US$92.116
Source: Bloomberg	Bid / Ask
Yield to Maturity (Bid/Ask)	7.895% / 7.859%
Yield to Worst (Feb 16, 2032)	7.877%
Risk Level	**Aggressive**
Recommendation	**OVERWEIGHT**

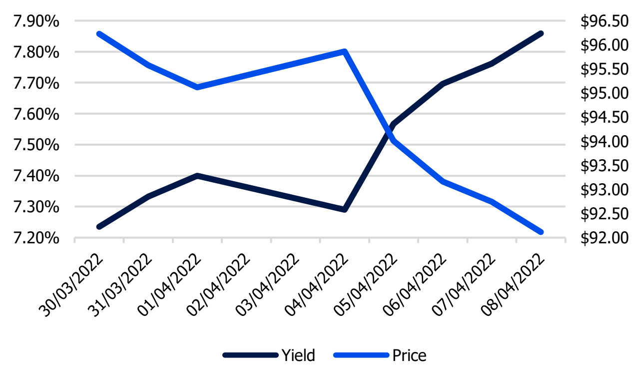
Executive Summary

In normal times, PEMEX accounts for 10% to as much as 13% of the Mexican government's revenue. However, as a result of the pandemic, in FY2020, the Company has suffered from a decline in income, driven by lower production volumes stemming from the depletion of major oil sites in Mexico and the decline in oil and gas prices during that year. The appointment of the country's current President in December 2018, Andrés Manuel López Obrador, or AMLO as he is typically called, brought some possibility in respect of a change in the company's operations. Particularly, president Obrador unequivocally noted that his administration intends to bring PEMEX back to its glory days by driving out corruption and tapping new oil fields within Mexico to boost production for the company.

This goal was underway. However, as a result of the COVID-19 pandemic, lower oil prices resulted in lower earnings and cash flow as well as the need for added debt which worsened the company's financial position. However, against most expectations, oil prices have rebounded significantly from the March 2020 lows and the government continues to hold its position as a source of support for this extremely important, government-owned, company. Thus far, the AMLO administration has provided tax relief, aided in debt servicing, and is expected to provide additional support throughout the AMLO presidency. We must note that the intrinsic risk of the company, by itself, is considerable. However, as is consistent with S&P and its rating on this particular company, we believe the government acts as the "real" determinant of this corporate's ability to service its debts and we believe that the company is vital to the Mexican economy, and as such, is "too big to fail" and will therefore continue to receive government support, at least once AMLO remains the Mexican President. **As a result, we recommend this bond to aggressive investors seeking income.**

Financial Summary (Peso MXN Millions)				
	FY2018	FY2019	FY2020	FY2021
Revenue	1,681,119	1,401,971	953,662	1,496,785
Tax	461,578	343,823	185,785	309,606
Net Income	-180,420	-347,911	-509,052	-224,363
Operating Cash FLow	141787	85,126	65,234	165,416
Net Debt	2,000,374	1,922,589	2,218,726	2,167,249
Ratios				
	FY2018	FY2019	FY2020	FY2021
EBITDA Margin	1.1%	-8.7%	-3.5%	31.96
Debt/EBITDA	110.4x	N/A	N/A	5.7x
Net Debt/EBITDA	106.0x	N/A	N/A	5.5x

Price and Yield Chart



Investment Positives and Negatives

Positives:

- **Sovereign Owned and Supported Entity:** Mexico depends heavily on PEMEX and as such, is expected to intercede when necessary to ensure the company is able to service its obligations.
- **Demonstrated Access to Capital Markets:** The very existence of its high debt load demonstrates that the international capital markets continue to support the refinancing and general borrowing of the Company. This suggests that future refinancing of debt remains likely, once PEMEX maintains its investment-grade credit rating from S&P.

- **Low Production Cost:** PEMEX's oil production is on the lower end of the cost of production "spectrum". Consequently, higher oil prices, as we have seen in 2022, have provided some benefit to the Company's income inflow and cash generation.

Negatives

- **Significant debt:** The company has a very large debt load which has made it impossible to meet its debt obligations solely through its operating cash flows.
- **Political Risk:** PEMEX remains an investment-grade company, solely on the basis that it is supported by Mexico. The current President of Mexico who has been very pro-PEMEX is serving his final term as president. If the opposing party wins the 2024 election and is not as supportive of PEMEX, the bonds could fall deep into non-investment grade territory.
- **Significant Commodity Price Risk:** While oil prices are high now, there is no guarantee that they will remain elevated for a protracted period, particularly given the volatility of the commodity's price.
- **Geographic Concentration:** Despite its immense size, PEMEX is largely concentrated in Mexico with 51% of revenue stemming from the sovereign, just 34% from the US, and the remaining revenue stemming from other regions globally.

PEMEX Credit Rating

S&P Global Ratings

Rating Summary: On December 20, 2021, S&P Global Ratings affirmed its 'BBB' long-term foreign currency and 'BBB+' long-term local currency sovereign credit ratings on PEMEX.

Outlook: The agency has affirmed a **negative** outlook for PEMEX. S&P notes that the negative outlook on PEMEX and its subsidiaries reflects that outlook for the sovereign (Mexico). They expect a close relationship between PEMEX and the government, where the latter will remain highly involved in all strategic decisions to execute its energy policy. They also note their expectation for active government oversight of the company's regular operations to continue, which supports the assumptions that PEMEX would receive additional support to mitigate unexpected setbacks, if necessary. Therefore, they continue to correlate the ratings on PEMEX and its subsidiaries with those on the sovereign.

Downgrade Scenario: S&P could lower the rating on PEMEX if:

1. They were to downgrade Mexico, or
2. If the company's relationship with the government and the likelihood of support diminishes. Furthermore, a downward revision of PEMEX's Stand-Alone Credit Profile (SACP) would follow an extended period of weak financial performance due to low oil prices, stagnant crude oil production, or further delays in meeting strategic objectives, which would compromise the company's liquidity. A lower SACP could also result from limited access to market or bank funding to address refinancing needs. As indicated by S&P, under such a scenario, they expect the likelihood of support from the government to remain unchanged, with the latter implementing specific actions to directly service the company's financial obligations.

Upgrade Scenario: An upgrade of PEMEX would only follow a similar rating action on the sovereign. S&P notes that it could revise upward the company's SACP if new projects materialize and bolster production and cash flows, while initiatives to strengthen finances improve profitability and reduce financing needs in the intermediate term, reducing debt to EBITDA below 5.0x.

Mexico Debt Rating

S&P Global Ratings

Rating Summary: On December 7, 2021, S&P Global Ratings affirmed its 'BBB' long-term foreign currency and 'BBB+' long-term local currency sovereign credit ratings on Mexico. At the same time, the Agency affirmed its short-term ratings at 'A-2', and its transfer and convertibility (T&C) assessment remains 'A'.

Outlook: The agency maintained the Sovereign's outlook at negative. The negative outlook indicates the possibility of a downgrade over the coming year due to a potentially weaker fiscal profile, given off-budget risks mostly from Petróleos Mexicanos (PEMEX) and CFE in the context of a comparatively low non-oil tax base and fewer fiscal buffers.

Downgrade Scenario: The agency notes that weak economic performance could complicate policy execution. Reversal of some policies and renegotiation of some contracts, particularly in the energy sector, and uncertainties about the autonomy of regulatory bodies and the judiciary that weigh on policy stability and depress investment further could lead to a downgrade.

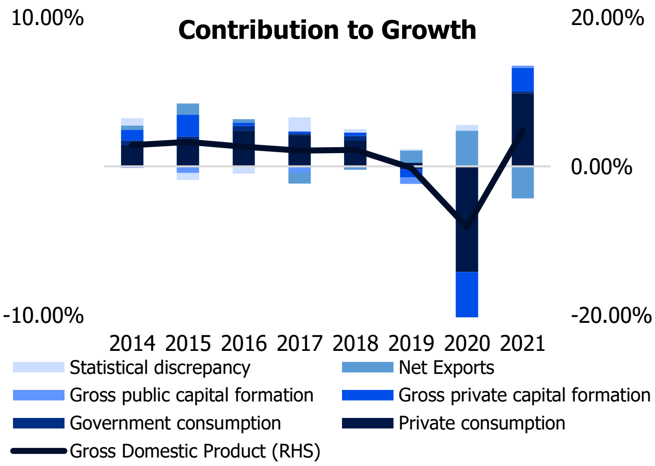
Upgrade Scenario: Conversely, effective economic management that raises investor confidence and encourages private investment could mitigate structural weakness in GDP growth prospects, helping to reinforce sound public finances. Greater political initiative to reform Mexico's fiscal regime could bolster budgetary flexibility and broaden the non-oil tax base. That, along with steps to contain the potential contingent liability posed by state-owned companies in the energy sector, could avoid erosion of the sovereign's financial profile. S&P could revise the outlook to stable within the coming year in such a scenario.

Given these factors, we believe the strength of the credit will be dependent on the strength and general fiscal space of Mexico. Hence, in assessing the fiscal capacity of the sovereign we will look at Mexico's debt capacity as determined by:

1) Growth 2) Fiscal policy stance 3) Investor confidence and external buffers

1) Real GDP and Growth

Mexico is primarily a service-driven economy with the tertiary sector contributing 63.7% to overall GDP followed by the industrial sector which contributes 28.7%. The economy is diverse compared to typical oil-producing/exporting nations with the oil and gas sector accounting for under 5% of GDP as of 2021. Pre pandemic (2014-2019), Mexican GDP grew at a compounded annual growth rate of 2.7%. Historically private consumption and to a lesser extent, private investment and net exports, were the main growth contributors. This pre-pandemic growth was, however, notably slowing with an eventual contraction in 2019, the first decline in a decade. This slowdown and eventual decline could be summarised as a slowdown in consumer spending (from a contribution of 2.4% in 2014 to 0.24% in 2019) as well as the continued decline in public sector investment which worsened in 2019 with a contribution of 0.42% in 2019 (total investment was the biggest drag on growth with a -0.96% contribution).



While the pandemic caused a further decline in the Mexican economy as real GDP contracted by 8.2%, primarily as private consumption plummeted, it remains true that growth was slowing before the pandemic. The country subsequently grew by 4.8% in 2021 but is still 3.3% below its pre-pandemic levels of output. The International Monetary Fund (IMF) in its latest world economic outlook, dated January 2022, is forecasting growth of 2.8% and 2.7%, respectively, for 2022 and 2023 (representing adjustments of -1.2% and 0.5% compared to their last forecasts in October 2021). The weaker growth prospects for Mexico were predicated on the expectation that the monetary response to the heightened level of inflation will eventually filter through and reduce domestic demand as well as the expectation of a slower US growth dragging on the external demand for Mexico in 2022. This expectation of mean reversion has already been seen with quarterly Point-to-Point GDP growth for the latest 2 quarters coming in at 1.1% and 4.52% for Sep and Dec 2021, respectively, compared to the high of 19.9% in the June 2021 quarter

Implications for fiscal space

A higher rate of GDP growth improves the government's earning capacity and its ability to unload more debt. Hence, growth is an important variable in debt sustainability analysis. The Mexican economy has notably been driven by consumption with weakening investment. It is well documented that long-run growth is primarily influenced by investment in the stock of capital and further to this, increased public investment can spur private investment. **This is therefore a negative for Mexico going forward (in the long run) as public investment has been weak in recent years but was however masked by continued private investment which has also now fallen off in recent years.**

The government has however outlined a growth strategy that includes numerous elements such as the implementation of the USMCA trade deal and attempting to increase public investment through a partnership with the private sector on infrastructure projects. **We however note that the ability of this attempt to spur greater private sector involvement in investment is likely to be tempered due to continued low sentiment given the Government's history of preferential treatment to the public sector. In summary, our assessment of growth**

in the future is for a continuation of low growth after the pandemic rebound unless there is a drastic shift in policy that increases competition and incentivizes private sector participation.

2) Fiscal Positioning – Fiscal Austerity

While continued fiscal prudence in recent times (2015-2019) has weighed on growth, it has ensured the country has maintained a stable debt-to-GDP ratio. The government's revenue is however still heavily exposed to the oil and gas industry. For full-year December 2021, a little under 20% of all government revenues were oil-related (13.3 % of all revenues were from PEMEX). Admittedly, there was a decline in this dependence in 2020 given some tax relief to weather the constraints which stemmed from the pandemic. However, since then, oil prices have lifted which has resulted in PEMEX's share of tax revenue increasing to $95.9 billion as of Feb 2022, an increase of 38.7% and 207.6% over the 2019 and 2020 periods, respectively.

As stated by Fitch, Mexico had the lowest tax to GDP ratio of all 36 OECD countries and hence the fiscal prudence has been austerity-driven, highlighting the need for improved tax collection. The government has however enacted a reform with the 2022 annual budget to strengthen tax collection, close loopholes, and increase intake from large companies, to raise revenues by 1.0% of GDP. However, the government has opted not to increase the tax on wage earners and hence the reform aims to tax evaders. While such a reform is a positive as noted by the IMF, further increases in the tax collection ability over the medium term would be needed to tackle chronic under-investment while keeping debt stable.

Federal Government Operations

Government revenues have recovered since the pandemic hit in the 2020/2021 fiscal year. This is evident in Feb 2022 Year to Date (YTD) total revenues of $986.8 billion which represents a 6.4% increase compared to the same period in 2021 and a 5.5% increase compared to 2020. Despite this, government expenses have grown at a faster pace (some of this increase being due to elevated social expenditure), and hence there has been

% of total Revenue	Dec 2013	Dec 2014	Dec 2015	Dec 2016	Dec 2017	Dec 2018	Dec 2019	Dec 2020	Dec 2021	Feb 2020	Feb 2021	Feb 2022
Oil related Revenues	35.4%	30.7%	19.8%	16.3%	16.7%	19.1%	17.7%	11.3%	19.4%	10.4%	13.7%	14.7%
PEMEX % of Revenues	12.7%	11.1%	10.1%	9.9%	7.9%	8.5%	9.7%	7.6%	13.3%	3.3%	7.4%	9.7%
Non-Oil Related Revenues	64.6%	69.3%	80.2%	83.7%	83.3%	80.9%	82.3%	88.7%	80.6%	89.6%	86.3%	85.3%
ederal Government Revenu	48.5%	52.9%	64.8%	67.3%	68.7%	65.1%	66.4%	72.9%	66.3%	75.2%	72.4%	70.9%
Tax Revenue	41.1%	45.4%	55.3%	56.1%	57.7%	59.9%	59.5%	62.5%	59.8%	67.2%	66.9%	66.9%
Non Tax Revenue	7.4%	7.5%	9.5%	11.3%	11.0%	5.2%	6.9%	10.3%	6.5%	8.0%	5.5%	4.0%
lic entities under direct cor	16.2%	16.4%	15.4%	16.4%	14.5%	15.8%	15.9%	15.8%	14.3%	14.4%	13.9%	14.4%
Millions (Peso)												
Budgetary Balance	-377,906.3	-544,989.1	-625,886.4	-502,224.2	-235,030.1	-474,240.2	-407,639.7	-655,035.3	-777,943.5	-2,814.3	-104,423.2	175,277.1
Balance of EIBC 4/	3,675.1	1,912.7	-11,800.7	-1,584.2	-3,442.3	-20,741.7	14,031.3	-21,387.6	20,153.9	13,480.9	5,449.2	4,869.1
Public Balance	-374,231.2	-543,076.4	-637,687.1	-503,808.4	-238,472.4	-494,981.9	-393,608.3	-676,422.9	-757,789.6	10,666.6	-98,974.0	-170,408
Primary Balance	-60,221.3	-191,855.4	-218,503.5	-24,986.9	304,765.0	141,370.3	268,004.6	29,651.4	-71,913.6	95,969.1	-13,915.7	-72,914.8

an increase in the budgetary deficit for the first 2 months of 2022, with a deficit of $175.3 billion compared to $104.4 billion in 2021. Likewise, there was an increase in the primary deficit for the first 2 months of 2022 to $72.9 billion compared to 13.9 billion in 2020 and a surplus of $96.0 billion in 2020.

Implications for fiscal Capacity

While government spending remains elevated and is expected to increase in 2022 due to greater social spending, we note that from a fiscal policy standpoint, the country's debt remains on a stable path and so while fiscal space is lower than it was pre-pandemic, the current debt situation is not in an unstable upward spiral. **The IMF, for example, is projecting the debt-to-GDP ratio to stabilize around the 60% mark in the medium term.**

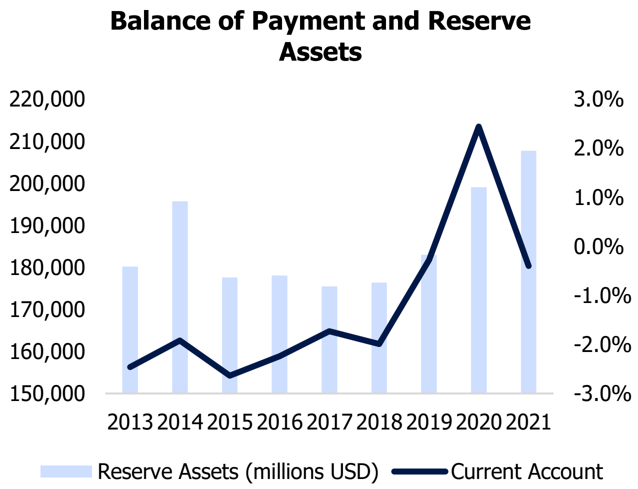
We also note that Mexico had shown prior commitment to return to fiscal prudence. This can be seen historically where the debt to GDP ratio has trended upwards from 43.9% of GDP in 2013 to 56.7% of GDP in 2016 before declining and averaging approximately 53% of GDP between 2017 to 2019, halting the upward trajectory. **The country had also navigated the pandemic well (in terms of conservatism) and we are cautiously optimistic about the return to fiscal prudence**. **This, when coupled with the composition of Mexico's sovereign debt, with over 80% being its local currency and 60% fixed rate with an 18-year tenor on average means that while the fiscal space has weakened relative to pre-pandemic levels, the near-term outlook for debt sustainability is favorable and we hence do not foresee a credit risk in the short term regarding the sovereign's support to the PEMEX credit.**

The risks, however, still lean towards the downside for several reasons. Firstly, the most recent budget presentation in April 2022 was predicated on a growth forecast of 3.4% for 2022 which is above consensus estimates (including the prior stated IMF forecast). This, therefore, opens the possibility of revenue being materially less than forecasted if this growth does not materialize which increases the risk of a higher than projected budget deficit and Debt-to-GDP ratio.

3) External Balance and Confidence

Mexico's solid external position, a rating strength (as per S&P), is based on the peso's status as an actively traded currency coupled with Mexico's moderate external debt. Specifically, the peso accounts for almost 2% of global currency transactions, according to Bank for International

Settlements' data, placing it among the highest share for any emerging market country. Mexico's current account has a track record of adjusting to contain external vulnerability amid swings in oil prices and economic activity, as demonstrated in 2020.



We would have noted that net exports would have contributed positively to growth during the pandemic and for the years leading up to the pandemic. Mexico has notably reversed a negative net export balance in 2018 of 567.9 trillion to a positive balance of $330.0 trillion in 2021. This was due to continued robust growth in exports outpacing imports. An underlying reason for this is the country being a beneficiary of the US-China Trade war which led to trade diversion to Mexico as well as the record growth in goods spending in the US coupled with the government fiscal stimulus during the pandemic period which had the impact of increasing external demand for Mexican goods.

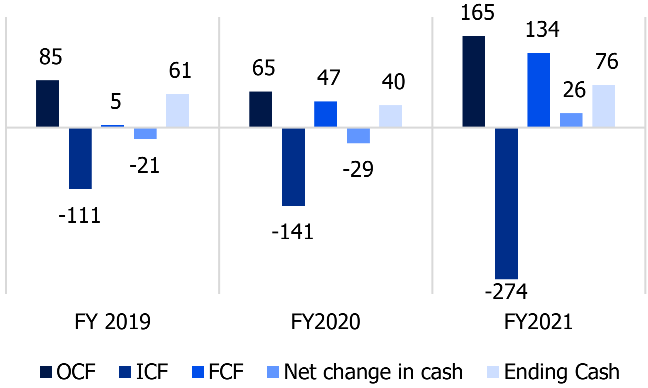
This benefit would have trickled into the country's current account where we have noted the current account deficit as a proportion of GDP has fallen from as wide as 2.6% in 2015 to a surplus of 2.4% as of December 2020. This was driven by the improvement in the trade of goods and services as well as a drastic improvement in the secondary income balance which improved from a surplus of 2.1% of GDP in 2015 to 3.7% in 2020, reflecting greater remittances, particularly aided by US growth and pandemic related fiscal stimuli. **This improvement in the external accounts would have facilitated an increase in the country's balance of payment cushion with international reserves increasing from US$177.6 billion in 2015 to US$207.7 billion at end of 2021 (the latest figures for the net international reserves place this amount at 200.8 billion at end-March 2022).**

Implications

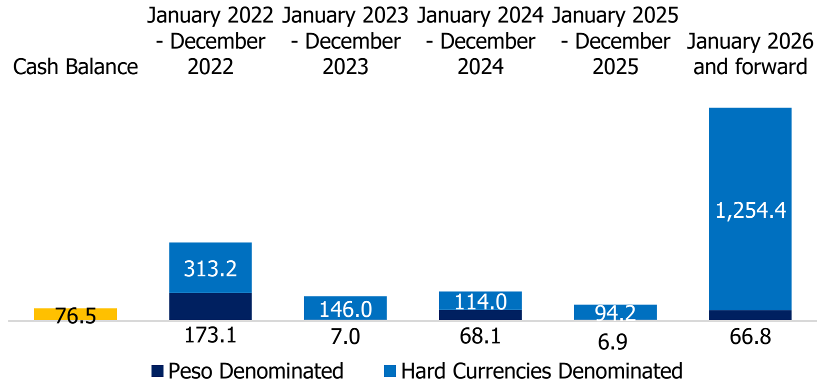
While we note that Mexico has a typically strong current account position, we expect to see some amount of reversion in the short to medium term (the IMF is also forecasting a current account deficit to the tune of 0.3% of GDP in 2022). Despite this, we believe the country has accumulated a sizeable reserve position which will provide some insulation from external shocks and more generally, points to the availability of foreign exchange. This, therefore, instills greater confidence in our belief that a currency crisis that may create difficulties as it relates to the repayment of foreign debt is unlikely in the short term.

PEMEX's Financial Analysis

Annual Cash Flows (Billions of Peso)



Pemex Debt Distribution (Trillions of Peso)

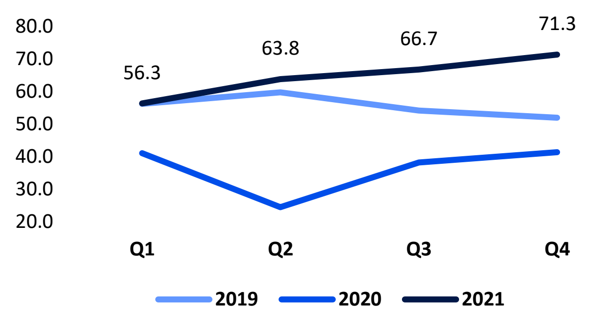


As indicated in the cash flow chart above, the Company reported an improvement in its Operating Cash Flows (OCF) in FY2021 with cash flows increasing from 65.3 billion pesos in FY2020 to 165.4 billion pesos in FY2021, largely driven by increased oil prices coupled with slight uplift in oil production. Despite the improvement in its operating cash flow, however, and considerable growth in its cash position during FY2021 relative to FY2020, PEMEX does not have enough cash to cover its debt obligations. This is made evident by the debt distribution chart which outlines the Company's debt maturities by year and its clearly, much lower cash position.

Importantly, however, we must note that the Company's cash flow management has improved materially in FY2021 by looking at some key points:

1. **The positive net change in cash:** PEMEX's net cash position for the 2021 financial year amounted to 25.8 billion pesos. This means, on a net basis, the Company was able to add fresh cash to its balance sheet. This is important since historically, PEMEX has not witnessed a positive net change in cash since at least FY2016.
2. **Debt Management and CAPEX:** With the aid of the government through direct financing, PEMEX's net borrowing was negative in 2021, meaning that the Company repaid more external debt than was borrowed. This is even more impressive when taken from the perspective that the Company increased its capital expenditure spending during the period, by 102.12 billion pesos or 88.8% YoY.

Mexican Crude Oil Basket Price Quarterly Average ($/bbl)



In addition to the government's support, the improvement has been driven by more favorable macroeconomic conditions as crude oil prices have increased, as indicated in the accompanying chart. Notably, these have increased further in 2022, the benefits of which will be reflected in PEMEX's performance over the 2022 financial year.

At present, however, we must be clear that the Company's financial position remains extremely strained and without the government's support, despite the improvements in net cash inflows, the Company is unable to service its obligations.

Within that vein, we highlight the previous statement by S&P which indicates that PEMEX can only be upgraded if Mexico is upgraded or if the profitability of the Company improves materially, such that its debt to EBITDA falls below 5.0x. At present, the Company's debt to EBITDA is 5.7x and without considerable continued government support, is unlikely to reduce materially below 5.0x for a sustained period.

PEMEX as a "contingent" liability

Despite PEMEX's weak standalone credit profile, the Company is an investment-grade credit, by virtue of the sovereign's ownership. Within that vein, in October 2021, PEMEX announced the government's continued provision of cash to the company to make payments on debt maturities beyond 2021. This would primarily cover debt amortizations over the 2022-2024 period (the remainder of AMLO's term). Once the federal government funds the entirety of PEMEX's scheduled amortizations over this period, this would require a total of US$4.6 billion in 2022 and US$4.7 billion in 2023.

To supplement this support, the Finance Ministry also confirmed that its 2022 federal budget incorporates a reduction of PEMEX's profit-sharing duty known as Derecho por la Utilidad Compartida or **"DUC"** for short. This DUC has been a major tax burden for the company, affecting its free cash flow. The government has tabled a reduction from 54% to 40%. This 14% reduction represents another step toward helping the Company to generate more robust free cash flows and comes on the back of a tax initiative that was unveiled previously as the DUC was cut from 65% in 2019 to 58% in 2020 and 54% in 2021. In our view, these efforts, as indicated by S&P, are clear representations of the current administration's support for the Company.

Political Risk Pemex and the Oil Sector

Energy reform has been a historical challenge for Mexico. The constitution in 1917 decreed that the subsoil and its constituents belong to the Mexican State. Foreign ownership of oil lands caused great resentment in the Mexican people which led to President Lazaro Cardenas's announcement on March 18, 1938, to nationalize all privately held oil fields and wells. Compensation was offered to foreign holders and hence this nationalization was "amicable". Further amendments were made in 1960 and 1983 which granted more rights to the national Oil company, PEMEX, to manage the petroleum industry's activities and prohibited contracts with third parties. The reforms in 2008 later would allow some amount of private contracting but exploration rights were still firmly with Pemex.

In December 2013, the Mexican government approved an amendment to several provisions on energy in the country's Constitution. Under the amendment, the Mexican State would explore for and extract oil and other hydrocarbons through contracts with private entities or with Pemex. These contracts may provide for profit-sharing arrangements, production sharing, services, or a combination of these options, although hydrocarbons would continue to be national property, as before the reform. Also, under the amendment, private investments would be allowed in oil refining and in the transportation, storage, and distribution of oil, natural gas, gasoline, and diesel fuel. The amendment was heavily pushed by former President, Enrique Peña Nieto, who at the time, indicated that the constitutional amendment would allow Mexico to have access to the technology and financial resources provided by private companies that are necessary to reach hydrocarbon deposits in deep waters as well as shale gas.

Private Investments and Entities Today: AMLO's coming to power has put a stop to the privatization of the energy sector, which is deemed by many internationally to be contrary to the interests of the nation. For the new government, energy sovereignty and security are the two key principles of its energy policy. Hence, AMLO has strengthened the link between Mexico and Pemex. **However, we note that his current term ends in 2024 when he would have served his six (6) full terms which is the maximum allowed under the Mexican constitution. This, therefore, presents a political risk to the credit of Pemex as it is not certain that the next president/ruling party will in effect offer as great of support for PEMEX.**

The stance of current Parties: Given the possibility of a new regime after 2024 it might therefore be important to have an idea of the stance (recent or historical) of the current main political parties.

- **MORENA**- The current Ruling Party also formed a coalition with the labor party and the Ecologist Green Party (Verde) of Mexico. While AMLO's party is in Favour of dialing back the 2013 energy reform, it remains questionable as to the level of support that this has from the Verde party which has sustainable development as its core mandate.
- AMLO and Morena's biggest rival in the 2018 general election was an alliance known as the Por Mexico al Frente which includes the National Action Party (PAN) and the party of Democratic Revolution (PRD) as the most popular members. From this coalition, the PAN party has been the most vocal on energy. Their plans include a form of privatization of PEMEX which would reduce debt by issuing citizen bonds and hybrid securities to private investors. While less vocal the PRD is also thought to be on the side of privatizing the energy sector.
- The third major block in the 2018 election was the Todos PO Mexico coalition which included the Institutional Revolutionary Party (PRI). While the PRI would have been the party to have initially brought forward the energy sector reform in 2013/2014, they have not been vocal in opposition to AMLO and MORENA's plan for amendments to the energy reform act or the continued protection of the energy sector.

Based on the above if more amendments are to be passed to protect Pemex, AMLO would need a majority in the Mexican House and Senate. While not impossible, this would represent a battle as AMLO will need some amount of oppositional support which at this current junction is more likely to come from the PRI party as the other parties have been more vocal in their opposition (334 needed if fully attended in the senate to reach a qualified majority Morena coalition has 278 and PRI 70).

Further to this, concerning the 2024 election, we note that AMLO and the MORENA party are quite popular, with AMLO being the first to win an election by popular vote and with the most states won by a candidate since Ernesto Zedillo won every state in 1994. Numerous online pollsters such as Oracle and Buendia y Marques also show that AMLO's approval rating remains high with the majority of Mexicans believing the country is on the right path. Hence, even though he may not be able to complete another term due to constitutional limits, his party remains favored going into the next election which might increase the possibility of favorable treatment for PEMEX going forward, assuming the MORENA party wins the 2024 election. As the outcome remains unknown, the political risk remains significant for PEMEX.

Outlook

In our view, the outlook for Mexico and PEMEX goes hand in hand. While a downgrade of PEMEX is contingent on a downgrade of the sovereign, we acknowledge that equally, a downgrade of the sovereign would be the result of its extensive support to PEMEX. We believe that Mexico currently has a strong external balance and favorable debt dynamics owing to the sovereign's fiscal prudence which further ensures they have access to external funding. The main negative, however, is how elusive long-term economic growth has become, primarily driven by chronic under-investment by the public sector, which has also filtered through to the private sector. We, therefore, expect growth to mean revert as we have seen in the latest quarter, which represents a downside risk (recall, Mexico experienced economic contraction before the pandemic in 2019).

The factors outlined previously, support our view that Mexico in the short term would have the fiscal capacity by which to service PEMEX's debt obligations. It is also our view that the sovereign will do its best to support the company, going as far as amending constitutional energy laws to give PEMEX an advantage over private investors. President Andres Manuel Lopez Obrador's administration has canceled new oil and gas auctions, designated PEMEX as the operator of a giant field discovered by foreign companies, and cracked down on private fuel importers to give the state driller the upper hand.

Over the long term, however, with the stagnant real growth that the country has experienced, a worsening of the performance of PEMEX might erode the sovereign's capacity to support the entity while keeping debt and debt/GDP at sustainable levels. S&P global would have also noted that continued slow growth is one of the conditions that may warrant a downgrade of the sovereign. Hence since we expect growth to slow and revert to long-run levels which were already relatively low, we expect that the downgrade risk is elevated, even in the short term.

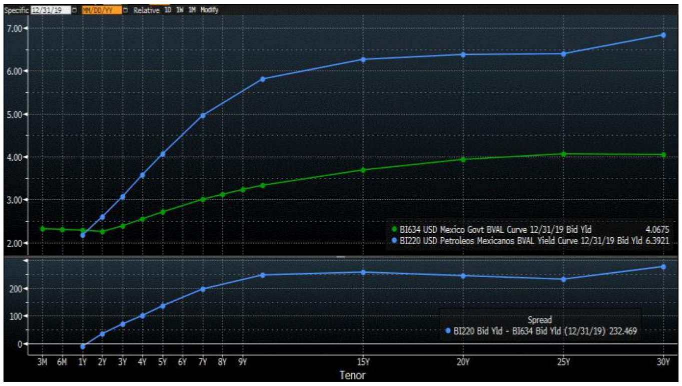
Relative Valuation and Recommendation

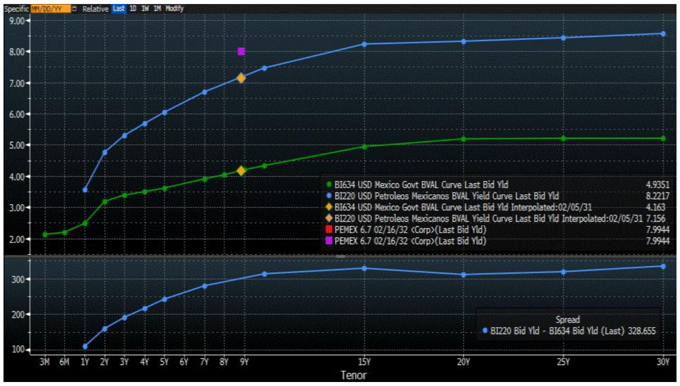
Relative Valuation

Given the clear linkage between PEMEX and Mexico, we believe the best comparison for the Company's bonds, is the sovereign's bonds. Consequently, if we look at the chart to the left with yields for the PEMEX and MEXICO dating back to December 31, 2019, before the pandemic, we note that PEMEX has always traded at a wider spread than Mexico. As we consider the PEMEX 6.7% 2032 bonds, we make note of the 10-year tenor as at December 31, 2019 (pre-pandemic) and as at April 8, 2022. Based on the yield curves from these dates, and looking at the 10-year tenor, PEMEX traded at a spread of 2.542% on December 31, 2019, while as at April 8, 2022, PEMEX traded at a spread of 3.131% relative to the sovereign. This spread widening has occurred despite the following:

1. The S&P credit rating for PEMEX and Mexico is intricately linked;
2. The financial performance of PEMEX improving materially based on its 2021 financial performance, compared to its 2019 performance as noted in its EBITDA which is now positive, its cash position which has improved, and its net operating cash flow generation which has strengthened;
3. The clear increase in oil and gas prices which has positive implications for the Company;
4. The very clear support from the government as it relates to the servicing of near-term debt and as well as tax relief to support better cash retention.

We believe that considering all these factors, on balance, PEMEX should at least be trading at a spread that is commensurate with its pre-covid spread of 2.542% for a 10-year tenor, as well as along the entire curve. As can be seen in the charts below, spreads have widened (right chart) along the curve relative to pre-pandemic spreads (left chart). **Given the aforementioned, we believe the price of the PEMEX 6.70% 2032 bonds can appreciate by 4.01% if spreads tighten to the December 31, 2019, Pre-COVID-19 level. Given the yield to worst of 7.88%, this would equate to a total return of 11.89%.**





Recommendation

Now, while we believe there's potential for upside given the trading dynamic of the Company, we must also note that our current view on the fixed income space is skewed towards shorter duration instruments. The reason for this is directly linked to the current bout of global inflation, as evidenced by the latest US CPI reading (February 2022) of 7.9%, its highest level since January 1982. This has been a worldwide occurrence with developed and developing nations reporting record-high inflation levels. This has therefore meant that there is a pivot by global central banks to more contractionary monetary which has then led to higher interest rates in many cases. The market has subsequently reacted with US ten-year yields at 2.71% as of April 8, 2022, up 107.4 bps YOY (Year Over Year). Since we remain in this hiking cycle, further rate increases are likely which has negative implications for bond prices and further reinforces our preference for shorter duration instruments.

In addition to the above, we recognize that there is heightened political risk associated with Mexico, and by extension, PEMEX. This is inclusive of the possibility of a new political party coming into power post-2024 that might take a different policy stance as it relates to PEMEX. This would change the Company's credit standing (Despite data suggesting that the current ruling party retains favorable standing amongst the populace, no formal declaration or plans for PEMEX beyond 2024 as it relates to the possibility of government support have been announced).

Now, while this is our preference, we note that the recommended bond is a 2032 maturity with a modified duration of 6.803. Given the tenor of the bond, we believe the duration is favorable. However, more importantly, PEMEX has swapped the majority of its shorter tenor bonds for longer tenor bonds, most notably, this PEMEX 2032 6.70%, with a yield to worst of 7.88%. Given the attractive yield, relatively favorable duration, and the potential for price appreciation while considering the significant risks associated with the bond, we've issued an **OVERWEIGHT** recommendation but note that this is directed at clients with **AGGRESSIVE** tolerance and a large capacity for taking such risks.