PEMEX REQUIRES A PROFOUND RESTRUCTURING

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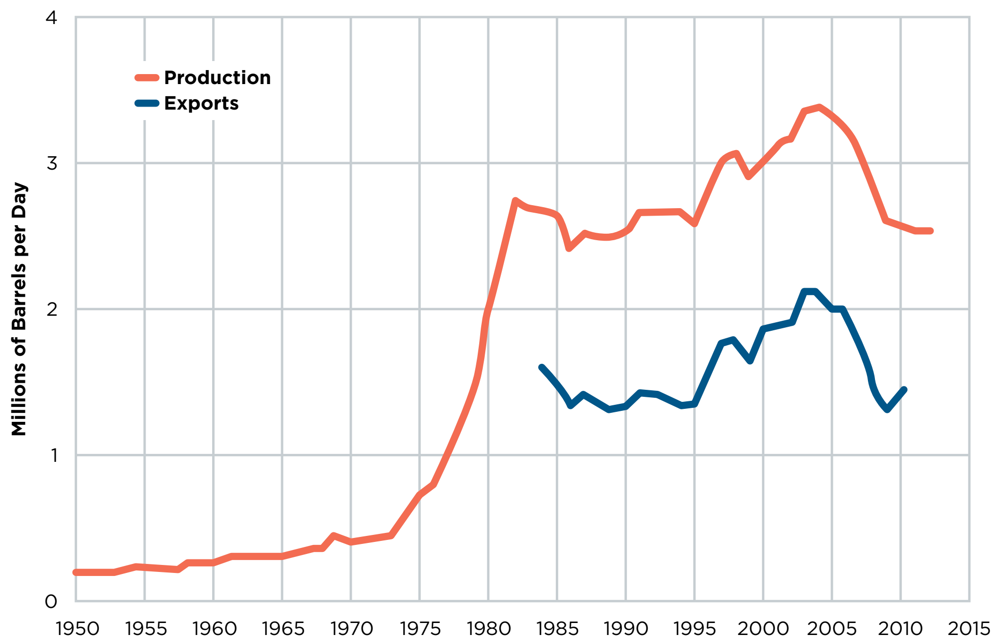
In 1938, almost 80 years ago, the Mexican government expropriated and nationalized the oil and gas industry, taking control of all assets from previous foreign owners and created Petroleos Mexicanos (Pemex), a state-owned petroleum company. For many years, Pemex has been an important source for government financing and a source of income for corruption, especially after the Cantarell field discovery in the late 70s, which provided up to two million barrels per day.

Since the 1980s, the Mexican economy has heavily relied on the Pemex oil revenue and government borrowings to finance spending. Unable to pay the required tax to the government, Pemex increased its borrowing by 60 percent over the last three years from $54.7 billion in 2013 to $87.4 billion in 2016. However, Pemex has not updated its infrastructure or discovered any new sources of production.



Source: U.S. Energy Information Administration

Given sustained production and lack of significant new discoveries, Pemex oil reserves are declining. Proven hydrocarbon reserves have fallen 35 percent from 20 billion barrels of oil equivalent (BOE) in 2003 to 13 billion BOE in 2015.

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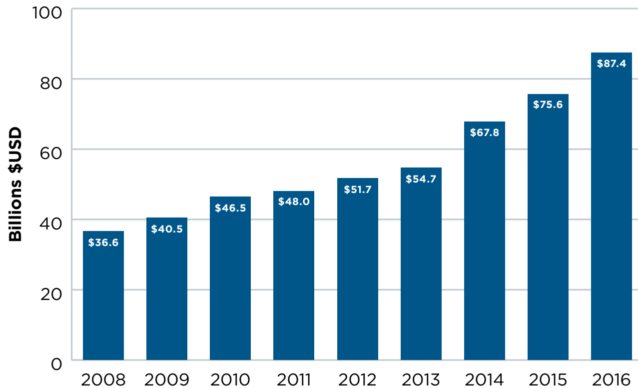
In 2014, for the first time since 1938, the Mexican government passed legislation permitting foreign investment in oil and gas. Unfortunately, the ability to obtain fresh capital came at the same time oil prices materially declined in January 2015, requiring the government to finance Pemex to avoid bankruptcy.

PEMEX Long Term Debt 2008-2016



Source: Pemex financial reports

Current Situation

In 2016, only 2.1 million barrels per day were produced—or 1.2 million fewer barrels per day than a decade ago—and fewer than 2 million barrels per day are expected to be produced in 2017. Pemex reported net losses of $33.6 billion in 2015 and $14.3 billion in 2016.

While dramatic steps were taken in 2016 to improve performance—management layoffs, procurement efficiencies and halting production from wells with extraction costs greater than $25 per barrel—the ultimate net loss was a result of arbitrary taxes and duties ("Profit Sharing Duties") charged by the government totaling $14.8 billion.

Pemex faces many challenges: outdated infrastructure, $59 billion in union obligations, $87 billion of debt, low productivity (17 barrels per employee vs. 37 barrels per employee at Shell Oil), corruption assigning contracts, clandestine oil theft from pipelines and requirements to continue financing the government. On a book balance basis, liabilities are more than assets, resulting in a deficit of equity.

Restructuring

In 2016, Pemex commenced a restructuring program, but it is unclear if these efforts will provide a surplus, as its business plan expects. Achieving the intended surplus for 2017 depends on the execution of the intended restructuring measures and the price of oil. Pemex former employees are under investigation related to the Odebrecht bribes and corruption will be very tough to eradicate.

Certain measures of the restructuring activities will improve profitability but will not solve the high debt level, reduce arbitrary duties and taxes paid to the government, or address the continuing theft of oil from pipelines that continue to be a drag on earnings.

Pemex can:

1. Continue reducing the excess labor force but many jobs are secured by the powerful and corrupted petroleum union.
2. Improve transparency in awarding contracts.
3. Continue to promote joint ventures with foreign companies to develop new fields.

It requires government intervention to do the following:

1. Reduce the taxes and duties that the government imposes.
2. Eliminate the theft of oil.
3. Sell unprofitable refineries and other assets.
4. Sell off-shore and off balance sheet companies (59 companies in total).
5. Renegotiate union and pension obligations.

Summary

If oil prices do not improve and the anticipated restructuring measures are not achieved in 2017, Pemex will require additional financing from the government or others. The Mexican government

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debt has already increased dramatically over the last four years, reaching 48 percent of GDP in 2016 (up from 33 percent in 2012). Additional borrowing by either Pemex or the Mexican government will be expensive. Pemex is no longer the main source of revenues for Mexico, but instead, a financial burden.

Alternatively, the Mexican government could seek the required capital by imposing additional levels of income tax on personal and corporate income. Per OECD data, taxes on personal income in Mexico are 3.4 percent of GDP while in the U.S. they are 10.7 percent. Time appears to be running out and tough choices will have to be made.

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Fernando has over 20 years of domestic and international experience, with a strong financial and operational background to analyze, model, design and implement business plans. Prior to joining Huron, Fernando was involved in turnaround consulting, including diagnosing causes of failure, developing strategies for cash management, profit improvement and financial recovery at Glass & Associates.

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