Mexico keeps 'investment grade', despite Moody's sovereign and Pemex downgrade

- ***Moody's Investors Service*** **cut Mexico's credit rating by one-notch to 'Baa1', from 'A3', while maintaining the outlook 'negative'**
- **The reaction from the market was limited, as the move was highly discounted**
- **The agency's decision was driven by three factors: (1) Mexico's weaker medium-term economic growth prospects; (2) risks to the sovereign's fiscal strength due to the continued deterioration of Pemex, among other factors; and (3) weakened policymaking and institutional capacity**
- **It should be noted that the agency also revised Pemex's rating down by two-notches to 'Ba2' from 'Baa3', which is no longer considered 'Investment Grade'**
- **Despite today´s downgrade, as well as recent actions from other agencies, we still believe Mexico will remain an 'Investment Grade' country in coming years**

Credit downgrade, but the investment grade prevails. In line with our view, *Moody's Investors Service* downgraded Mexico's sovereign rating to 'Baa1' from 'A3', today leaving the 'negative' outlook. This action came in tandem with previous downgrades from *S&P Global* (April 15th, 2020) and *Fitch Ratings* (March 26th, 2020) in recent days, acknowledging that the Coronavirus pandemic, combined with the plunge in crude oil prices have resulted in relevant headwinds for the Mexican economy and fiscal accounts. It is worth mentioning that Mexico's sovereign profile is holding its 'Investment Grade' status (IG), after this round of reductions (see table below). The IG standing is highly relevant for the federal government to access better financial conditions in the international markets during the current liquidity squeeze due to the strong risk aversion worldwide. By the same token, *Moody's Investors Service* trimmed Pemex´s rating to 'Ba2' from 'Baa3', following similar actions by their other peers recently. However, in contrast with the sovereign case, Pemex is no longer an IG issuer with today's decision (joining *Fitch Ratings* with the same assessment).

Mexico's sovereign and Pemex credit rating
Bold rating indicates current level

FitchRatings	S&P Global	Moody's	
A-	A-	**A3**	
BBB+	BBB+	**Baa1** Sovereign	
BBB	***BBB*** Sovereign PEMEX	Baa2	
BBB- Sovereign	BBB-	Baa3	Investment grade threshold
BB+	BB+	Ba1	
BB	BB	*Ba2* PEMEX	
BB- PEMEX	BB-	Ba3	

Source: Banorte with data from S&P Global, Fitch Ratings and Moody's Investors Service

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www.banorte.com
@analisis_fundam

Gabriel Casillas
IRO and Chief Economist
gabriel.casillas@banorte.com

Alejandro Padilla
Executive Director of Economic Research and Financial Markets Strategy
alejandro.padilla@banorte.com

Juan Carlos Alderete, CFA
Director of Economic Research
juan.alderete.macal@banorte.com

Manuel Jiménez
Director of Market Strategy
manuel.jimenez@banorte.com

Tania Abdul Massih
Director of Corporate Debt
tania.abdul.massih@banorte.com

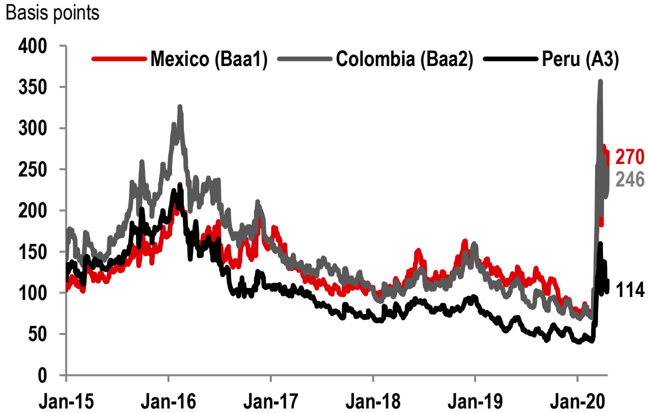
Francisco Flores
Senior Economist, Mexico
francisco.flores.serrano@banorte.com

Santiago Leal
Senior Strategist, Fixed-Income and FX
santiago.leal@banorte.com

Limited market reaction. Given the strong market reaction in the past few months, particularly in the Mexican government bond yields as well as Pemex global bond yields, and their respective CDS, it seems that market participants had already discounted today's rating actions, including the loss of Pemex's investment grade. It is worth noting that anecdotal evidence from portfolio managers of several relevant global investment funds, they have been creating new high yield funds to 'catch' the 'fallen angels', *i.e.* the bonds losing IG. So, these are two underlying reasons why we believe market reaction was tame.

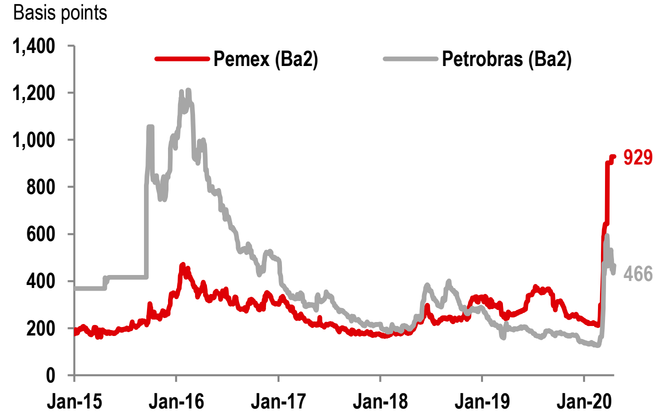
Market participants priced in today's actions from *Moody's Investors Service*. The Mexican peso depicted a mild and short-lived reaction to the announcement, confirming our thesis that investors had already priced in this event. Nonetheless, it is worth stressing out that risk premia embedded in almost every asset in emerging markets have already soared following the dual shocks coming from the COVID-19 pandemic and the plunge of oil prices since the beginning of March, foreseeing situations like this. Mexico's 5-year CDS lifted from 79bps in 2019-end to 269bps currently, not observed since the 2015-2016 oil shock. In a regional comparison, Mexico, Colombia, and Peru portray a similar credit profile. However, Mexican assets are trading with an additional premium in a credit-adjusted basis (see chart below on the left). These wider spreads suggest that investors remain concerned about the lower resilience of the Mexican economy and fiscal accounts to the complex global landscape.

Sovereign 5-year CDS
Basis points



Source: Moody's Investors Service and Bloomberg

Oil companies 5-year CDS
Basis points

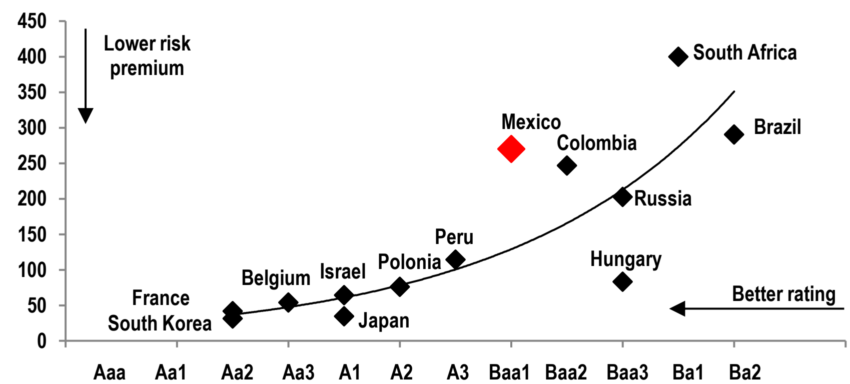


Source: Moody's Investors Service and Bloomberg

Mexico is still considered to be investment grade. Despite these adverse conditions, Mexican risk premium continues trading in the investment grade threshold as depicted in the lower scatter plot, confirming our view that despite the global recession triggered by the Coronavirus, Mexico will remain an IG issuer by the end of the pandemic. In terms of Pemex, the financing costs have skyrocketed, explained by the highly expected loss of the IG status from two of the main credit rating agencies (*Moody's Investors Service* and *Fitch Ratings*) and the headwinds associated to lower oil prices. Pemex's risk premium proxied by the 5-year CDS is significantly higher than Brazilian oil company Petrobras, despite having as of today the same credit status of 'Ba2' (929bps *vs.* 466bps) as observed in the lower right chart.

This can be explained by the forced selling of some Pemex securities included in debt indices (*e.g.* Bloomberg-Barclays or JP Morgan's EMBI) that required an IG status by at least two major credit rating agencies. This pricing depicts that the abovementioned situation is already priced in.

5-year CDS and *Moody´s Investors Service* credit rating
(vertical axis basis points, horizontal axis credit rating score)



Source: Banorte with data from Moody's Investors Service and Bloomberg

***Moody's Inverstors Service* particular argument.** The arguments rating agencies have been using in the backdrop of the recent downgrades in both Mexico's sovereign debt, as well as Pemex have been quite similar. Nevertheless, in contrast to *Fitch Ratings* and *S&PGlobal*, it is worth noting that *Moody's* emphasized in the role of the government in terms of backing up the state-owned oil company. In fact, the second reason of Mexico's sovereign rating was "*…The continued deterioration in Pemex's financial and operational standing is eroding the sovereign's fiscal strength, which is already pressured by slower revenue growth due to a weaker economy…*".

Challenges ahead for Mexico triggered the ratings downgrade. Specifically, for the sovereign, *Moody's Investors Service* summarized the drivers behind the credit rating action in three broad themes: (1) Mexico's weaker medium-term economic growth prospects; (2) risks to the sovereign's fiscal strength due to the continued deterioration of Pemex, among other factors; and (3) weakened policymaking and institutional capacity.

Medium-term GDP growth, at best at 2%. Regarding the first factor, the agency reminds that they upgraded the rating to 'A3', from 'Baa1', back in 2014 as they saw the possibility of higher potential GDP growth, north of 3%, driven by a broad range of structural reform. Nevertheless, "*...since then, however, implementation has been uneven at best, with the energy reform being de facto reversed…*". Moreover, "*…economic policy decisions and mixed policy messages under the current administration have materially altered business sentiment and will likely continue to dampen private sector investment in the coming years…"*. The latter has been compounded by the shock that the global COVID-19 pandemic will have in the country's economy in 2020 through manufacturing exports, tourism, and social distancing measures, among others. Given these and other drivers, the ratings agency "*…expects medium term growth to be depressed, […] with the economy growing at best 2% on average in 2021-23…*".

Pemex financial needs and COVID-19 could result in a higher sovereign debt burden. On the state-owned oil company, more specific comments were outlined in the stand-alone credit rating review, which is presented in the section below. For the sovereign, *"…the impact of higher support to Pemex, anemic government revenues amid weaker GDP growth and rising interest burden will lead to higher fiscal deficits and increased debt ratios…".* As a result, and under the agency's base case scenario, *"…the debt burden is likely to increase 10 percentage points to 46.2% of GDP by 2022 from 36.4% of GDP in 2019…*". If the COVID-19 outbreak is more severe and results in increased fiscal measures, *"…then debt would likely rise beyond the 50% mark by 2022…".* Lastly, there are also other medium-term risks, as they *"…do not expect the government to help the company* (Pemex) *meet both its debt obligations and capital expenditure needs…",* which could negatively affect oil-related government revenues that are around 14% of total revenues.

Weakened policymaking and institutional capacity. These factors are incorporated by the agency in their Environmental, Social and Governance (ESG) framework. In their opinion, both have weakened, resulting in a lower capacity for the country to respond to shocks. About the former, *Moody's Investors Service* argued that "…*Economic policy decisions over the last year and a half and mixed messages are dampening business sentiment and investment prospects*…", leading to uncertainty about the potential sovereign credit consequences of future policy shifts. When talking about the latter, *"…broad based salary and benefit cuts across government ministries have weakened the government's administrative capacity…",* which along *"…with the significant reduction in budget and governance changes to some autonomous regulatory institutions…"*, have eroded the country's institutional capacity.

Moreover, the agency maintained a 'negative' outlook. Among the factors that could result in an additional downgrade, they highlighted: (1) Further evidence that medium-term growth is in decline; (2) rising fiscal deficits that cause debt to shift upward, whether due to Pemex or higher government spending; and (3) a continued deterioration in the policy framework. Other risks include a higher-than-expected economic contraction in 2020, and higher spending either due to a worsening of the pandemic or the mid-term elections in 2021. On the contrary, and despite the agency saying that there is a low likelihood of an upgrade in the near future, while a shift to 'stable' would result from *"…regained confidence in the government's ability to lay out and implement consistent policies and improve growth prospects in the medium term…"* including *"…A credible plan towards Pemex that would reduce the risk of recurrent and substantial government support to the company…".*

Pemex downgraded to high-yield. As it was widely expected, *Moody's Investors Service* downgraded Pemex's senior unsecured ratings from 'Baa3' to 'Ba2', lowering it to a high-yield level. Simultaneously, the agency lowered Pemex's Baseline Credit Assessment (BCA), which reflects its standalone credit strength, from 'caa1' to 'caa2'.

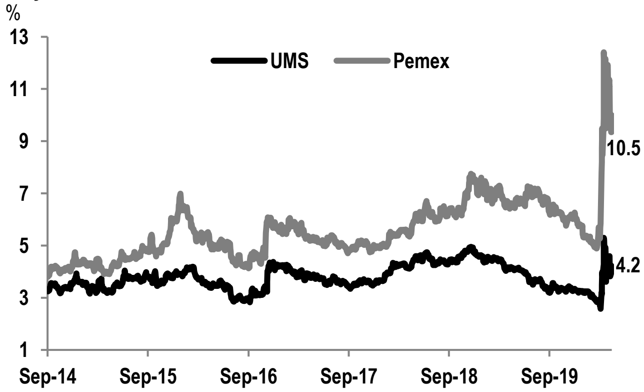
According to the agency, *"…these rating actions were triggered by the company's higher liquidity and business risk and by Moody's announcement on April 17, 2020 that it had downgraded its ratings on the Government of Mexico's from 'A3' to 'Baa1' and maintained the 'negative' outlook on the government's ratings. The outlook on Pemex's ratings remains 'negative'…"*.

Pemex's rating action, following sovereign downgrade. The agency affirmed that Pemex's downgrade with 'negative' outlook, follows Mexico's rating action, reflecting *"…the critical importance of the government's financial strength and support in the assessment of Pemex's credit risk…"* commented Nymia Almeida, Moody's Senior Vice President. *"…the actions took in consideration our expectations for an extended period of negative free cash flow and the need for external funding, despite the company's efforts to adjust costs and investments to low oil prices…"*

Credit weakness and a complex scenario led to a two notches downgrade. In the last days, *S&P Global Ratings*, *Fitch Ratings* and *Moody's Investor Services* took several negative credit actions in Pemex's ratings driven by the concerns about a complex global scenario for the oil and gas industry and Pemex's "*…high vulnerability to low commodities prices given its fragile position and excessive debt burden…"*. The downgrades were also based on the financial assessment of the company, specially the deterioration of its standalone credit strength (stand-alone credit profile) which reflects the negative free cash flow generation, high leverage, rising per-barrel lifting costs, and high investment needs to replenish reserves and to maintain production. All of this, despite Pemex's efforts to stabilize oil production and refinance debt.

"Pemex has weak liquidity and is highly dependent on government support". As of December 31, 2019, Pemex had MXN$60.5 billion of cash and around MXN$178 billion in unused committed revolving credit facilities to address over MXN$368 billion (USD$20 billion) in debt maturities in 2020-21 besides negative free cash flow. Today, Pemex loss the investment grade, trading from now on as a high-yield. Despite this adverse scenario and considering the performance of the company's bonds and CDS in last days, we consider that the market impact will be limited as investors anticipated to this rating action.

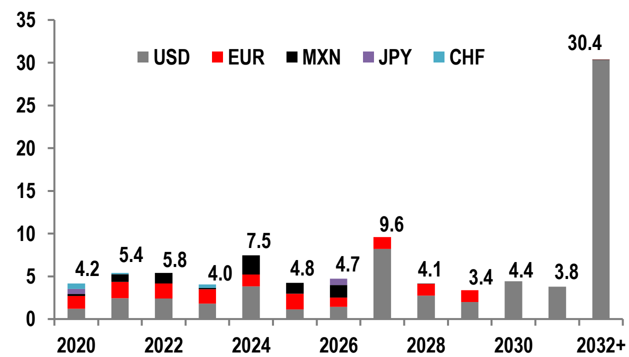
10-year USD-denominated bonds



Source: Banorte with data from Bloomberg

Pemex Debt Maturity Profile

USD Billion



Source: Banorte with data from Bloomberg

Mexico keeps 'investment grade'. Investment funds consider that a debt instrument is 'investment grade' (IG) if at least two out the three global credit rating companies rate it above the IG threshold ('BB+' for *Fitch* and *S&PGlobal*, and 'Ba1' for Moody's). Fortunately, Mexico's sovereign debt is still considered IG, despite the series of recent downgrade activity. Nevertheless, as we mentioned throughout this note, Pemex debt lost IG. We highlight that the finance team at Pemex did a great job improving the company's debt profile, as well as along with the operational areas, boosted production so it could increase for the very first time since year 2005. However, COVID-19 pandemic and the crude oil price war between the Russian Federation and the Kingdom of Saudi Arabia did not allow Pemex to keep IG, at least in the short run. It is our take that it is time for reopening the 'farmouts' -among other actions-, so Pemex and private-sector companies could mutually benefit from the knowledge and technology, while being able to share the risk of this highly uncertain drilling and extraction operations. This would significantly help Pemex as well as the health of Mexico's public finance.

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We, Gabriel Casillas Olvera, Delia Maria Paredes Mier, Alejandro Padilla Santana, Manuel Jiménez Zaldívar, Tania Abdul Massih Jacobo, Katia Celina Goya Ostos, Juan Carlos Alderete Macal, Víctor Hugo Cortes Castro, Marissa Garza Ostos, Miguel Alejandro Calvo Domínguez, Hugo Armando Gómez Solís, Gerardo Daniel Valle Trujillo, José Itzamna Espitia Hernández, Valentín III Mendoza Balderas, Santiago Leal Singer, Francisco José Flores Serrano, Luis Leopoldo López Salinas, Jorge Antonio Izquierdo Lobato, Eridani Ruibal Ortega and Leslie Thalía Orozco Vélez, certify that the points of view expressed in this document are a faithful reflection of our personal opinion on the company (s) or firm (s) within this report, along with its affiliates and/or securities issued. Moreover, we also state that we have not received, nor receive, or will receive compensation other than that of Grupo Financiero Banorte S.A.B. of C.V for the provision of our services.

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HOLD	When the share expected performance is similar to the MEXBOL estimated performance.
SELL	When the share expected performance is lower than the MEXBOL estimated performance.

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GRUPO FINANCIERO BANORTE S.A.B. de C.V.

Research and Strategy			
Gabriel Casillas Olvera	IRO and Chief Economist	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godinez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611
Economic Research and Financial Market Strategy			
Alejandro Padilla Santana	Executive Director of Economic Research and Financial Markets Strategy	alejandro.padilla@banorte.com	(55) 1103 - 4043
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251
Economic Research			
Juan Carlos Alderete Macal, CFA	Director of Economic Research	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Francisco José Flores Serrano	Senior Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Katia Celina Goya Ostos	Senior Economist, Global	katia.goya@banorte.com	(55) 1670 - 1821
Luis Leopoldo López Salinas	Economist, Global	luis.lopez.salinas@banorte.com	(55) 1103 - 4000 x 2707
Market Strategy			
Manuel Jiménez Zaldívar	Director of Market Strategy	manuel.jimenez@banorte.com	(55) 5268 - 1671
Fixed income and FX Strategy			
Santiago Leal Singer	Senior Strategist, Fixed Income and FX	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Strategist, Fixed Income and FX	leslie.orozco.velez@banorte.com	(55) 5268 - 1698
Equity Strategy			
Marissa Garza Ostos	Director of Equity Strategy	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Senior Strategist, Equity	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Senior Strategist, Equity	valentin.mendoza@banorte.com	(55) 1670 - 2250
Víctor Hugo Cortes Castro	Senior Strategist, Technical	victorh.cortes@banorte.com	(55) 1670 - 1800
Jorge Antonio Izquierdo Lobato	Analyst	jorge.izquierdo.lobato@banorte.com	(55) 1670 - 1746
Eridani Ruibal Ortega	Analyst	eridani.ruibal.ortega@banorte.com	(55) 1103 - 4000 x 2755
Corporate Debt			
Tania Abdul Massih Jacobo	Director of Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Senior Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Analyst, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248
Economic Studies			
Delia María Paredes Mier	Executive Director of Economic Studies	delia.paredes@banorte.com	(55) 5268 - 1694
Miguel Alejandro Calvo Domínguez	Senior Analyst, Economic Studies	miguel.calvo@banorte.com	(55) 1670 - 2220
Wholesale Banking			
Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(81) 8319 - 6895
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.ceballos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Corporate Banking	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Commercial Banking	victor.roldan.ferrer@banorte.com	(55) 5004 - 1454