Head of New Ventures: Pablo Medina

M&A
Mexico
8 April 2024

Pemex's evolution: uncovering hidden gems through divestment

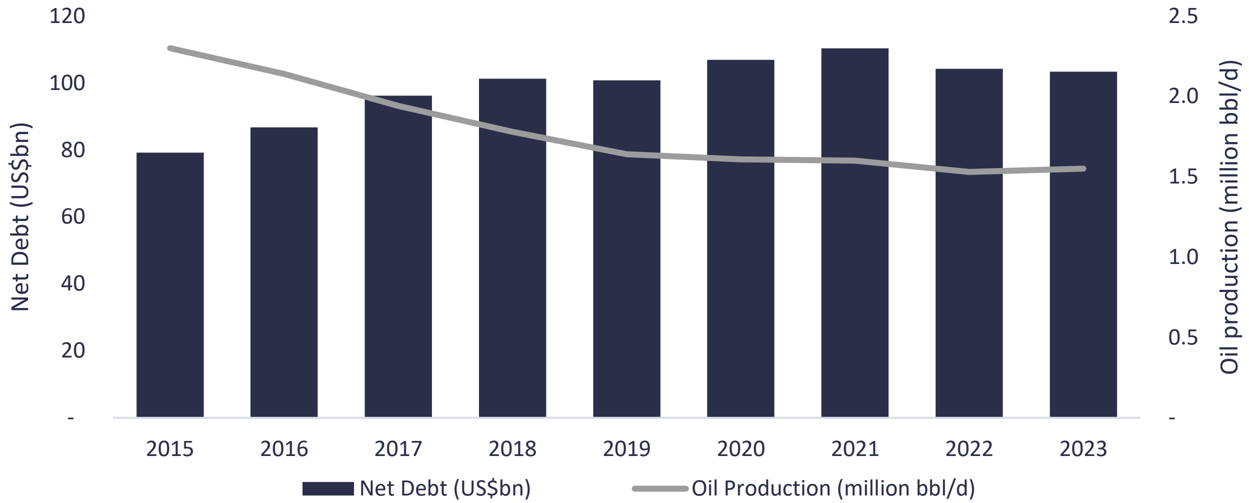
Key takeaways

- **Pemex is the world's most indebted oil and gas company, with a net debt of US$106 billion (end-of-2023), owing over US$8 billion to its service providers.**
- **Our divestment plan proposes that Pemex keeps its top 25 assets, accounting for 85% of its portfolio value, and divests everything else.**
- **By divesting Pemex´s non-core assets, Mexico can obtain up to US$17 billion in asset sales and US$147 billion (NPV10) in increased long-term government revenues.**
- **Value can be unlocked from non-core fields by lowering costs, increasing investment and raising recovery rates. Focused operators can achieve all this, relieving an overstretched Pemex.**
- **The June 2024 Presidential election presents a pivotal chance for change. The bold divestment plan for Pemex could be a significant boon for the incoming administration, offering a clear path to alleviate the company's financial woes and bolster Mexico's economy.**

Pemex's evolution: uncovering hidden gems through divestment

Pemex's portfolio comprises ~350 producing fields, with the Top 25 contributing 76% (2 MMboe/d) of total production. This elite group primarily consists of shallow-water oil/gas fields—such as Ku-Maloob-Zaap, Ayatsil, and Ek-Balam—and significant onshore gas/condensate producers like Quesqui, Tupilco Profundo, and Ixachi. The remainder, each producing below 18,000 boe/d, has seen years of neglect.

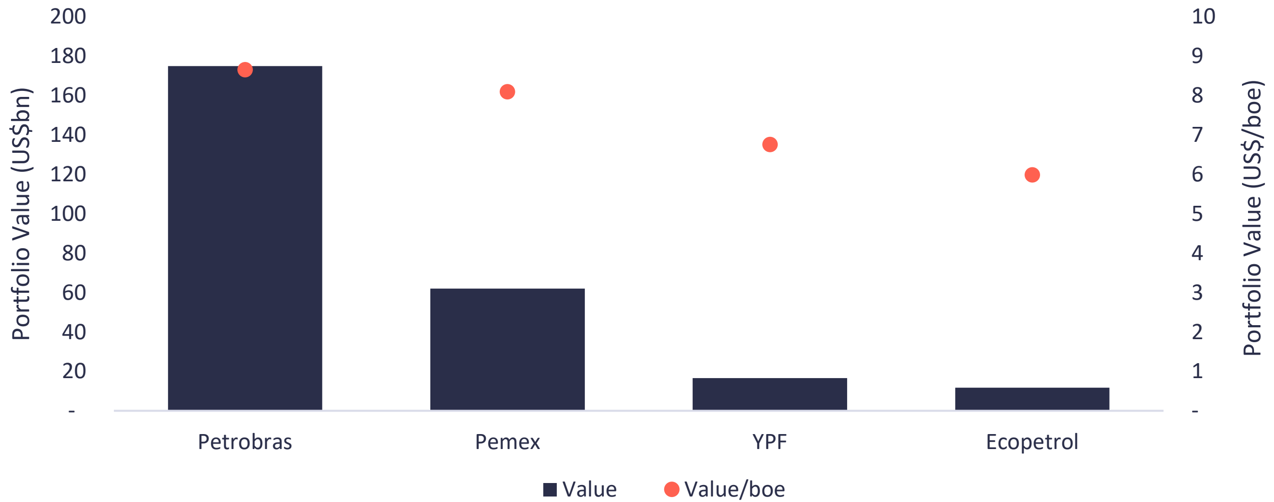
Pemex – net debt vs. oil production



Source: Welligence Energy Analytics

Facing severe financial pressure, Pemex's net debt has soared to US$106 billion (as of end-2023), positioning it as the world's most indebted oil and gas company and burdening Mexico's economy. Pemex owes US$8 billion to its suppliers, creating significant problems. Contrary to the belief that a stringent fiscal regime is to blame, Pemex's government profit share (DUC) has significantly decreased from 70% in 2015 to 35% in 2024, well below the 70-86% offered by IOCs during the post-reform licensing rounds. Compared regionally, Pemex even has the second highest portfolio value per boe among Latin American NOCs. The problem is not taxes.

Latin America NOCs – portfolio value



Source: Welligence Energy Analytics

A profound transformation is key for Pemex. Mirroring Petrobras's strategy—once the most indebted in the sector—which divested US$23 billion in assets since 2018, we believe Pemex should kick off a comprehensive portfolio high-grading. The next presidential election in June 2024 presents a golden opportunity for transformation.

Pemex's portfolio potential: harnessing the value of non-core assets

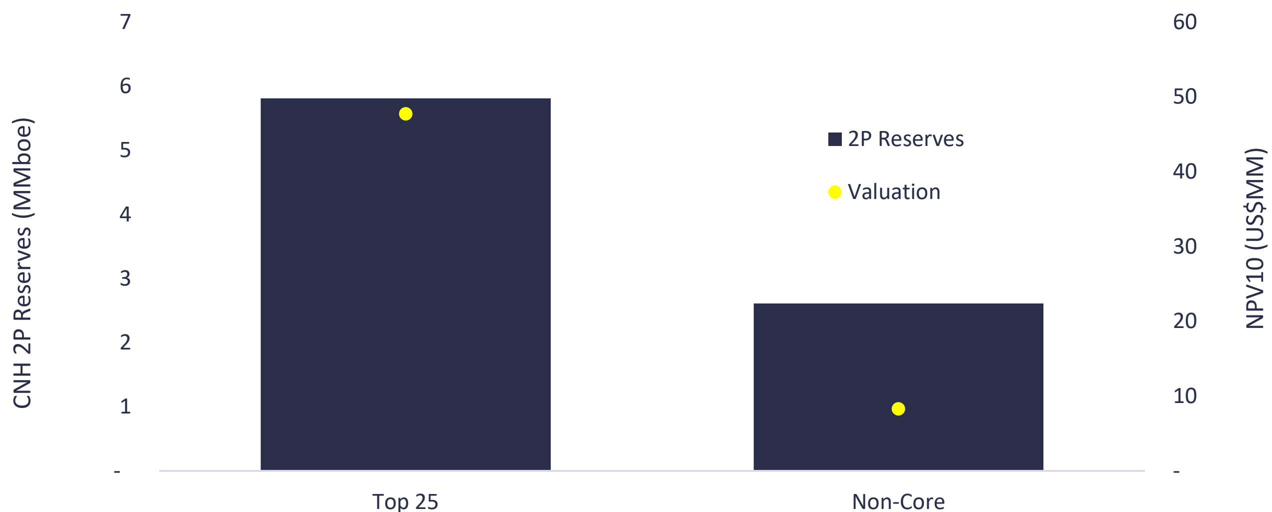
Pemex's portfolio has hundreds of fields, but only a few dozen move the needle. The company's top 25 assets account for 78% of production – these should be retained, while the remainder should be divested, including most exploration acreage. IOCs have drilled 50+ offshore exploration and appraisal wells at a cost of ~US$3 billion in the last five years – the government should let them do more, risking their capital, not Pemex's.

Under our long-term US$70 Brent price scenario, we value Pemex's upstream portfolio at US$56 billion (NPV10), with the top 25 assets comprising 85%. These assets are Pemex's backbone.

The non-core portfolio is diverse, so to aid with our analysis, we have categorized it into four main field groups: onshore oil/gas, onshore non-associated gas, the Chicontepec tight oil play, and shallow-water oil/gas. Chicontepec is excluded from this plan due to its unique challenges.

The analysis reveals that the non-core portfolio, though only representing 15% of Pemex's value, holds 25% of the CNH 2P reserves, totaling 2.6 Bnboe. Yet, Welligence models half in our base case (1.3 Bnboe) due to the limited investment and, thus, drilling. While our view is intentionally conservative given Pemex's financial constraints, there is clear untapped potential that could be realized by private sector investment. If required politically, Pemex could even partner as a non-operator, but we believe the required investment and Pemex's constraints would lead to inefficiencies.

Value and reserves per portfolio



Source: Welligence Energy Analytics, CNH

Limited opportunities for IOCs in Mexico

The market for mature assets post-Energy Reform has seen limited activity, except for deals such as Wintershall Dea's Ogarrio and Cheiron's Cardenas-Mora fields and service contract migrations like Perenco's Santuario and Diavaz's Ebano fields. Beyond these, the onshore fields offered in the licensing rounds were minor, with Pemex retaining the huge majority.

Pemex has not divested or relinquished any of its producing shallow-water fields. Instead, Round One offered only three undeveloped shallow-water fields—Eni's Amoca-Mizton-Tecoalli, Hokchi Energy's Hokchi, and LUKOIL's Ichalkil-Pokoch.

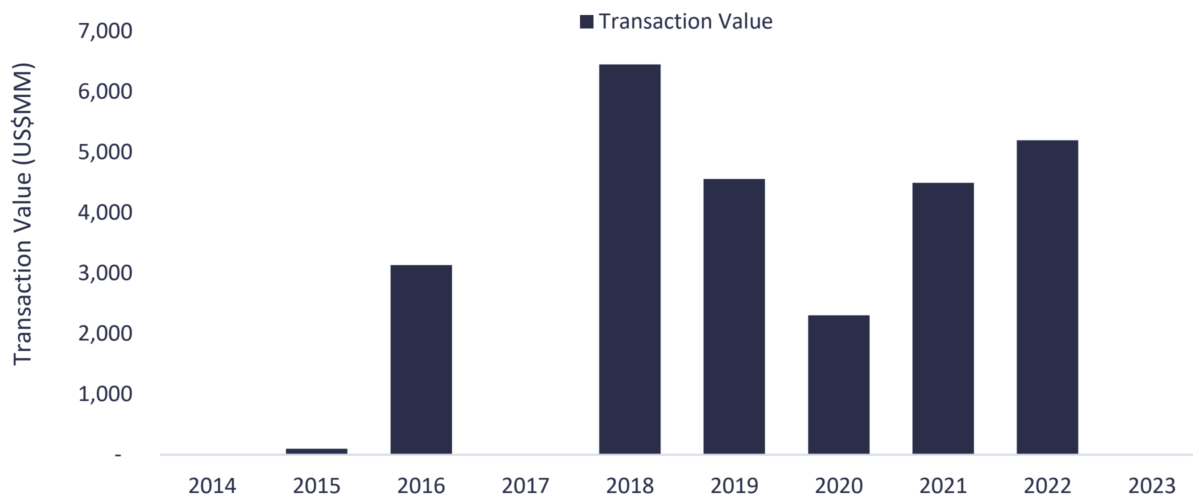
This approach has restricted growth opportunities in Mexico to exploration and select M&A deals since the AMLO administration stopped all licensing rounds.

Latin American players are looking elsewhere for growth

There is an opportunity for Mexico. The Latin American market demonstrates a strong appetite for M&A, driven by high commodity prices and regional dynamics. Colombia has halted its licensing rounds due to political decisions. Peru and Ecuador continue to battle their perennial above-ground risks, while Argentina's economic challenges deter most entrants to its upstream sector. Guyana and Suriname have been big-player exploration playgrounds, but to date, only ExxonMobil's Stabroek acreage has yielded commercial success.

In Brazil, significant activity, both onshore and offshore, was spurred by Petrobras' divestment program, which reduced its portfolio from 255 to 98 assets. Noteworthy transactions include Carmo Energy's acquisition of the onshore Carmopolis Cluster for US$1.1 billion and PetroRio's US$2.2 billion acquisition of Albacora Leste in the deep waters. However, these divestments were largely complete when the Lula administration came to power in 2023, terminating the effort. This redirected investors' focus to other regions such as Norway, Southeast Asia, US GoM, and West Africa.

Petrobras divestment program



Source: Welligence Energy Analytics

Amidst this backdrop, Mexico has a golden opportunity to establish a mature asset market that could attract significant investment if done correctly. Success would also help alleviate Pemex´s troubled financials and remove drag from its portfolio. Others are already following Petrobras' portfolio high-grading. In Argentina, under the Milei administration, YPF is expected to divest 50+ mature onshore fields, although the country's economic situation might limit interest to incumbents.

What's in it for the government? Massive upside!

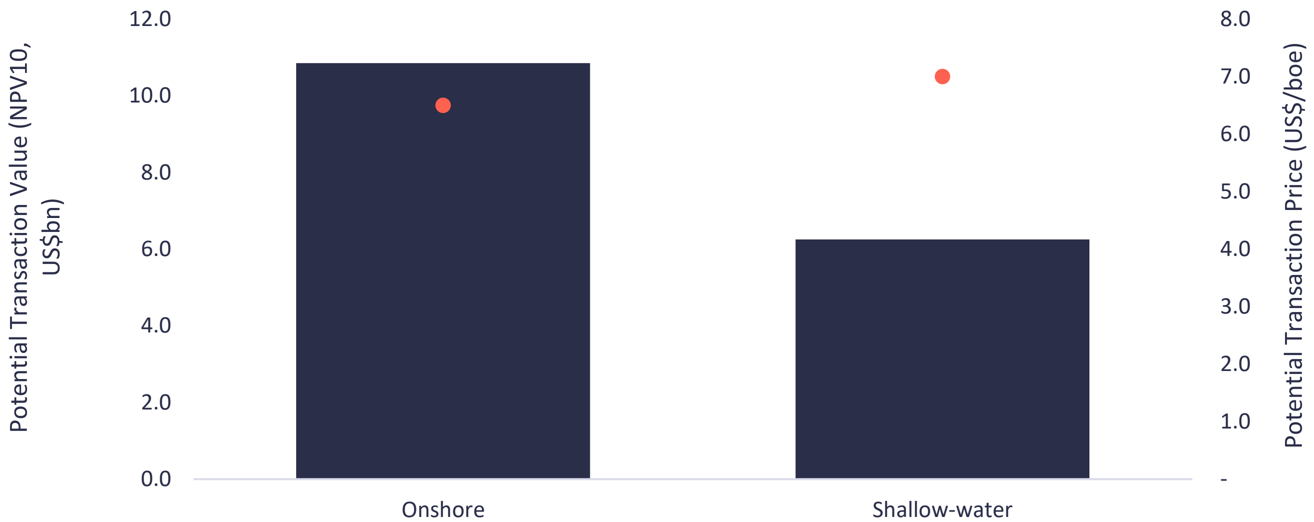
A comprehensive divestment program offers the government multiple ways to maximize value while providing attractive investment opportunities:

1. <u>A hot M&A market could lead to high levels of interest</u>

   Welligence's extensive M&A database provides insights into comparable asset valuations, such as Perenco's acquisition of Petrofac's Mexico onshore assets at ~US$6.50/boe. Others include Wintershall Dea's acquisition of a 37% stake in the producing Hokchi field, for which no consideration was released, but we estimate at ~US$7.00/boe. Internationally, this sits well within the current range of US$7-14 NPV/boe paid in recent deals for offshore producing assets.

   Using these benchmarks, the government could realize over US$17 billion from the divestment program.

Potential transaction value of non-core assets



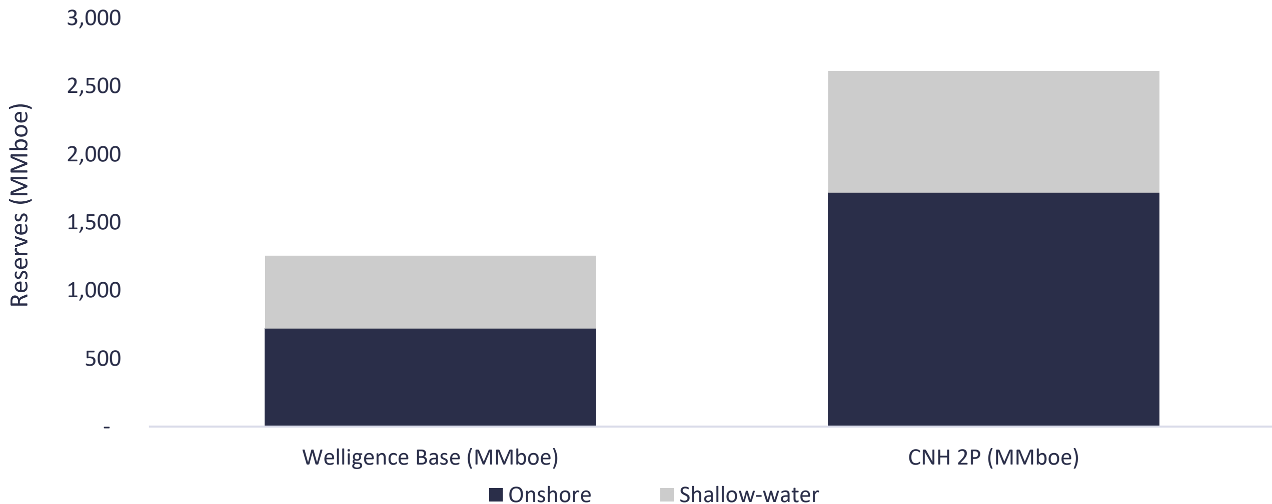
Source: Welligence Energy Analytics

2. <u>The neglected non-core portfolio 2P reserves are out of reach for Pemex</u>

   Welligence estimates that the non-core portfolio's reserves are 1.3 Bnboe, half of the CNH-reported 2P reserves. This gap shows these assets are underexploited by Pemex due to financial and technical challenges, limiting additional activity.

   Using Welligence's valuation models, we estimated the additional government revenue generated by fully exploiting these 2P reserves. The upside includes both additional production and US$21 billion (NPV10) in royalties and taxes.

Non-core portfolio reserves



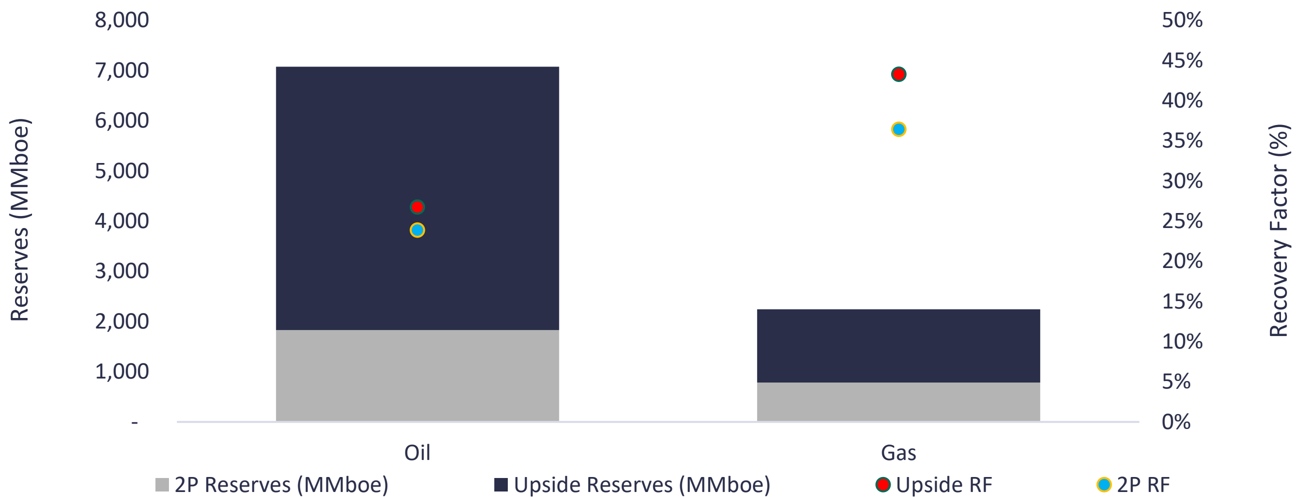
Source: Welligence Energy Analytics

3. <u>The non-core portfolio's low recovery factors offer significant upside</u>

   The non-core portfolio has low recovery factors, not just from a lack of IOR (Improved Oil Recovery) or EOR (Enhanced Oil Recovery) techniques but also due to inefficiencies in primary recovery. Focused new operators could optimize recovery factors, yielding considerable benefits.

Given Mexico's large in-place resources, a conservative increase in recovery factors could yield 6.7 Bnboe in additional reserves. This is almost 3× the current CNH 2P reserves. This upside could generate an additional US$106 billion (NPV10) in long-term government royalties/taxes and create a US$44 billion opportunity for IOCs operating these assets.

Recovery factor upside



Source: Welligence Energy Analytics

4. Pemex's cost base can be massively reduced

   Pemex's high costs are due to structural inefficiencies and the strain of operating hundreds of spread-out fields. Prioritizing the top 25 assets could address these issues, leading to a leaner, more focused company. A deep cut of the bloated 117,000-strong workforce is well worth it, even if it triggers union pushbacks.

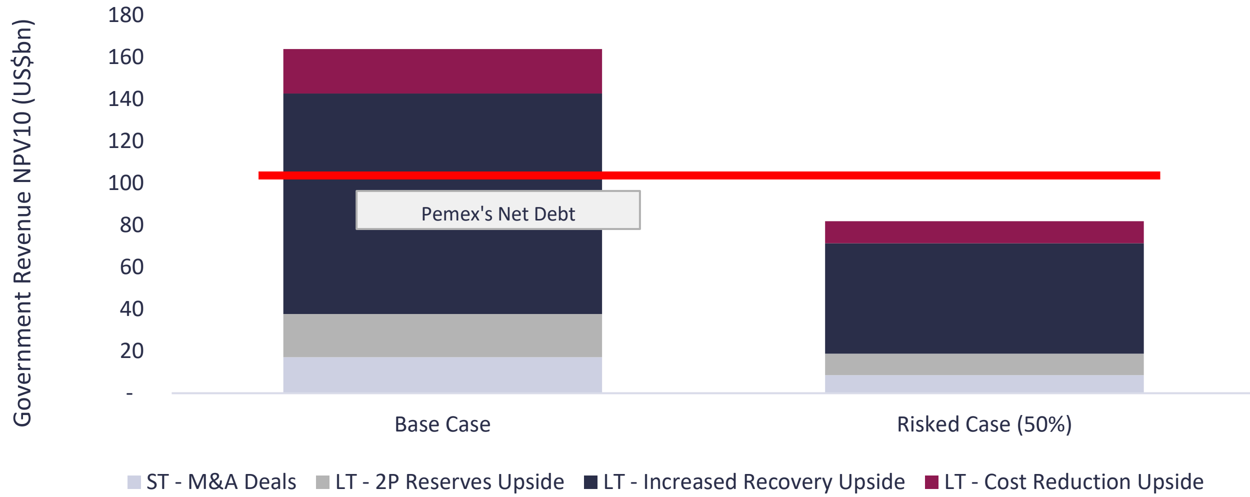
   There is a significant cost disparity among its assets. The non-core portfolio's operational expenses per boe are ~60% higher than those of the top 25. Reducing costs by 50% in the non-core portfolio could boost government revenue in the 2P scenario by US$3.1 billion (NPV10), potentially reaching US$7.2 billion (NPV10) if production meets our upside recovery factor scenario.

   For IOCs, similar cost efficiencies could increase valuations by 15% in shallow-water assets under PSCs and 47% in onshore assets with concessions, unlocking up to US$6 billion (NPV10) in the CNH 2P reserves scenario and as much as US$21 billion (NPV10) in our upside recovery factor scenario.

Now or never: Mexico cannot afford the status quo!

Pemex is in a downward financial spiral, which is dragging Mexico along. A drastic change, such as the divestment of the non-core portfolio, is needed. Implementing the plan could yield up to US$17 billion in asset deals and US$147 billion in long-term tax revenues (NPV10), compared to Pemex's net debt of US$106 billion. This analysis envisions an ideal scenario, but even if only a portion of it materializes, it still offers a significant value opportunity for Mexico and Pemex.

Potential government revenue (NPV10)



Source: Welligence Energy Analytics

To counter market and execution risks, adopting Petrobras' asset packaging could incentivize transactions. Assuming a fixed fiscal regime similar to that in the farmouts, with lump sum payments as the only variable, can enhance the appeal of these deals. Furthermore, involving investment banks to manage transactions, mirroring Brazil's strategy, could speed up the process and address previous concerns about the CNH's excessive involvement.

Managing the pre-existing abandonment liabilities of these fields is crucial to prevent decommissioning costs from discouraging IOCs. A committed new operator can prolong their economic life while supporting Mexico's finances.

Politically, though divestment appears bold, it is essential to address Pemex's liquidity crisis and Mexico's economic stability. The next president, regardless of their party, would benefit from a divestment that boosts Pemex's liquidity and efficiency, revitalizing the energy sector.

The key is pragmatic action over ideological opposition. Hesitation risks Pemex's solvency and Mexico's credit standing. Adopting the proposed divestment signifies a crucial step in revitalizing Mexico's energy strategy and economic health. Now is the moment for decisive, practical measures to ensure the energy sector's prosperity.

Join us on Social Media

Contact Us

We are ready to help. For questions or more information on Welligence products, please contact us at news@welligence.com.