Case Study

Fixed Income, Q3 2021

Pemex

Mounting ESG concerns and lack of response to engagement leads to divestment from our credit strategies as we view ESG risks as too high. However, our stewardship efforts will continue.

Pemex, one of the world's largest oil producers, is 100% owned by the Mexican government. With $98bn borrowed in the international capital market, it is the largest global high yield issuer, accounting for close to 2% of the index. As a result, every global credit investor is impelled to have a view on the name.

Until recently, we were investors in the company and, although we were aware of its credit challenges, we drew comfort from the continuous government support that the company received. We were also aware of the company's troubled ESG track record. Nonetheless, given our successful stewardship efforts with previous management teams, we were hopeful that we could continue to drive ESG improvements with the new team in place as well. However, lack of progress and response from the company – despite our multiple efforts – and concerns over rising ESG risks have led to our decision that ESG risks for this company are currently too high. As a result, we have divested of Pemex across our strategies. In this note, we outline why we have grown increasingly concerned about the company's ESG performance and provide background on our engagement efforts.

Pemex credit profile remains challenged, but government support continues

When Mexican president Andrés Manuel López Obrador (AMLO) appointed a new management team to Pemex in December 2018, the company made good strides in stabilising production and replacing reserves. The company also improved performance in its refinery business as evidenced by increased production of petroleum products and positive refining margins in the first half of the year. To support the company, the government has been generous with various forms of aid, including reducing the profit sharing duty, additional tax breaks and equity contributions towards funding building the Das Bocas refinery. Despite this, the company's credit profile continues to be challenged as reflected in:

- net leverage at 7.4x as of 2Q21, though a decline compared to 10.4x in 1Q21;
- negative free cash flow of $8b in first half of 2021 (or -$2.3b after government aid) with improvement in EBITDA as commodity prices rebounded being offset by continuous high interest, tax and working capital payments;
- despite the company's commitment to zero-net indebtedness, rising debt levels ($115bn as of 2Q21, up from $105bn as of 4Q19) due to depreciation of the peso and increase in the company's usage of short-term financing.

Weakness in the company's credit profile is also reflected in Moody's recent downgrade of the company's standalone rating to Caa3 (from Caa2) based on liquidity and rising business risk. However, the likelihood of government support to the company results in a six-notch uplift of the rating to Ba3 with negative outlook. In the first quarter earnings call, management noted that ~ $6.5bn of upcoming debt maturities over the next 12 months will be paid with support from Mexico's Ministry of Finance, suggesting that government aid likely will continue, providing bondholders some comfort.

Governance

The absence of mechanisms to prevent state intervention is detrimental to the company's credit profile and a material concern. Ideally, for state-controlled companies, there should be mechanisms in place to signal strict separation between sovereign and the company. In Norway's Equinor, for example, the government's and the company's roles are strictly defined. In Brazil's Petrobras, the board has a core of at least 40% independent directors and government officials cannot be board members, which enables it to more effectively fulfil its critical function of overseeing management. At Pemex, however, the board is populated by government officials, including the chair, who is the energy minister. Although there is a core of independent directors, poor disclosure and lack of direct engagement with investors make it difficult to assess genuine independence. All of these factors elevate the risk of the board being unable to act as a counterbalance to management and government interference.

Most importantly, over the last few years, Pemex has been used as a tool to drive the government's energy agenda of becoming self-sufficient in refined products by building a new refinery. The undertaking of a new refinery is questionable for a number of reasons: 1) low economic returns given ample refining capacity globally, 2) reduced crude exports will lead to reduced US dollar revenue generation, crucial to serve the company's ~ $98b foreign debt stack, increasing its credit risk, 3) risk of cost overruns and delays, given the company's limited knowledge of refinery building.

Number of accidents has been on the rise, leading to operational disruptions and injuries

The number of workplace incidents at Pemex was already high relative to its peers (16 major refinery accidents since AMLO took office), however, over the last few months the number of accidents has accelerated:

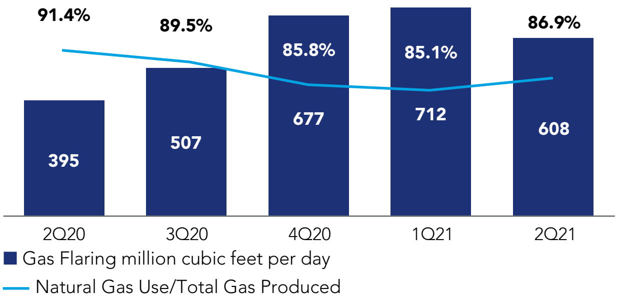
- April 7, 2021 – a fire occurred in the transfer pump house of the General Lazaro Cardenas del Rio refinery located in Minatitlan, Verakruz. Pemex personnel extinguished the fire, but 12 people sustained minor injuries.
- April 20, 2021 – a fire occurred in the pipeline that supplies natural gas from the Cenagas to the company's and private work centres, around the Pajaritos Petrochemical complex. The fire was immediately controlled by firefighters.
- July 2, 2021 – a fire erupted on the surface of the Gulf of Mexico, a short distance from company's platform in the area of Pemex's largest production field – Ku Maloob Zaap (images of the fire went viral on social media). The fire was believed to have been caused by a gas leak from an underwater pipeline combined with electrical storms. It took five hours to put out the fire and while no injuries were reported, the fact that fire erupted close to the company's largest production field is of particular concern.

The increasing number of incidents caused us to question the management's ability to conduct the company's operations in a safe way, putting its workers and the environment at risk. This may also result in lost revenues and cash flows due to operational disruptions and repair costs.

Gas flaring and emissions going up

The company's gas flaring has been on the rise, up 54% in 2Q21, year on year. The increase in flaring appears to be driven by a number of factors, including 1) increased production in the Ku-Maloob-Zaab and Cantarell assets 2) the lack of infrastructure for gas conditioning in the Ixachi field 3) failures in the nitrogen elimination plant 4) maintenance and failures of compression equipment and 5) rejections from gas processing centres. It is concerning that a lot of the flaring is caused by seeming mismanagement of Pemex operations, since failures of equipment or processing plans are identified as key reasons for higher flaring. The company's sulfur oxide equivalent missions also increased 37% year on year in 2Q21, the increase being driven by 1) the ramp up of refining activities 2) higher gas venting in gas processing centres due to failures of compressions systems 3) shutdown of sulfur plants in gas processing complexes and refineries for corrective maintenance.

Pemex's natural gas use



Source: Pemex - Company Financials.

Response to Covid-19 appears to have been inadequate, especially on the offshore platforms

Since the beginning of the pandemic, there have been numerous reports of Pemex providing inadequate Covid-19 protection to its workforce. These include poor conditions on the offshore platforms (such as doctors instructing sick patients to return to their bunks in shared rooms, and sick workers continuing to work). Last April, the company said it had implemented an emergency plan to fight Covid-19 on offshore platforms, but workers have said the company was slow to sanitise working and living spaces, reduce the number of personnel, evacuate sick employees and provide testing for people before boarding[1]. In August 2020, a floating Pemex oil processing and storage facility off the coast of Campeche State halted operations for six days because of a Covid-19 outbreak.

Our engagement efforts drew little response from the company

Our engagement efforts with Pemex began in 2017 when the previous management team made it clear that it understood and was committed to improving the company's ESG practices (see note). With the change of administration in Mexico and a newly appointed management team at Pemex, our efforts to engage with the company on crucial ESG factors proved to be more difficult. We have been trying to engage with the company not only on behalf of The International Business of Federated Hermes but as part of a broader investor coalition under Climate Action 100+ (an organisation that aims to ensure that the largest corporate greenhouse gas emitters take necessary action on climate change).

Our recent engagement activity is as follows:

- *October 2020 – call with Pemex's environmental, planning and investor relations teams to introduce Climate Action 100+*. We emphasised the importance of long-term sustainability issues to bondholders, highlighting three main expectations: 1) governance and board oversight of climate change 2) action and targets to reduce carbon emissions in line with the Paris Agreement and implementation of Taskforce on Climate-related Financial Disclosures (TCFD) recommendations 3) fully embedding climate change considerations into the strategy. The company said that the new business plan for 2021-2025 will be published shortly and the new strategic planning cycle was underway. We agreed to discuss the progress

[1] https://www.bloomberg.com/news/features/2020-09-10/oil-producer-pemex-has-the-most-covid-19-deaths-of-any-company-in-the-world.

on the climate change strategy after the publication of the business plan for 2021-2025. Disappointingly, our letter (introducing the Climate Action 100+ initiative) was not delivered to the chair and the other board members. We reiterated that we expect to engage directly with the board to provide our input and assess the board oversight of climate change.

- *January 2021 – call with the CFO.* In a call with the CFO, we highlighted that Pemex is lagging behind its peers in climate change strategy and asked for an ambitious carbon emissions reduction target. The company acknowledged that progress in the climate change strategy has been slow due to the political environment in Mexico. However, the CFO sought to assure us that the company was aware of the importance of climate change and that the new business plan will bring more clarity, including carbon emissions reduction targets.

The company published its highly anticipated business plan in March 2021. Unfortunately, the business plan was published in Spanish only, despite the fact that the company relies on English-speaking investors to fund $98b of its debt. More importantly, the business plan contained very little about the company's efforts to position itself for a lower carbon world and its carbon emission reduction targets were, in our view, minimal and disconnected from a wider climate change strategy.

Divestment and continued engagement

Rising ESG risks and lack of responsiveness from the company lead to divestment. However, our engagement efforts continue. We currently deem Pemex's ESG risks to be too high on account of a number of ESG issues including weak governance, an increasing number of incidents, rising emissions, inadequate response to Covid-19 and a lack of response to our engagement efforts. As a result, we recently downgraded the company's ESG score to 5, which suggests that its ESG policies and behaviours are materially impacting its cash flows and credit profile in a negative way, requiring us to manage out of our positions.

However, given our aim to drive sustainable wealth creation, we will continue engagement with the company as we believe in the positive impact of stewardship in the long term. In addition, if we get results from stewardship and we sense that management is genuinely committed to driving positive change, we can reconsider our currently very negative view on the company. In July 2021, we had a call with a senior finance official in the Mexican Ministry of Finance to raise awareness of how serious investors are about the company's ESG performance. The outcomes of this call were as follows:

- *July 2021 – call with Mexican Ministry of Finance official.* We discussed the lack of progress in the engagement with Pemex and agreed on a plan of action. We explained how ESG factors are being integrated in investment processes, which limits the ability of many investors to hold Pemex's bonds, given the company's poor track record on climate change strategy and action, labour safety and compliance. We also outlined how we have been trying to engage with Pemex's senior management and board without success. The Ministry of Finance official offered to organise a call with Pemex's CFO and asked to be involved in the engagement. We were encouraged by the positive response.

Risk profile

- Past performance is not a reliable guide to future performance. The value of investments and income may go down as well as up and you may not get back the original amount invested.
- Where the Fund invests in debt instruments (such as bonds) there is a risk that the entity who issues the contract will not be able to repay the debt or to pay the interest on the debt. If this happens then the value of the Fund may vary sharply in value or result in loss. Also, the value of the debt instrument may go up or down with changing interest rates.
- The performance of the Fund will have some dependence on the economic environment of emerging markets which may negatively affect the value of the fund.
- The Fund makes extensive use of Financial Derivative Instruments ('FDIs'), the value of which depends on the performance of an underlying asset. Small changes in the price of that asset may cause larger changes in the value of the FDIs, increasing either potential gain or loss. FDIs can be used to alter the exposure to underlying Investments. Depending on how they are used, FDIs may increase or decrease the overall volatility of the Fund and carry the risk of substantial loss in market conditions which are not expected by the Investment Manager at the time the FDIs are entered into.
- The use of leverage may result in large fluctuations in the net asset value of the Fund, amplifying both gains and losses.
- For more information on risks please refer to the Key Investor Information Document and Prospectus.

Audra Delport
Head of Corporate Credit Research

Jaime Gornsztejn
Engagement Professional

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