April 15, 2020

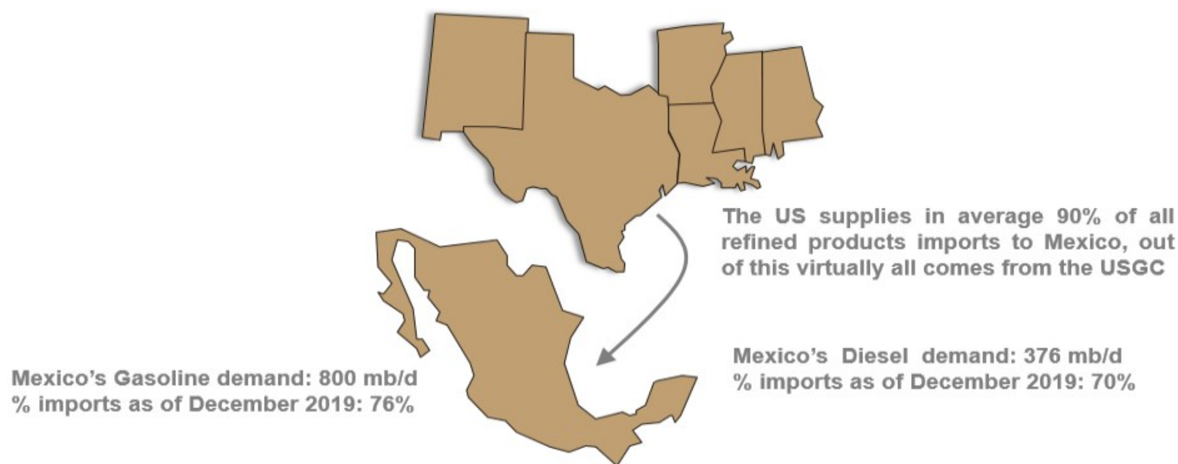
Implications of COVID-19 in the Mexican Market and Impact on US Refiners

Why This Analysis is Important for US Refiners

The Mexican refined products market is of paramount importance for US refiners, who cover over 90% of Mexico's import needs. The USGC is particularly advantaged for exporting to Mexico thanks to its refining capacity and logistics nearby the Veracruz State, which is the prime location for importing refining products into Mexico.

Just prior to the COVID 19 crisis Mexico was importing 75% of its gasoline demand, and 70% of its diesel needs. The main reason behind this import dependency is Mexico's low refining utilization rate, of about 40% for December 2019. The most recent information indicates that the domestic refinery utilization has decreased yet again, so the utilization rate would be hovering the 25% by February-March.

Out of all refined products imports into Mexico the USGC represents in average around 90% of all the volume, so any disruption in the Mexican supply chain, or a change in the business regulatory environment can have significant implications for refiners in PADD III.



The main driver behind Mexico's low refinery utilization rate is the lack of sweet crude that stems from the natural decline of their traditional crude production sites, without the necessary exploration work to replace them. Also, an structural lack of budget to the Pemex Refining subsidiary over the last ten years has created technical bottlenecks as well as a spate of unplanned shutdowns that have kept utilization low altogether.

 © 2018 Stratas Advisors. 1616 South Voss Road Suite 675 | Houston, TX 77057 | United States | +1.713.260.6426 | stratasadvisors.com

Mexico was Facing Severe Challenges Before COVID-19

Besides the challenges related to domestic refining production and lack of budget, Mexico was already facing severe challenges prior to the COVID-19 crisis. Mexico's economy was already in recession, as the final economic numbers were disclosed recently. They show three consecutive quarters of negative GDP change.

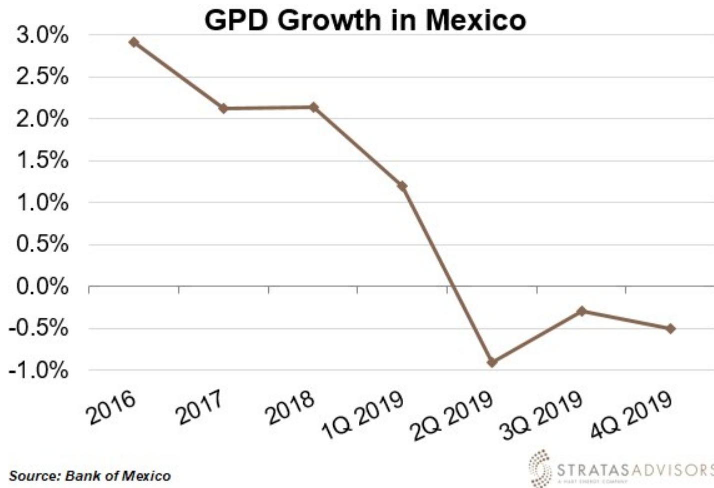
The Mexican economy slowed down severely during 2019 mainly due to the public spending policy and economic decisions implemented by President Andres Manuel Lopez Obrador (AMLO). His economic plan can be summarized easily, as it focused in gathering funds to complete three large key projects he wants to finish during his period: a new international airport, a new refinery and a new high-speed train in the south of Mexico.

Due to this focus, and in order to avoid additional international debt, AMLO's directive was to slash budgets of all other State agencies in Mexico, in order to gather the necessary funds to make these three projects possible. The unintended consequence of this policy was that, by slashing budget that is typically oriented to highways, hospitals, education and additional infrastructure in general, it created a domino effect that negatively impacted private industry and increased unemployment by cutting public spending in general.

Besides this economic strategy, which in itself created a hard break on several public and private investment projects, AMLO's political position is of full support to governmental entities, on top of private investment. Translated into the Energy Sector this means that AMLO's administration has changed the legal and regulatory environment in order to benefit and give a competitive advantage to Pemex, on top of any other private company. Issuance of private permits to import, commercialize products, or invest in new infrastructure have been delayed or denied under this administration, which is a big change compared to the time of President Peña.

With a private industry weary of the new economic and regulatory environment, of how the rules of the game have changed and with uncertainty of the economic path of Mexico, several investment plans have been delayed or canceled, which in itself exacerbated the negative results of the Mexican economy for 2019.

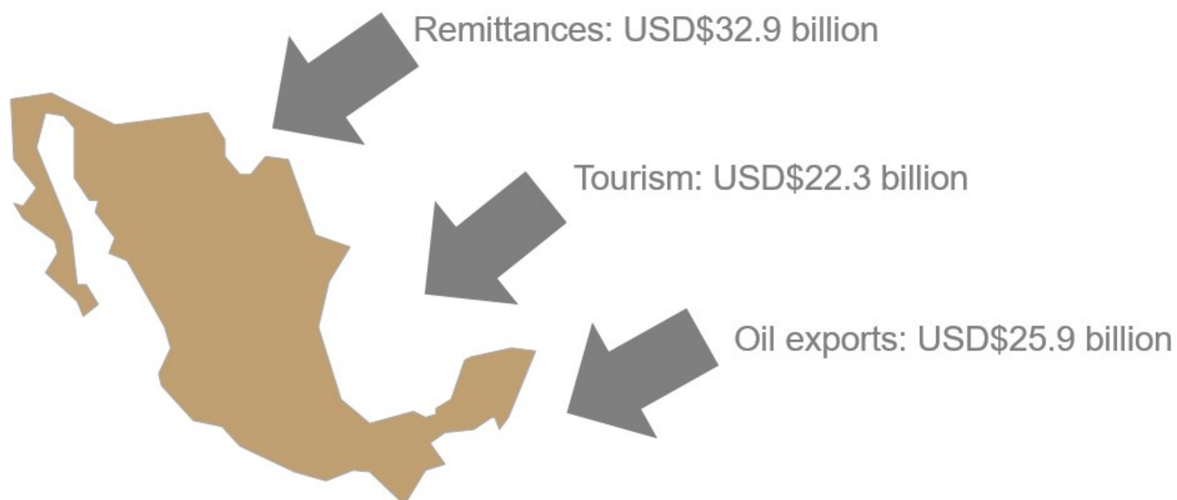
 © 2018 Stratas Advisors. 1616 South Voss Road Suite 675 | Houston, TX 77057 | United States | +1.713.260.6426 | stratasadvisors.com



Potential Implications of COVID-19 in the Mexican Refined Products Market

On a broader context and looking forward, the current path of the COVID-19 crisis has impacted business in the US, Mexico's main commercial partner and the home of most of the Mexicans sending remittances to the country, as well as the main source of tourists.

The direct impact of the crisis will create a perfect storm around Mexican economic indicators, as remittances, tourism and exports in general are severely reduced at the same time crude prices plummet and USGC refinery utilization is poised to decline, thus slashing its need for heavy crude from Mexico.



 © 2018 Stratas Advisors. 1616 South Voss Road Suite 675 | Houston, TX 77057 | United States | +1.713.260.6426 | stratasadvisors.com

This gloomy picture might create political pressure points in AMLO's presidency. And what might be concerning for private energy companies is the way his approach tends to be more on the idealistic, populist side, rather than on the strategic or economic one.

As soon as his presidency kicked off, AMLO changed the regulatory environment that in some instances stopped or canceled progress made during the 2016-2018 energy reform with regard to competition. There are two key regulatory entities in Mexico, in charge of different aspects of oil markets, are:

- The Energy Regulatory Commission (CRE) is in charge of approving and issuing permits for the fuels supply chain, including LPG, jet fuel, gasoline, diesel, among others. This entity laid the path for allowing private companies to own retail stations in Mexico, complete infrastructure investments such as storage terminals, connections to rail infrastructure, among others.
- The National Hydrocarbons Commission (CNH), is in charge of the administration of upstream assets and reserves. This entity organized the crude exploration and production blocks that attracted world interest over the last four years.

These two entities were meant to be independent, autonomous with regards to their technically oriented decisions, and focused on incentivizing private participation. But not only that, the importance of CRE and CNH was because they helped to reduce Pemex power. The Mexican law created for the energy reform specifically mentioned that CRE and CNH would be "asymmetric" with regards to Pemex, which meant that some regulations for Pemex would be unique and not applicable to private entities, in such a way that Pemex was forced to share assets or prohibited to participate in certain part of the opportunities in order to incentivize private investments.

This was valid until 2018. The current administration replaced the leaders of both CRE and CNH, making sure that the new heads would follow the new policy of giving back to Pemex its dominant position in the energy Industry and hurting the interests of private companies in the process.

For instance, the government has again given Pemex the power to unilaterally and arbitrarily define the wholesale pricing it applies to private companies when selling them products for their gas station networks. This was supposed to be liberalized and Pemex was going to be forced to apply pricing formulas linked to international references and specific components, but Pemex has leeway to sell more expensive product to certain competitors in specific regions so it can kept its market share. This neglects the whole purpose of the energy reform and fails to comply with the expectations of the private industry in the retail supply chain.

During the last 18 months international private companies that designed investment plans for either the upstream or downstream sector have been torn with respect to their reaction, or how to adjust their strategies. Some of them actually seem to continue investments as if the regulatory environment of 2016 was still valid, while others understand the writing on the wall and are changing its tactics.

 © 2018 Stratas Advisors. 1616 South Voss Road Suite 675 | Houston, TX 77057 | United States | +1.713.260.6426 | stratasadvisors.com

Another important element to point out is the fact that AMLO's approach to private investment has not been friendly in general, which provides a strong glimpse of what could happen under a more challenging economic environment that could threaten his popularity before his voters. As an example, over the last few days he just announced the unilateral cancellation of one of the biggest private investments in the beer sector in order to please a leftist approach to this investment. The beer exports plant was a $1 billion dollar project and was already halfway under construction. The bottom line is that Mexico's presidency has consistently given preference to idealistic rhetoric messages rather than economic ones.

Over the past few months AMLO's administration has sent several public messages blaming the private industry for gasoline prices, supply bottlenecks or other market conditions that are related to Pemex or global events and not to private companies operating in Mexico. In other words, when it fits politically, he has demonstrated that the private energy companies can serve as escape goats and be blamed for certain situations where they had no participation.

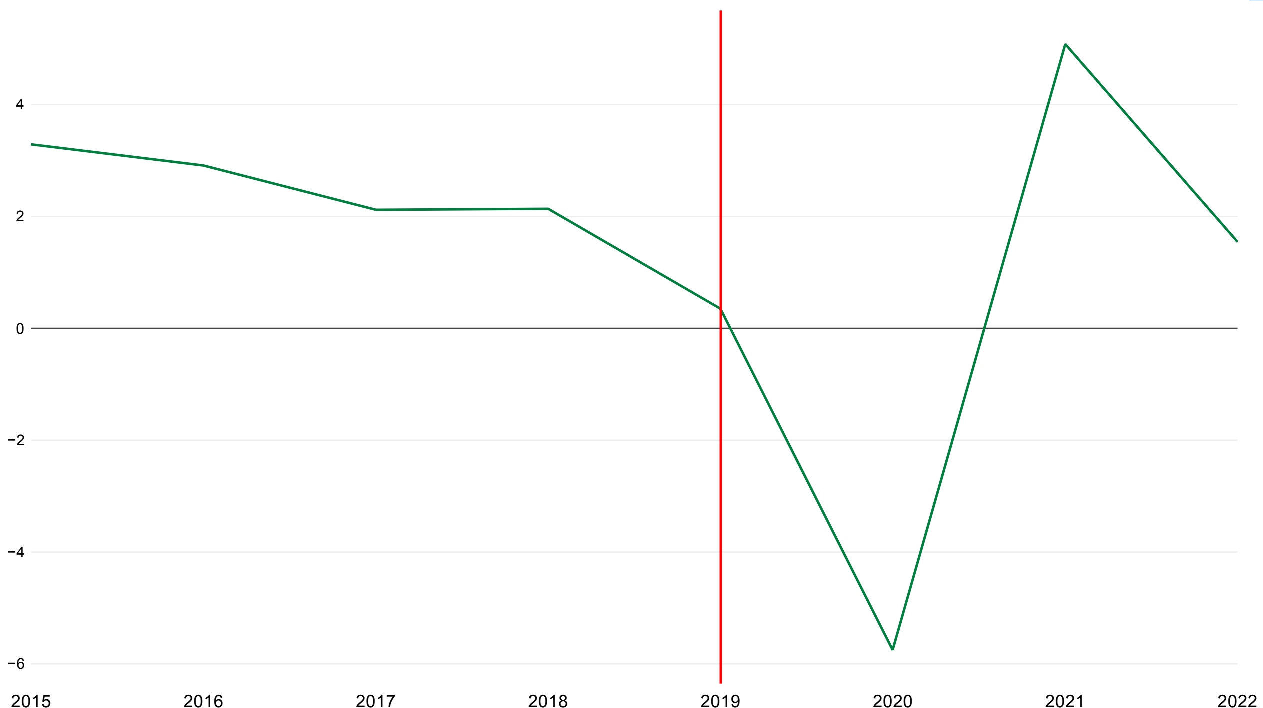
The recent cancellation of the beer plant might scare away additional private investments of all sectors in Mexico, and it might exacerbate the current outlook for an economy that will see domestic taxation revenue fall severely, on top of lower international revenues coming from remittances, tourism and oil exports.

We observe a decline in Mexico's GDP of -5.7% during 2020, with GDP growth of 5.1% in 2021 and 1.5% in 2022.

Economic Driver

Real GDP Growth

Mexico Economic Drivers Outlook



 © 2018 Stratas Advisors. 1616 South Voss Road Suite 675 | Houston, TX 77057 | United States | +1.713.260.6426 | stratasadvisors.com

Real GDP Growth (%)

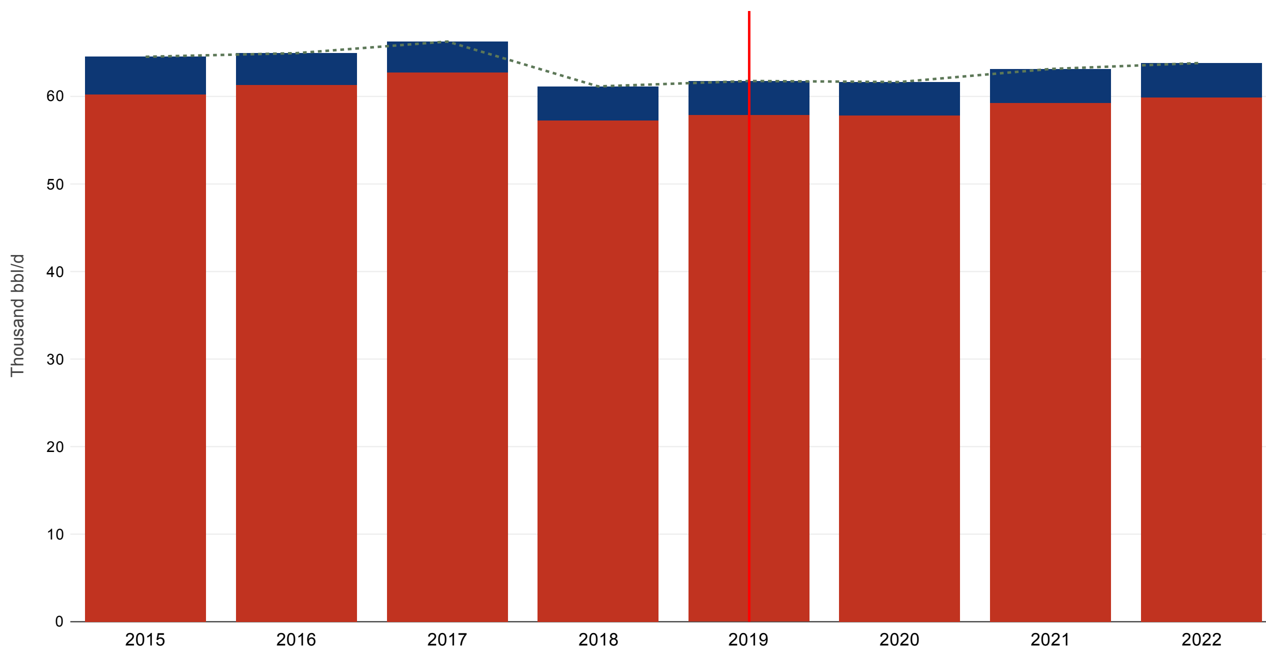
Edit View

Under this context, and given the potential economic evolution of Mexico, we flesh out the implications for Mexico's product demand below.

All Sectors

Agriculture

Mexico Refined Products Demand Growth Outlook by Sector



Gasoil
LPG Total
Total

Edit View

What this means for the refining industry and specifically the US

Any decline in Mexican refined product demand and imports will impact USGC refiners by forcing them to reduce utilization rates or by seeking alternative markets in Latin America or beyond. But the overall decline of fuels demand will limit exports to other market in Latin America.

Companies exporting gasoline or diesel to Mexico on a regular basis will potentially need to reduce utilization rates. Such companies are Shell, ExxonMobil, Citgo, Valero, Marathon and Chevron.

Companies that have completed investment to participate in Mexico's retail sector and its supply chain will find a challenging

 © 2018 Stratas Advisors. 1616 South Voss Road Suite 675 | Houston, TX 77057 | United States | +1.713.260.6426 | stratasadvisors.com

business and competitive environment for the next two years: BP, ExxonMobil, Shell, Valero, Total, Repsol, Cepsa (Red Energy), Kansas City rail, COSTCO, Wallmart, Marathon, Glencore, Trafigura, among others.

Some potential implications:

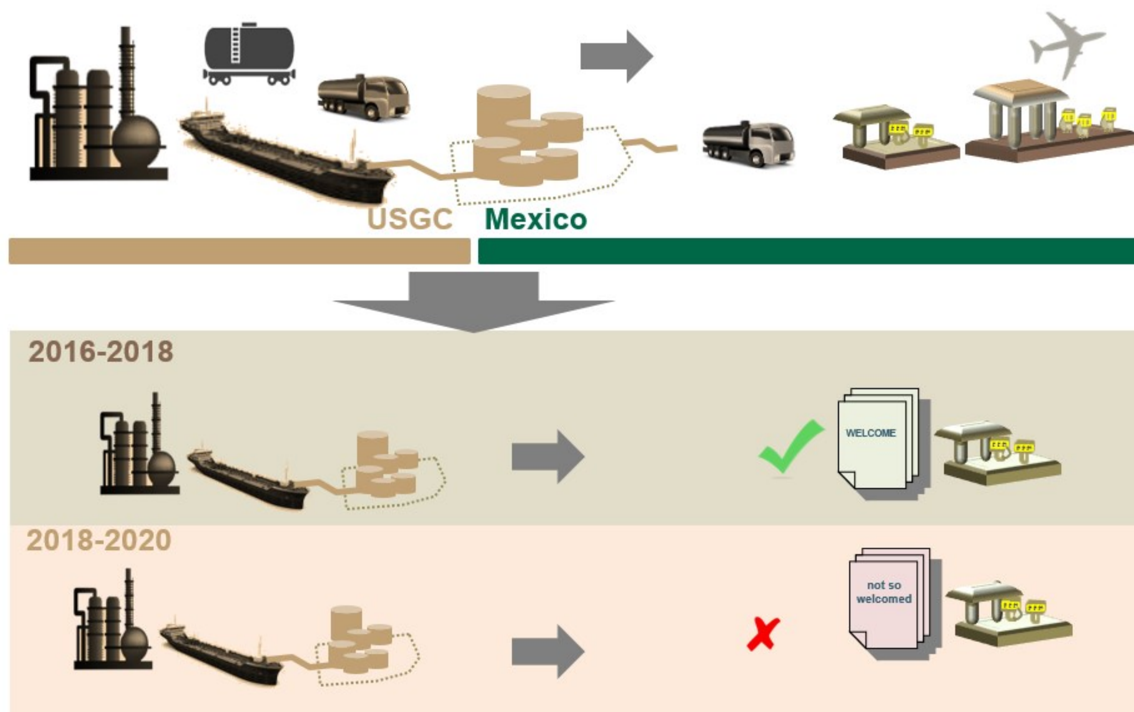
- A negative path of the Mexican economy in the range of a 2%-7% decline in GDP will mean less discretionary spending, less industrial production and trade, less employment, and less infrastructure investments and less transportation. Lower taxation revenues due to lower economic transactions will put additional pressure on the federal government, which so far has not shown signs of a potential cancellation of any of the three large and costly projects they want to complete (new refinery, high speed train, new airport).
- If needed due to political reasons, the Mexican government could resort to implementing price controls back to the retail sector as a way to respond to price variations and social despair under a gloomy economic outlook. This would damage margins for private companies.
- This environment all in all might combine with a populist approach when handling crises, which could create an environment where specific assets could be nationalized from private companies owning storage, transportation or

even retail space. The rationale is simple, and we have seen it applied in the recent past. If the administration cannot control the economy or other factors, it responds with a decision on something that can be controlled in order to send a message of leadership,independent of the economic implications.

- International companies owning fuel terminals, logistics, ports or transportation assets are at risk due to the potential political response to the upcoming economic crisis.

Exploring Mitigation Strategies: Conclusions

Given the potential outcome of the Mexican business environment and approach of the current administration to private companies it will be important for International participants to review their commercial strategies in Mexico to make sure it will be ready for potential outcomes in this market.



How Stratas Advisors Can Help

- Providing forecasts of product flows, prices, and additional fundamental analysis for the Americas, the USGC, and Mexico as a whole or by region.

 © 2018 Stratas Advisors. 1616 South Voss Road Suite 675 | Houston, TX 77057 | United States | +1.713.260.6426 | stratasadvisors.com

- Helping review your current commercial strategies, suggesting actions for mitigating risks.
- Help in understanding the political and economic environment in Mexico, fleshing out stakeholders and decision-makers in the energy sector in order to identify potential alliances or validate investment decisions.
- Complete feasibility studies for new investments, due diligence for divestments or identifying additional markets in Latin America.
- Providing a deep dive of the Mexican fuel sector by region, by market, or by product with consideration of the competitive environment in the country and potential future scenarios.

 © 2018 Stratas Advisors. 1616 South Voss Road Suite 675 | Houston, TX 77057 | United States | +1.713.260.6426 | stratasadvisors.com