Mexico Energy Reform:

What Investors Should Know Now

In May, we posted "Mexico: A Country in Transition". That piece received favorable feedback related specifically to its overview of energy reform taking place in Mexico. At that time, we mentioned that the reform is a journey and not a destination, stating that occasional updates would be necessary to stay plugged into the reform process. Recent events create the need for such an update.

What You Should Know

This month, legislation to implement energy reforms was approved with the spotlight now on implementation. The information that will begin to flow will cover corporate investment and business opportunities and will dwell less on the legislative process. Regardless of how these opportunities present themselves and whether investors are able to take advantage in direct ways, the country of Mexico has pushed the 'go' button on activity that will create long-term, growth-enhancing capabilities. Investment vehicles that could play the benefits of the structure reforms are limited presently, certainly for average investors. However, the Mexican equity market as a whole should benefit, the Peso should see relative strengthening, the trajectory in economic growth will tilt further upward, and societal benefits will also be seen in a country that has already begun to grow its middle-class. Further sovereign credit rating upgrades are likely to be seen, lowering risk premiums and spreads for Mexican bonds. Some have likened Mexico's energy reform to Germany's reunification in terms of economic impact, timing, human capital, and infrastructure. Investors should consider the shot-gun approach to investing in Mexico currently, building exposure broadly across Mexican asset classes while looking for positive knock-on benefits from the ongoing energy reform.

What You Should Watch

However, to stay in front of the curve and to build knowledge and awareness of how the game is evolving, the playbook, and an understanding of the roster of players, a brief overview follows.

***The Players*:**

- SENER. Secretaría de Energía de México. SENER will have the responsibility to select fields and define contracts in the bidding process. The Secretariat's website has video and other material covering recent and future efforts in the reform process.
- SHCP. Secretaría de Hacienda y Crédito Público de México. The Finance Ministry will determine the fiscal regime related to any bidding process.
- CNH. Comisión Nacional de Hidrocarburos. CNH is a technical body dealing with the implementation of Mexico's hydrocarbon policy. It will supervise and regulate

exploration and production which will include opening the bidding process and awarding contract.
- Pemex. The state owned petro company established in 1938 whose mission and business model will change significantly going forward.
- CFE. The state owned electric utility whose dominance is second only to Pemex.

Recent Regulatory Changes
- CFE and Pemex are now "State Productive Companies" with budgetary autonomy as well as economic, administrative, and technological independence. Both are free to partner with private entities through a process managed by SENER.
- CFE can engage in contracts with private companies for the operation of the distribution and transmission network. Private companies will be able to generate electricity for self-consumption.
- SHCP will slowly migrate from collecting taxes on CFE and Pemex to dividends starting in 2014.
- Expropriation of private land will cease. Land owners will get rent or 3% of project earnings.
- The Mexican government will assume a percentage of the Pemex and CFE's pension liabilities.
- CNH will regulate and grant contracts through auctions in which private and state companies can participate.
- SENER will determine the technical conditions of the contracts to be awarded.
- CNH will receive all geological and technical information held currently by Pemex.
- Private companies can distribute gasoline with impendent franchises in 2016 and import gasoline from 2017.

Opportunities for Foreign Investors
- Investors can participate in gasoline commercialization and petroleum gas distribution
- Investors can own up to 49% of companies dedicated to offshore activities in exploration.
- Pipeline construction is possible for foreign investors.

***Future Steps*:**
- Round 0. This is what has been happening over the course of 2014 and was essentially wrapped up this month. Pemex was required to present to SENER the economics and technical aspects of the projects they wanted to keep. Pemex also provided a list of likely private company partnerships. Pemex requested 100% of proved reserves, 83% of proved and probable, and 70% of proved, probable and possible, as well as 31% of prospective resources. SENER effectively ended Round 0 by issuing a resolution in which Pemex was declared to keep certain projects where they are considered a competitive operator and a list of projects where a private partner could improve production or efficiency. Of those projects requested, Pemex has been granted all of the reserves requested which is about 20.6 billion proven barrels of oil equivalent (boe) and 22.1 billion boe of possible reserves. In the Round 0 disclosure only a small fraction of the prospective resources were awarded to Pemex. Hardly any of those already small prospective resources correspond to deep sea and shale gas fields. The lower initial

allocation should be seen as a desire for SENER to be flexible and allocate broadly to private enterprise.

- Round 0.5. This round should take place over the remainder of 2014 and into the Q1'15. It is in this round where farm-outs and JVs will be announced. SENER will auction projects in which Pemex has solicited or been assigned a private partner. This round is unlikely to involve any meaningful transfer of assets as Pemex was granted most of the reserves requested already in Round 0. Projects that will be farmed out will be the deep sea, heavy crude oil in shallow waters and mature fields. There are approximately 10 sites fitting these descriptions that have been identified.

- Round 1.0. This round is likely to play out in H2'15 and will focus most attention on the auction process. SENER, CNH and the Treasury will auction oil and gas projects in which Pemex and private companies can compete head-to-head. The bidding process currently includes 109 blocks in exploration and 60 blocks in production, leading to 28k sqm. Blocks include fields in deep water, extra heavy crude oil and shale resources. Nearly $13B p.a. in additional spending is expected to be invested in the sector over the next six years. Pemex has been spending about $23B p.a. in capex in recent years.

What You Should Remember

In the country of Mexico, Energy Reform will create a significant number of new jobs, lower the cost of energy, increase the manufacturing competitive advantage, ignite a strong infrastructure build-out country wide, bring significant foreign investment, all adding up to increased economic growth to as much as two percentage points higher. It is not just in the energy sector where benefits will be seen, but across the entire economy with important benefits to society as a whole.

Investors will find it difficult to uncover any pure-play investment vehicles focused on energy reform. However, all asset classes should be considered for increased exposure. The Mexican stock market is not cheap currently, but it has always traded at a premium to EM and should not discourage long-term investors from building positions. Mexican sovereign debt should see relative price improvement through spread compression given potential rating-agency upgrades. This would include the quasi-sovereign entities, CFE and Pemex. Pemex is currently rated A3 by Moody's and BBB+ by both S&P and Fitch. All three services have the credit as "Stable". Pemex disclosures all abide by US SEC standards and most of the USD-denominated bonds are eligible for major investment grade indexes. A broader base of investors will be holding the bonds going forward. Corporate credits in Mexico also can see spreads narrow. Much of the fixed-income sector of the market has not seen the improvement yet that can be expected. Exposure to MXN is also a likely beneficiary of energy reform and should be sought through local fixed-income instruments.

Sources: SENER, Credit Suisse, UBS, Morgan Stanley

Disclosures:
This article was written by Brad Jensen, a portfolio manager at Accuvest Global Advisors. The opinions expressed in this report are those of the author. The materials and commentary are strictly informational and should be used for research use only. This brochure should not be construed as advertising material. The opinions expressed are not intended to provide investing or other advice or guidance with respect to the matters addressed in this brochure. All relevant facts, including individual circumstances, need to be considered by the reader to arrive at investment conclusions to comply with matters addressed in this brochure. Past performance is not indicative of future results. Remember that investing involves risks, as the value of your investment will fluctuate over time and you may gain or lose money. Investment risks are born solely by the investor and not by AGA. AGA is an independent investment advisor registered with the SEC. All disclosures, marketing brochures, and supplemental firm sheets are available upon request Charts and information used in this report are sourced from Accuvest Global Advisors, unless otherwise noted above.