

UBS Global I/O®

Oil & Gas

Mexico seeks reform and opens up

Equities

Global
Energy

Input: Mexico to open energy sector to outsiders

Mexico's new President Enrique Peña Nieto this week presented proposals to amend the country's constitution to and reform the energy sector introducing foreign capital and expertise. Mexico's oil and gas industry has been largely closed since nationalisation in 1938. The absence of the benefit of the type of expertise being deployed in the US deepwater and unconventional plays is clear when comparing the two neighbours.

Opportunity is significant. And process is achievable though complex

While we shouldn't downplay the nationalistic issues that attach to the country's oil and gas industry, we see many examples around the world where structures address the simultaneous demands of Mexico to retain control (and possibly title) and the global industry to make competitive returns and recognise barrels. We don't underestimate the work needed to be done both legally and practically, however, which may make the initial rate of progress slower than is hoped for.

Longer term add to Americas role as engine of non-OPEC growth

Although an improving production profile would certainly help with Mexico's internal balances, it wouldn't have a meaningful impact to global balances although it cements the Americas (Canada, US, Brazil) position as the centre of non-OPEC liquids growth. We think current Mexican projections for the timing of any production impact are highly ambitious.

Output: For practical purposes leverage still lies with the Services

We agree there is high potential in Mexico opening up but think that the production effects are likely to significantly lag what could be material new investment. While the E&P/Majors may ultimately benefit, the real near term leverage lies with the oil service industry as capital is deployed and investment in exploration and appraisal kicks off. In the table below we have summarized the most exposed services names to this theme.

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Figure 1: Stocks with key exposure (in order of market cap)

Stock	Rating	M.cap US\$bn	Local Price	Upside to PT	P/E		Rationale
					2013E	2014E	
Schlumberger	Buy	109.1	\$81.99	20%	17.2x	14.6x	Benefits from new access and step up in activity
Halliburton	Buy	43.5	\$46.68	18%	14.5x	11.1x	Benefits from new access and step up in activity
Tenaris	Neutral	27.2	\$46.13	-2%	14.8x	13.0x	Sole supplier of tubular goods in country makes Tenaris a key beneficiary of investment but potential threat of overcapacity in the global seamless pipe market and valuations warrant a Neutral stance.
Weatherford	Neutral	11.3	\$14.74	2%	17.8x	12.6x	Benefits from new access and step up in activity.
Petrofac	Buy	6.6	1,235p	50%	10.3x	8.6x	First mover advantage in production enhancement services contracts with 4 agreements already secured with Pemex.
PGS	Buy	3.0	Nkr80.5	43%	10.1x	6.9x	Expect increased deepwater exploration in Mexico part of Gulf of Mexico, benefitting seismic

Source: UBS

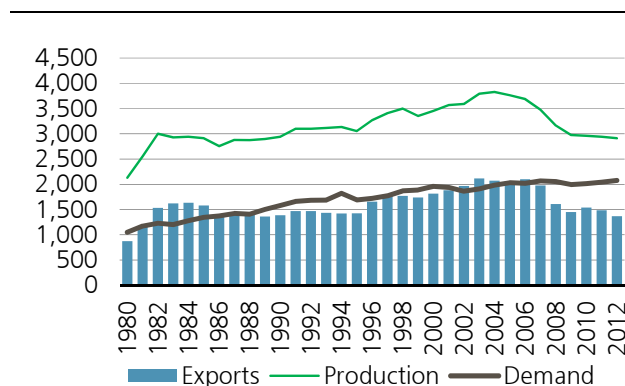
Mexico presents energy reforms bill

This week Mexico's President Enrique Peña Nieto presented a bill to the country's Congress that proposed to open the country's energy sector to private investment. Mexico's upstream oil and gas sector has been effectively closed to foreign investors since 1938 when the then President Lázaro Cárdenas nationalised the sector. The current President's proposal is to change articles 27 and 28 of the Mexican constitution to facilitate the change. Nieto's ruling Institutional Revolutionary Party (PRI), which came to power in December 2012, and the National Action Party (PAN) are believed to have enough votes to secure a 2/3 majority in the Senate and in Congress to pass the reform.

Nieto has stated that the reforms will increase Mexico's oil production to 3Mb/d by 2018 and 3.5Mb/d by 2025 from the current 2.5Mb/d while gas production would increase from 5.8Bcf/day currently to 8Bcf/day by 2018 and 10.4Bcf/day by 2025. The proposals are an attempt to introduce an overdue overhaul to Mexico's energy industry introducing both fresh capital and expertise.

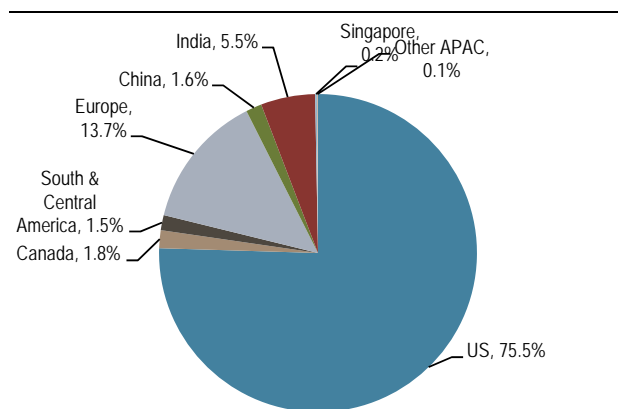
Qualitatively, Mexico's industry is underperforming. Geology does not stop at the border yet it hasn't developed the type of unconventional industry that has flourished north of the border, while the Mexican portion of the deepwater Gulf of Mexico remains largely undeveloped in contrast to the US. This is especially pertinent given the declining oil production which when allied to rising domestic demand has seen oil exports, important for the country's balance of payments, deteriorate. In recent years Mexico has also seen rising LNG imports.

Figure 2: Mexican oil production, consumption and exports



Source: UBS, BP Statistical Review of World Energy

Figure 3: Mexico's oil exports by destination country (2012)



Source: UBS, BP Statistical Review of World Energy

While BP's Statistical Review of World Energy shows falling proved oil reserves, standing at 11.4bn bbls as at end 2012, industry reports suggest potential materially higher – around 115bn bbls of recoverable resource (per the Financial Times) with ~27bn bbls estimated to be in the deepwater GoM. Consequently the upside prize is not trivial.

Media and industry reporting has also focussed on legal title of any reserves. As with many countries the national interest in the country's oil and gas reserves is high in Mexico and deeply political. The current constitution provides for Pemex as the exclusive operator of all fields and that no booking by any 3rd party partner of Pemex (there are some existing limited service contracts in existence) is allowed.

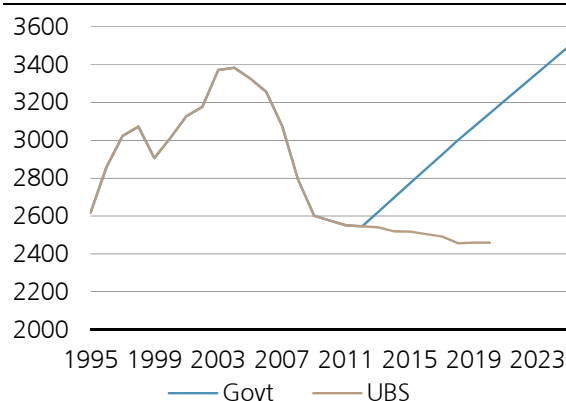
The oil industry is traditionally reluctant to invest without being able to book reserves. We don't see this issue as a deal-breaker, however. There are many examples, globally, of title being retained by the state yet the contract (however it is titled) being structured in a way (manner of economic interest; risk and reward sharing; ability to lift crude) which create compliance with SEC rules (eg Iraq). Practically speaking, just as important to prospective investors will be how any work in terms of returns on capital (IRRs) and returns on expertise (NPVs – especially where there is an exploration element). Retaining Pemex as the controlling operator would theoretically be little different, for instance, to the effective current situation in Brazil with Petrobras.

Global market implications

In terms of long-term balances and the effect on the global outlook, an opening up of the Mexican upstream would further cement the Americas as the most important source of supply growth in years to come. In our outlook, we expect the US, Canada and Brazil to make up the bulk of new oil production this decade, driven by shale oil, oil sands and pre-salt barrels respectively. The only other truly major source of new oil is expected to be Iraq in the global supply/demand balances put together by UBS' oil economist, Julius Walker.

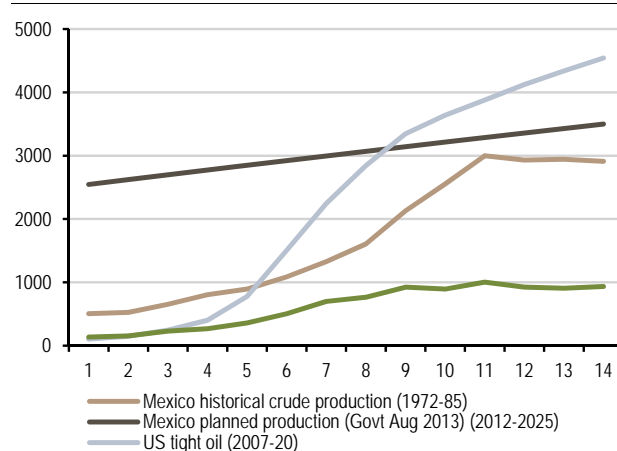
On the surface, the Mexican government's growth targets, if achieved – an increment of 0.5 mb/d by 2018 and another 0.5 mb/d by 2025 (from current crude production around 2.5 mb/d) – would only represent a relatively small contribution to *annual* non-OPEC supply growth around 0.9 mb/d. However, on the basis of what are expected to be substantial unmapped reserves in both Mexico's deepwater and in shale formations onshore, there is significant potential for further growth in subsequent years. Indeed, a look at Mexico's original ramp-up in oil production in throughout the 1970s show that strong growth rates were achieved, albeit not nearly as strong as seen in the recent growth spurt in US shale oil, for instance.

Figure 4: Mexico - production projections kb/d



Source: UBS

Figure 5: Ramp up profiles (by year since taking off) - kb/d



Source: UBS

As we show above, however, the increase the politicians are discussing is ambitious in the context of absolute Mexican production and the direction of travel of Mexican production. Given the law needs to be agreed and passed, the legislation needs to be interpreted in a fashion that is acceptable to both Mexico

and the potential new investors, the licences need to be awarded and appraised, and then any discoveries need to be developed, the time line appears unrealistic.

Producers

In terms of producer participants, it is reasonable to look at large players in the US deepwater (e.g. **BP, Royal Dutch Shell, Chevron, Anadarko, ExxonMobil**) and for the non-conventionals, potential participants in addition to those names would be **EOG Resources, ConocoPhillips, Marathon Oil** and **Devon Energy**. We'd also add companies where there is a form of strategic or cultural fit (e.g. **Repsol, Statoil** and **Petrobras**).

Oilfield Services

From the services side the opening of Mexico could be extremely important. The large oil companies would again tap into the expertise of both the oil service and contract drilling companies to partner and meet their production targets, similar to Iraq. However, unlike Iraq the drilling expected to be done in Mexico would be technology driven – deepwater and oil shales. Both deepwater and oil shales require technology, expertise and as a result tend to be higher revenue and margin opportunities for the oil service/drilling sector. Local oil service companies would be less of an option given the complex nature of these type of projects.

Ultimately, Mexico could become a sizeable market for the US oil service companies, as well as the offshore drillers. Currently there are 39 deepwater rigs operating in the US portion of the Gulf of Mexico and yet only 5 in the Mexican waters today. The offshore drilling contractors would be a leading beneficiary. However, we believe the oil service companies would benefit even more as they would participate in both the offshore and land drilling activities. Pursuing shale in Mexico could ultimately provide an outlet for excess pressure pumping equipment in the US. The Eagle Ford shale play in Southern Texas spills directly into Mexico's Burgos Basin (see Figure 5). We believe a number of shale opportunities exist throughout Mexico; however development in some cases has been hampered by drug wars within local communities.

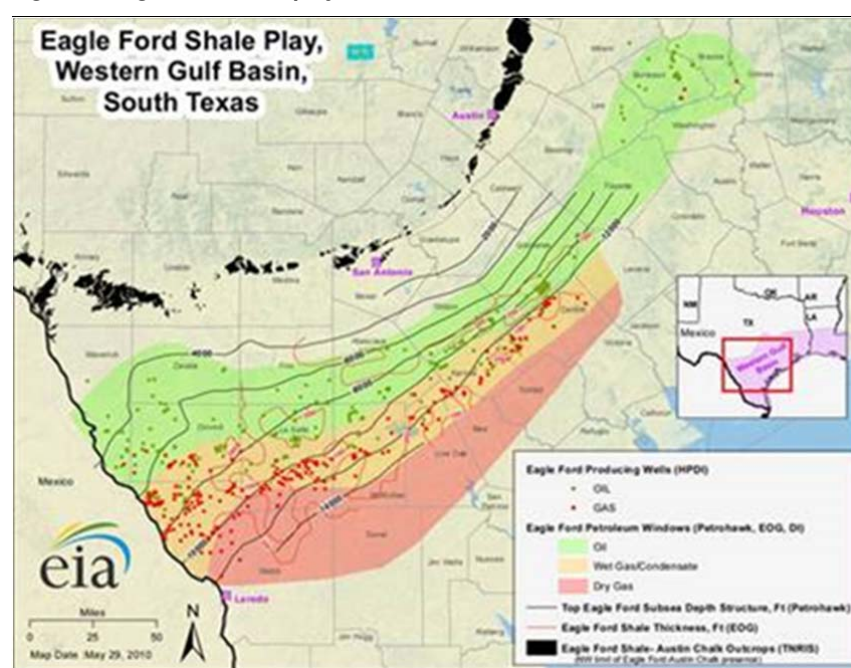
We think it will take time for the region to develop, oil laws put into place, the majors to tender and then the eventual awards to the oil service companies. This could easily be a 2-3 year process in our view but given the even longer lead times towards production the oilfield services sector is likely to be the biggest immediate beneficiary of new access and a step up in activity – Pemex has estimated an incremental \$10bn a year of spending. **The leading beneficiaries would be: Weatherford, Schlumberger, Halliburton, Baker Hughes, as well as Noble, ENSCO, Diamond Offshore and Transocean.**

Several European oil service companies already are present in Mexico. **Tenaris** has 1.2mt capacity seamless pipe mill in country and is basically the sole supplier of OCTG to the domestic oil and gas industry. Offshore construction companies such as **Subsea 7** and **Technip** have indicated the potential of the GoM. Increases in exploration spend would also benefit the seismic companies **PGS, CGG, Polarcus** and **TGS Nopec**. These represent a more conventional supplier relationship.

Outside of the more conventional equipment and construction service relationships, integrated service contracts represent a big opportunity. Under this contracting model, the service company is paid a tariff per barrel of production to cover upfront capex and an appropriate rate of return. This contracting model essentially removes direct commodity price exposure to the service

company. **Petrofac** is, thus far, the only European oil service company to enter into integrated service contracts with Pemex. Currently, it has signed four integrated contracts with Pemex, three onshore and one offshore. Under this model, Petrofac is paid a tariff per barrel of production to cover upfront capex and an appropriate rate of return. We do expect this could be an area of significant growth potential but the barrier for many service companies is the upfront capex requirements. Interestingly, Schlumberger and Petrofac announced a Co-operation Agreement in January 2012 to deliver services under production services and production enhancement market - currently, this venture has taken over operatorship of the Panuco field. Petrofac has also signalled that integrated service contracts are expected to be a significant opportunity for them, not just in Mexico but also in other countries such as Malaysia, Iraq, certain countries in Africa and Central Eastern Europe.

Figure 6: Eagle Ford Shale play extends into Mexico



Source: EIA

Table 1: Co-operation agreements signed by Pemex/Mexico in the last 2 years

Date	Company	Country	Agreement details
Jun-13	GE	US	Signed \$84m agreement to supply and install subsea wellheads for PEMEX E&P's deepwater and ultra-deepwater drilling projects in the GoM.
May-13	Statoil	Norway	5-year non-commercial agreement with Statoil to enhance research and technological collaboration.
Apr-13	ExxonMobil	US	5-year technical agreement to collaborate in research, science, technology and human-resources training for the exploration, drilling, production, transportation and storage of hydrocarbons.
Apr-13	CNPC	China	Signed a MoU for cooperation in oil and natural gas.
Apr-13	Mitsui	Japan	Agreement to develop pipeline for Mexico to import gas from US.
Jan-13	Repsol	Spain	Strategic alliance to collaborate on exploration projects. Pemex owns 9.6% of Repsol.
Feb-12	N/A	US	Signed an agreement with Mexico for the joint development of oil and gas reserves ending the oil exploration and production moratorium in the Western Gap portion of the Gulf of Mexico.

Source: Reuters, company reports

Statement of Risk

The risks associated with our investment thesis include volatility in oil and natural gas prices, margins for global refining, marketing, and chemicals, as well as normal exploration risks associated with the oil and gas business.

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Neutral	FSR is between -6% and 6% of the MRA.	44%	37%
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Source: UBS. Rating allocations are as of 30 June 2013.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Halliburton Co. ¹⁶	HAL.N	Buy	N/A	US\$46.68	15 Aug 2013
Petrofac ¹⁶	PFC.L	Buy	N/A	1,235p	15 Aug 2013
PGS ^{2, 4, 6a, 16}	PGS.OL	Buy	N/A	NKr80.45	15 Aug 2013
Schlumberger Ltd. ¹⁶	SLB.N	Buy	N/A	US\$81.99	15 Aug 2013
Tenaris ¹⁶	TS	Neutral	N/A	US\$46.13	15 Aug 2013
Weatherford International Ltd. ^{4, 5, 6a, 6b, 7, 16}	WFT.N	Neutral	N/A	US\$14.74	15 Aug 2013

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