April 2015

PANORAMA

THE MEXICAN ECONOMY FACES HEADWINDS

COFACE ECONOMIC PUBLICATIONS

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Since the signature of the Pacto por Mexico in December 2012, an agreement struck by the three main political parties, the country has witnessed a variety of reforms. President Peña Nieto was efficient in securing cross-party support and big improvements were made in 2013. The government obtained approval for a landmark energy reform, bringing to an end the 75-year old monopoly of state-owned Pemex and, by opening the oil and gas industries to private investment, freed up the labor market. It has also introduced competition in the telecoms sector. However sluggish growth was reported in 2013 and during the early part of 2014.

The upturn in the Mexican economy began in the 2nd quarter of 2014 and GDP expanded by 2.1% last year. The pick-up in growth has been partly driven by stronger exports to the United States. Nevertheless, the freefall in oil prices in recent months has raised worries that the energy reform could be impacted, as could the government´s financials. Against this backdrop of headwinds, Coface expects moderate growth ahead (+3.1% in 2015).

In this edition of the Panorama we will discuss the current impact of lower oil prices vs Mexican dependence on oil revenues. The overall current macroeconomic environment will also be presented. Secondly we will assess the outlook for the country´s main sectors. This section includes our Mexican sector barometer, which shows the financial performance of companies in different industries, coupled with Coface´s payment experience. The third section focuses on two major industries, illustrating the headwinds the Mexican economy is facing at the moment in the automotive and steel sectors.

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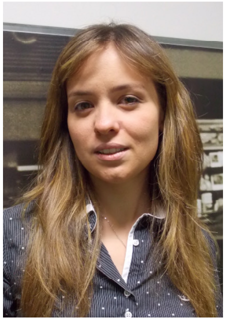


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« Beyond fiscal accounts, lower oil prices are likely to affecteconomic activity. However the impact should be manageable, insofar as the oil industry accounts for around 6% of GDP »

1 CURRENT ECONOMIC ENVIRONMENT

Mexican activity has been profiting from the economic vitality of the United States, thanks to its preferential trade access and geographical proximity. In addition, manufacturing exports have benefitted from the lower peso. Between September 2014 and February 2015, the peso depreciated by 13.5% and it is expected to weaken further as US monetary policy normalizes its stance. The upturn in the Mexican economy began in the 2nd quarter of 2014 and the country's GDP expanded by 2.1% last year (according to officials). Agriculture was the fastest expanding sector, at 3.1%. Industry was the weakest, at only 1.8%, due to the contraction (2.2%) of the mining sector. Manufacturing showed growth (3.7%), as did services, which rose by 2.2%.

Despite the recent drop in oil prices, the impact on the economy should be manageable in the short term.

Admittedly government finances are very dependent on the oil industry, which represents one-third of total fiscal income, but thanks to a portion of oil revenues that has been saved in stabilization funds; the need for a drastic reduction inpublic spending does not seem to be necessary. However, the government has announced a preemptive measure that consists of cutting the national budget by around 0.7% of GDP in 2015, in order to avoid raising taxes or adding further debt.

Inflation closed 2014 at 4.1%, just above the Central Bank's target range (2-4%). Inflation is expected to abate, thanks to slower rises in prices for food and oil products. February data confirms it is the second consecutive month in which annual inflation was within the target range (3%). However, since the Fed announcement anticipating an increase of its main policy interest rate in 2015, Mexico will experience a period of volatility, reflected in particular by the depreciation of the local currency against the dollar. Thus inflationary pressures may accelerate if the peso depreciates further as a consequence of the strengthening of the dollar. A weaker peso could put upwards pressure on prices, given the impact on import costs - as a large share of consumer goods is produced abroad.
Despite lower oil prices, the economic outlook is improving somewhat. Coface forecasts GDP growth of 3.1% in 2015, mainly thanks to the performance of the manufacturing

sector which will benefit from rising US demand - especially from the car sector. Consumption remains stagnant, but an improved labor market and increased remittances from Mexicans working in the United States will probably lead to a recovery. However the increase in private capital inflows expected, following the deregulation of the energy market, could be compromised if the drop in oil prices persists - especially for deep-water and shale.

Progress on the country's social development is rather mixed. Poverty still affects half of the population, and the percentage of Mexicans whose income is insufficient to purchase a basic basket rose between 2010 and 2014, from 48.77% to 54.77%. The poorer population is concentrated in Mexico's southern states, while inhabitants of states on the northern border with the US, as well as some states in the centre of the country, enjoy much higher average income levels, with better living standards and infrastructure.

On the political side, the government is concentrating on the implementation of its structural reforms until the next mid-term elections. These will be held in July 2015 and will enable the renewal of the Chamber of Deputies' 500 seats. In the run-up to the next elections, the government's image remains embroiled in a major political crisis following the disappearance and presumed murder of 43 students last year, involving police in the city of Iguala. However, the opposition will find it difficult to capitalize on this amid widespread public frustration against the political establishment as a whole and the corruption scandal involving the opposition itself.

Mexico	2013	2014 (f)	2015 (f)
GDP	1.4%	2.1%	3.1%
Inflation	4%	4.1%	3%
Private Consumption	2.5%	2.1%	3.4%
Budget balance (1)	-4.1%	-4.2%	-4%
Public debt (1)	46.4%	48%	49%
Industrial Production	-0.5%	1.8%	3.7%
Unemployment Rate (2)	4.9%	4.8%	4.6%
Current account balance (1)	-2.2%	-2.1%	-2.5%

Pct of change in real terms, except (1) % of GDP and (2) % of labor force
Source: Dane, Coface, IMF and Oxford Economics

Oil revenues and energy reform in a context of falling prices

The passage of the landmark energy reform by Congress in December 2013 breaks up a 75 year old monopoly on drilling held by Mexican Petroleums (Pemex). The approval, considered one of President Pena Nieto's main achievements, should encourage foreign investors and ensure solid growth. Nevertheless, oil prices have reported freefall in recent months, from the peak of 114.81 USD on June 20 2014, to a six-year low of 44 USD reached in late January 2015. How do these prices impact the government's ambitious plans for the energy sector and its budget?

The sharp decline in oil prices is associated with an increase in output, combined with lower demand. On the supply side, the recent shale revolution in the US has raised production in the country to the highest level in three decades. In counterpart China, which is the main consumer (12% of total oil consumption), has demanded lower volumes due to the slowdown in GDP growth. The OPEC decision, on November 27, to keep production at the same levels, contributed to the downwards pressure on oil prices. After having reached a minimum quotation at the end of January, the crude-oil market has shown some relief, but the old level of prices will not recover in the medium term. Coface expects the Brent oil price to average 55 USD in 2015.

Energy Reform

It was the worse time for the oil prices to collapse and the government has worked to keep foreign investors' interest in Mexican fields alive. They wisely decided to focus the first round of tenders (known as Round One) on shallow-water areas, which require lower investments, before the deep-water oilfields.

Despite the unfavorable price scenario, Mexico´s first round of bids appears successful. According to the National Hydrocarbons Commission, the first phase of Round One attracted the interest of 43 companies and 16 have entered the pre-qualification process (including the world´s leading oil firms). The area announced on December 11 2014 comprises 14 shallow-water exploitation blocks off the coasts of Veracruz, Tabasco and Campeche (south-eastern states). The second phase was launched at the end of February, offering another nine shallow-water fields in the Gulf of Mexico (also in Tabasco and Campeche).

On March 9 2015, Mexico´s Energy Secretary, Pedro Joaquin Coldwell, said that the first 23 fields offered for investors should generate 21 billion USD (roughly 1.6% of GDP) in funds over five years. These funds should start to flow into Mexico by the fourth quarter of 2015. The first contracts will be granted beginning on July 15, with signing of the deals taking place between August and September this year.

Whether the following rounds, composed of deep-water and shale gas, will attract demand is another chapter to be seen later. Mexico's deputy energy minister, Lourdes Melgar, recently admitted that the lower oil prices would likely delay the auction of unconventional Chicontepec basin and of deep-water blocks, originally scheduled for March and April 2015.

Government budget

Oil-related revenues represent around one-third of the government's budget, so the impact of lower oil prices should not be disregarded. Nevertheless, some factors reduce the negative effects on government financials. Foremost is the fact that every year Mexico hedges its oil revenues, so that it will limit part (43% of oil exports unhedged) of the possible losses in 2015. The price negotiated this year was 76.40 USD per barrel, which is slightly lower than the 81 USD per barrel budgeted and roughly double the price of *Mezcla Mexicana* (a local oil mix).

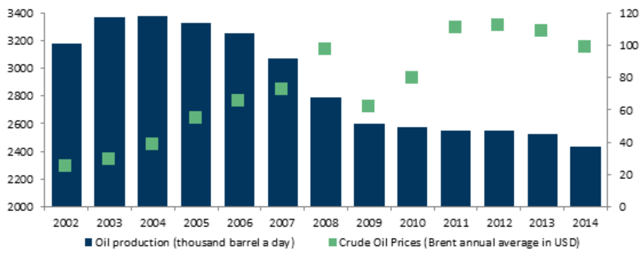
Two other points should be considered. The first is that Mexican domestic oil prices do not freely float. They are actually set by a smoothing mechanism known as *gasolinazo*. The second is that the recent depreciation of local currency positively impacts on the budget, since the country´s oil exports are sold in dollars.

Despite the relatively low risk presented above, in late January the Finance Ministry announced expenditure cuts of 124 billion pesos (roughly 8.3 billion USD, or 0.7% of GDP). Around two-thirds will come from current spending, but the remaining third will affect investments. Besides the negative effect of reducing resources for investment, the fiscal adjustment for this year signals the commitment to maintaining fiscal stability and ensures that no additional debt will be issued.

The energy reform seeks to reverse Mexico´s 10-year decline in oil production. As it can be seen on chart 1, the peak was achieved in 2004, with 3.38 million barrels per day. Since then, production has declined by roughly 30% and stood at 2.43 million bpd in 2014. Aging oil fields and years of underinvestment explain the fast deterioration, which was counterpointed with rising oil prices. In this manner, the monopoly on drilling that was held by Pemex significantly reduced the government´s potential resources over the last decade. It will now take some time before a rebound in production can be observed.

Beyond fiscal accounts, lower oil prices are likely to affect economic activity. However the impact should be manageable, insofar as the oil industry accounts for around 6% of GDP. This is lower than in most other major Latin American countries. It reflects the diversification process the Mexican economy has undergone over the past years. It is worth noting that low prices offer the possibility of eliminating local fuel price subsidies. Activity should be hit indirectly through lower investments in energy, but the first news on Mexico´s Round One makes us believe that the new reality of lower oil prices will not significantly impact the country´s GDP.

Chart 1: Mexican Oil Production vs Crude Oil Prices
(Brent – annual average)



Sources: Pemex and World Bank

2 SECTOR BAROMETER

The Sector barometer shows the financial performance of companies in different industries, coupled with Coface's payment experience. The average outlook in Mexico is at medium risk. Agro-food and textile-clothing are at higher risk, while the automobile and pharmaceutical sectors are at moderate risk. Below we will discuss the outlook for each segment.

Sector Risk Assessment

Automotives	Moderate risk
Steel	Medium risk
Chemicals	Medium risk
Pharmaceuticals	Moderate risk
Construction	Medium risk
Agro-food	High Risk
Retail	Medium risk
Textile-clothing	High Risk
Services	Medium risk

Moderate risk · Medium risk · High Risk · Very high risk

Chemicals: Medium Risk

Latin America as a whole faces lack of competitiveness, due to relatively high costs and here Mexico is no different from the rest of the region. Shale gas exploitation in the USA has also revolutionized the global cost chain. Mexico also holds reserves of this gas, estimated to be one of the world´s ten largest by the US Energy Information Administration. The energy reform will also compromise auctions on shale, notwithstanding the fact that the advantage of developing this has become more questionable with the recent sharp drop in oil prices. The proximity to the US also opens the possibility to pipe gas in from Texas. American gas now costs roughly four times less than Mexico pays for liquefied natural gas from Asia and Latin America. Mexico currently imports the equivalent of around 88% of domestic production. Industry´s risk should stand at medium risk, as the possible positive effects of the energy reform will not be felt in the short term.

Pharmaceuticals: Moderate risk

Mexico is considered the second largest pharmaceutical market in Latin America and the 12th in the world. The pharmaceutical industry is the second largest manufacturing sector in Mexico, after the car industry. Nearly 200 pharmaceutical industries are located in Mexico, generating 80,000 jobs directly and 330,000 indirectly. In 2013, the local population consumed over 17 billion dollars of pharmaceutical products, whereas production achieved was around 14 billion dollars. Investments in this industry are expected to increase, partly because of lower production costs compared to its neighbour, the United States, which is the main market for pharmaceutical exports.

Construction: Medium Risk

Industry was hit strongly in 2013, mainly due to housing policy changes conducted by the government and by delays in infrastructure projects. Activity remained weak in the first half of 2014, but it has started to report rebound signals and ended the year with a growth of 1.7%. Bimsa Reports, a company specializing in the construction industry, forecasted a growth of 4% for the segment this year. That was before the government announced cuts to its budget of 124.3 billion Mexican pesos (roughly 8.3 billion USD). Now the plan for a passenger train in the Yucatan peninsula has been cancelled and a high-speed rail project meant to connect Mexico City and Queretaro has been suspended. This negatively impacts growth estimations for the segment this year - but nothing compared to the 2013 turmoil scenario. Risk should remain at medium level.

Agro-food: High Risk

The agro industrial segment represents around 9% of GDP. Exports to the US have increased significantly in recent years, thanks to the North American Free Trade Agreement (NAFTA). The variety of products ranges from fresh fruits (such as avocados, watermelons, mangoes, papayas, grapes and Persian limes) to food products (such as wine, beer, breakfast cereals, processed fruit and vegetables). The industry was impacted in early 2014 by tax hikes on high-calorie food and drinks.

The agro segment is classified as high risk due to the following factors: 1) lower international prices of commodities; 2) significant dependence on imported fertilizers, within the context of the depreciating Mexican Peso; 3) long payment terms normally prevailing in the segment; 4) the necessity of financing the crops vs good cash flow management and 5) weather conditions that cannot be predicted.

Retail: medium risk

Retail sales growth remains modest due to the sluggishness in consumption. Sales increased by 2.6% YoY in November 2014, while at the same time consumption rose by 2.1% YoY. A moderate recovery is expected to 2015, given the improvement in the labour market. The official employment rate increased by 4.3% in December 2014, compared to December 2013, and remittances increased from Mexicans working in the United States. Consumer loans grew by 6% last year and should continue to increase further, as a result of the financial reform. In addition, lower inflation should boost real wages and by extension households' purchasing power.

Textile-clothing: High risk

The textile and clothing industry is the sixth largest manufacturing activity in terms of economic contribution to Mexico's GDP (3.8% of manufacturing GDP in 2012). With the opening to foreign trade, particularly after the entry into force of the North American Free Trade Agreement in 1994 (NAFTA), the sector benefited from a greater participation in international markets. However, companies are facing growing competition from Asian textile manufacturers, causing a drop in production, export sales and employment. In December 2014, the government announced public spending of over 540 million dollars (0.04% of GDP) to raise the productivity and competitiveness of the textile industry. Despite public spending efforts to boost the textile-clothing sector, it will remain risky in the short and medium term.

Services: medium risk

The service sector represents around 62% of Mexico´s GDP and has been performing well in recent years. The outlook is positive, in line with a perspective of a stronger labour market and decreasing inflation. The segment also holds an advantage when compared with industry. It is easier to promote adjustments in prices, as it does not face competition from imported products. This facilitates the maintenance of profit margins and classifies the industry at medium risk.

3 SECTORS

Auto Sector: Mexico is emerging as a major automotive hub

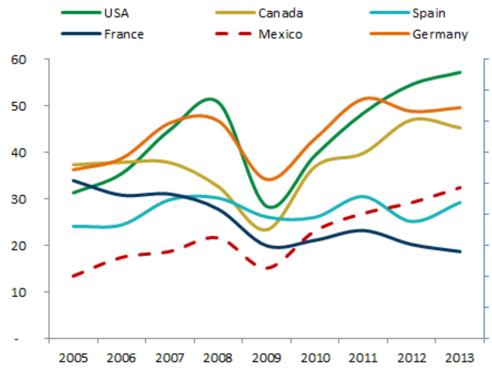
Mexico is the fourth-largest automobile exporter in the world after Germany, Japan and South Korea and the seventh-largest vehicle producer (surpassing Brazil in the first half of 2014). The automotive sector is dynamic and in continuous growth. This industry employs around 700,000 local workers. Eight out of ten vehicles are dedicated for export, but in contrast with other countries, Mexico doesn't have any domestic automakers.

The world's top ten vehicle assembly companies are established in Mexico, with General Motors, Ford, Chrysler, Volkswagen, Nissan, Honda, BMW, Toyota, Volvo and Mercedes-Benz. The automobile industry is to become further integrated into the US production chain over the following years, thanks to its geographical proximity to the US market and the NAFTA agreement that allows auto makers to optimize their production operations within North America.

The automotive sector has been growing strongly, further boosted by a number of additional vehicle assembly plants in recent years. These (notably Asian and European) auto makers are attracted by the reduced trade barriers within North America and around 40 different free-trade agreements. Other car companies, such as Nissan, General Motors, Ford, Fiat and Chrysler, have chosen to finance the expansion of their plants. At the beginning of March, Volkswagen announced that it would spend 1 billion dollars to expand a Mexican plant to build small SUVs (sports utility vehicles) for the US market. According to officials, auto makers and parts suppliers have plans to invest more than 20 billion dollars in Mexico's car industry over the next few years.

Factories of luxury brands, such as BMW and Audi, are contributing to the improvement of the country's value chain. Mexico has held seventh place in terms of car export values since 2012, ahead of France and Spain. Germany still holds the leading position (see chart 2).

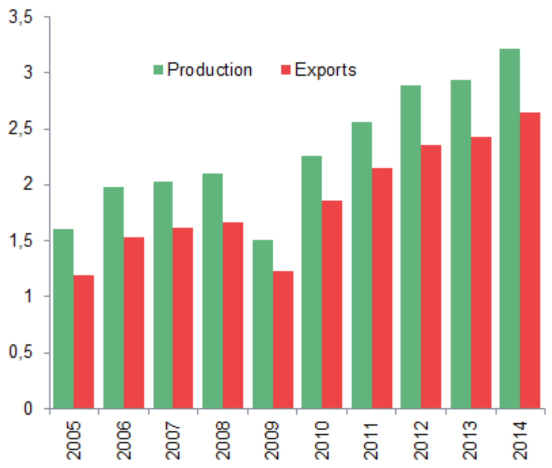
Chart 2: Car export (in value)



Sources : Unctadstad and Coface

With 82% of Mexico's light vehicle production exported in 2014 (against an average of 75% ten years ago), Mexico's growing automotive industry is a production center rather than a sales market (see chart 2). The automotive sector represents 30.8% of the country's total exports.

Chart 3: Mexico car prodution/ millions of units



Sources : Unctadstad and Coface

According to AMIA (the Mexican automotive industry association), in 2014 car production grew by 9.8% to 3,219,786 units, exceeding Brazil's car production for the first time since 2002. This results from a combination of many factors that include cost competitiveness, increases in productivity and, especially, the increasing demand for cars in the United States. Mexico's annual production of cars and light trucks is expected to rise by more than 50% by 2018, to five million units, thanks to a wave of current investments.

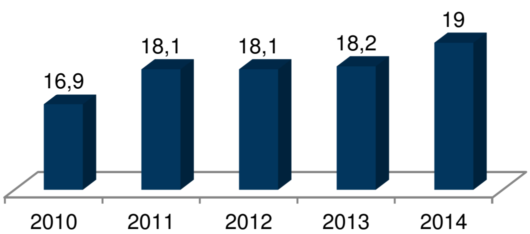
North America is the main market for Mexican cars, representing 81% of total exports last year. Mexico has become the number 2 supplier of vehicles to the US market after Canada, surpassing Japan. The United States absorbed 71% of total exports and Canada 10%. Brazil occupied the third place with 3.9%, followed by Germany with 3.3%. Exports to Argentina should rebound, thanks to a new automotive agreement signed between Mexico and Argentina which puts an end to the conflict which erupted in 2012 when Argentina decided to unilaterally suspend it.

The outlook for the automotive industry is positive. The robust growth expected in the US in 2015 will benefit Mexico's car industry, while depreciation of the local currency is reinforcing the competitiveness of its vehicles. Related activities (such as spare parts and electrical equipment), notably by companies located around Mexican plants, will probably capitalize on this. Monthly US car sales picked up by 52% between January 2010 and October 2014, while production increased by 45%. The positive trend in investments in the automobile industry is linked to the strong outlook in the US. Between 2009 and 2013, capital expenditure steadily increased from 9 692, to 26 672 million dollars.

Steel

Mexico is the world's 13th biggest steel producer and the second largest in Latin America. The states of Coahuila, Michoacán, Nuevo Léon, Guanajuato and Veracruz represent 82.1% of the nation's total production. It reported an annual average growth of 1.47%, higher than the world average of 1.16%. The industry performed well in 2014 in terms of production, rising by 4.2% to reach 19 million tonnes (chart 4). These results were supported by strong demand from the automobile industry (+8.2%) and from metal products (+5.1%). However, international steel prices remain at low levels, due to world oversupply.

Chart 4: Steel Production (million tonnes)



Source: World Steel Association

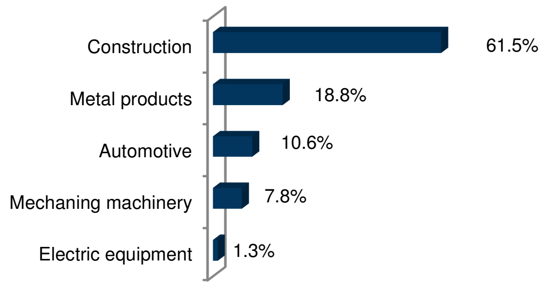
World steel overcapacity is a major issue. China is responsible for 50% of the world´s total steel production and consumption, so its influence in determining international prices is very strong. Many Chinese steelmakers are state-owned and the decision of how much to produce is not necessarily connected to economic reasons. This leads to international steel oversupply and therefore lower prices. With the context of lower growth rates in China, the segment is negatively impacted worldwide.

Altos Hornos de Mexico SAB de CV is the country's largest steelmaker, with an annual liquid steel capacity of over three million tonnes. Other important players are Arcelor Mittal, Deacero, Industrias CH, Tenaris-Tamsa and Ternium. Given the tight margins, companies have been struggling to reduce costs. Fortunately the prices of iron ore, the main raw material, are in free fall (by roughly 53% since the end of 2013). Energy also represents another major cost and the recent energy reform should mean the provision of cheaper solutions. However, in the short term, energy costs will continue to weigh on companies' profit margins. The poor transport infrastructures, as well as high fiscal and financial costs, are also challenges to be dealt with.

The combination of low steel prices and high costs make the country very vulnerable to imports. In order to try to protect local production from imports (emanating mainly from China and Russia), a string of anti-dumping investigations related to a large range of products have been launched.

Construction represents the country's main steel consumer (see chart 5), followed by metal products and capital goods. The latter two segments should report moderate growth, due to the scenario of lower oil prices and the impact of the energy reform. In contrast, the automobile industry is expected to continue its strong performance in 2015. This industry is very export oriented, accounting for approximately 80% of local production and the US market absorbs around 71% of total exports.

Chart 5: Mexico Steel Usage Composition



Source: Canacero

In general, the steel industry will continue to be affected by fierce competition from imported products, which will impact its margins. In response to this sensitive scenario, a steel mill located in Michoacán announced that it will turn off its furnaces indefinitely, leaving 8,500 people unemployed. Risk is expected to remain at high level.

4 CONCLUSION

The energy reform adopted by the Mexican authorities was a great success. However its implementation is far from easy given the trend of lower oil prices. The reform's objective is to reverse Mexico´s 10 years of decline in oil production, but deregulation of the energy market could be compromised if the drop in oil prices persists. Currently, the impact of low oil prices on the economy seem to be manageable, as the Mexican economy is relatively well diversified and is benefiting from support factors (such as the automotive sector). Thus the performance of the manufacturing sector and the recent depreciation of local currency have made budget adjustments easier.

Mexico's economic outlook for 2015 points to an improvement in activity, notably thanks to the manufacturing sector's performance which is benefiting from growing US demand. Coface expects GDP to increase by 3.1% in 2015. A slight recovery in consumption is also expected, given the improved labor market and increased remittances. Inflation should abate, but the weaker peso could put upwards pressure on prices, given the impact on import costs.

On the supply side, the agro-food and textile-clothing sectors remain at risk. The agro-food sector is challenged by lower prices for commodities and its dependence on imported fertilizers, while depreciation of the local currency is raising production costs. The textile-clothing sector is losing competitiveness compared to Asian products. In contrast, the automobile and pharmaceuticals sectors seem to be in a better shape. Indeed, the robust growth expected in the US in 2015 will benefit the country's car industry. Mexico is becoming a platform for selling worldwide and its production is expected to increase by more than 50% by 2018.

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