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Mexico Sovereign Credit Strategy | Latin America

MEXCAT: Deal or No Deal?

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Incentives and likely demands from both sides suggest an agreement is likely, even if after further volatility. Projecting TUA payments, we value the potential bonds, including under a default. These scenarios suggest a slightly positive risk/reward from current prices. We still prefer 30y bonds.

A deal on the table: A tender offer and consent solicitation has been issued with an early deadline of December 17 for both and a final tender deadline of January 2. Points of contention are set to be the tender price being less than par given the 90-100 range, a total buyback amount of US$1.8 billion meaning most investors are likely to be left with bonds and the consent solicitation which on balance leaves non-tendered bonds worse off.

The government's standpoint: The government wants to resolve the MEXCAT issue so that works at the new airport at Texcoco (NAICM) can be stopped and a budget can be passed with less uncertainty. From a financial standpoint, the government is in a position to improve on the current deal even though a full repayment of the US$6 billion is unlikely.

Bondholders' standpoint: In addition to securing a higher tender offer price, making sure that un-tendered bonds are still attractive instruments is likely to be a key demand. This includes capturing potential future TUA receipts from other airports and a possible amortising structure. Bondholder leverage is the negative impact that a default would have for the broader Mexican assets in addition to a claim on the indemnity and TUA payment stream in case of default.

What gives: We think that it's in both parties' interest to reach a deal and expect an agreement to eventually materialise, even if negotiations extend into 2019. Forecasting TUA payments, using a bond that repays over 25 years and a final tender price of 100 for 30% of the bonds results in a price of 86.7 at a yield of 7.5% and 91.3 at a yield of at 6.5%. In a default scenario, we think that the market will struggle to price an IRR below 15% due to the uncertainty of realising on the indemnity payment and future TUA, which in a best case scenario of a US$3 billion payment upfront results in a price of 82 or as low as 50 in case no upfront payment is made.

Strategy implications: Current prices of 83-86 leave the risk/reward balanced if not slightly positive, given that we expect the two parties to come to a settlement. However, volatility is likely to persist in the coming weeks, particularly as it appears hard to reach a settlement ahead of the budget. Negative events outside of the airport negotiations cannot be excluded either. We still see the long-end bonds as more attractive and stick to our trade of switching out of MEXCAT 26 into MEXCAT 46.

Sovereign credit strategy: Deal or no deal?

The offer specifics

After weeks of uncertainty following the consultation in late October that confirmed that the new Mexico City International Airport (NAICM) would be cancelled, the incoming administration proposed on Monday, December 3 the terms of a voluntary tender and consent solicitation regarding the MEXCAT bonds. As we noted in our earlier piece, this is needed in order to avoid a default.

The tender is for a maximum of US$1.8 billion worth of notional proportionally split across the four outstanding MEXCAT bond issues using their market capitalisations. This equates to 30% of each bond issue (Exhibit 1). The tender will take the shape of a reverse Dutch auction with a price range of 90-100 cents. This includes an early tender fee of 5 cents. In case a bond is tendered, it is automatically assumed that consent has also been given for the amendments, for which a fee of 0.75 cents is also already included in the 90-100 cent range. Note that even if a bond is tendered and subsequently returned due to the total selling demand exceeding the US$1.8 billion cap, the consent solicitation will not be reversed. This feature is unusual and may well be contested by bondholders. If a bondholder does not want to tender their bonds, they may also only agree to the consent solicitation, in which case a fee of 0.75 cents is paid. The early tender and consent solicitation deadline has been set for December 17, meaning that after this date the 5 cents for the tender and 0.75 cents for the consent solicitation will be deducted from the final price set at the early tender date.

Exhibit 1: MEXCAT tender details

Bond	2026	2028	2046	2047
Amount outstanding	1,000	1,000	1,000	3,000
Tender cap	300	300	300	900
Early tender payment	5.00	5.00	5.00	5.00
Consent payment	0.75	0.75	0.75	0.75
Min bid / base price	90.00	90.00	90.00	90.00
Max bid	100.00	100.00	100.00	100.00
Bid increment	0.25	0.25	0.25	0.25

Source: MEXCAT, Morgan Stanley Research

Note that each bond issue needs to see 50% minimum participation or the entire offer falls through. This makes sense as if even one bond does not see its event of default amended, stopping the building works at NAICM would lead to a default and in turn lead to cross-defaults for the other three bonds. However, it does mean that it would only take US$500 million of a single bond issue to block the entire deal.

The specifics of the auction process are as follows: Bondholders can submit an amount of bonds to tender with a specific price ranging from 90 to 100 in 0.25 intervals. Alternatively, no price can be submitted, which would mean 90 is used. The clearing price will be calculated on the early tender date of December 17 as the minimum price needed to reach the tender cap of each bond series (after taking into account the cash needed for those that elect only to accept the consent solicitation). If the amount tendered does not reach the tender cap then the clearing price will be the highest bid submitted. Additionally, if the cap is not reached by the early tender date, the tender offer would remain open until January 2. However, at this point the amount paid would be the initial clearing price minus the 5.75 sum of the early tender and consent solicitation fees.

Comparing new and old terms: While we are not legal experts and this should therefore not be taken as legal advice, here are a few points we think are worth looking at when comparing the existing and new terms:

- **New terms remove certain covenants and events of default that relate to the new international airport** (NAICM or Texcoco site). One impact would be that a cancellation of NAICM would no longer cause a default. This is one of the main leverage points that investors have since the new administration would likely want to avoid the negative repercussions of a default which would likely include funding costs rising for both the sovereign and PEMEX.

- **New terms release the security interest over the passenger charges (TUA) and other assets relating to the Texcoco Airport:** While it makes sense to remove the TUA related to NAICM since this is now unlikely to come into play, it could be argued that some wording should be added to include the potential for future TUA streams from Santa Lucia, Toluca or even other potential new airports (or even if Texcoco was indeed revived). This is particularly important in case new airports intend to take capacity away from the existing airport (AICM) and hence impact the existing TUA stream negatively.

- **New terms amend certain conditions to make restricted payments** under the indentures governing the Notes due in 2026 and 2046 that require a minimum debt-service coverage ratio to be consistent with the corresponding condition in the indentures governing the Notes due in 2028 and 2047. While the net effect is negative, this is likely a smaller matter than the two above.

- **Green credentials:** Given that the old bonds were green due to the new airport (NAICM) having achieved green status, it is hard to see how the bonds would be deemed as green going forward. Indeed, Moody's has already downgraded its green rating from GB1 to GB5 while S&P has stated that once the government executes the cancellation (or by January 31, 2019 since green evaluations last only 18 months), it will remove its green evaluation. On the margin this is also a negative since it can prevent certain holders from holding the bond.

The government's viewpoint

The near-term priorities for the government appear to be: i) To actually end works at the Texcoco site; and ii) To approve a 2019 budget. Resolving the uncertainty around the MEXCAT bonds would go a long way towards helping both these since it would allow the works at Texcoco to stop without potentially triggering a default (see our previous piece where we explain why this is likely the case). A MEXCAT default would have no direct financial impact on the sovereign since there are no guarantees or cross-default clauses, but such an event is still likely to see the risk premium of the sovereign and other government entities such as PEMEX rise due to the uncertainty. The budget needs to be approved by December 31, which is likely why a date of December 17 has been set for the consent solicitation and early tender, providing some room for negotiations (though arguably end-December is a tricky period for such negotiations to take place).

There are also questions as to how the government will pay for the bonds and whether the government will reveal anything in the upcoming budget plans. In short, we don't think that we will learn much from the budget. There is unlikely to be a specific line item detailing what cost has been put aside for the MEXCAT bonds, given that spending is usually set out per division and by broad function such as investment or wages. Going into 2019, in case a larger hole develops, there is also the potential to deviate slightly from initial plans or even use the 1.5% GDP stabilisation fund.

That said, US$6 billion is a sizeable amount and not something the government will be happy to pay in one go. For comparison, US$6 billion is equal to 0.5% of GDP, 2% of all spending or the equivalent windfall from a US$10/bbl oil move. While the entire US$6 billion is unlikely to be paid up front, it nonetheless makes the point that the government will try not to see the upfront amount increase much further. The use of the construction fund may provide a partial offset. There is currently estimated to be an amount of around US$5.8 billion, yet this will first go towards paying contractors.

Three choices for bondholders

Tender the bonds: Having seen bonds fall to lows of 73, being given a chance to get out at 90 or higher may seem attractive. However, there are a few points to keep in mind. First, with a total limit of US$1.8 billion of bonds being bought back (for now at least since the size may be increased at the discretion of the issuer), there is no guarantee that investors will be able to exit fully. Only a minimum of 30% is guaranteed,in a scenario in which all bondholders tender, which can then rise to 100% depending on participation levels. This means that anyone tendering will need to factor in what the new terms look like.

As we outline above, on balance the new terms are worse. In addition to items reviewed above, the potential for revenue growth under the new set-up has fallen significantly due to there no longer being a new airport that has been appropriately designed and tested for future passenger growth. Related to this is how the remaining bullet maturities will be refinanced. A potential compromise would be an amortising structure (see more below). On the positive side, the potential buyback of 30% of the outstanding reduces the required debt payments and hence leverage ratios.

Finally, and perhaps most importantly, once the termination of the Texcoco airport has been removed as a default trigger and hence acceleration, bondholders will have much less leverage. This means that any additional concessions from the government would likely need to be negotiated now.

Note that this option can be further broken down into accepting before or after the Early Tender date. However, given that accepting after the Early Tender deadline would mean losing out on 5.75 points, we assume that all that want to tender would do so before.

Accept only the consent solicitation: In this case, bondholders would be paid 0.75 cents to accept the new terms. As reviewed above, given that some of the new terms of the bonds are worse, this appears to a be a small compensation amount. However, it also makes the point that the government is intending bondholders to accept via the tender offer.

Reject both: Bondholders clearly have the option not to accept either of the two offers above. In case 50% of each series and overall outstanding do accept, bondholders may end up being forced into the new terms anyway, given that only a majority is needed for these amendments. This would see bondholders missing out on the 0.75 consent solicitation fee.

On the other hand, if the amendments don't pass due to less than 50% of each series not agreeing to the consent solicitation, the two sides would need to enter into further negotiations. Bondholder leverage comes from the government wanting to avoid default and wanting to pass a clean 2019 budget. However, overall, bondholders lack significant leverage given that the collateral would be tough to realise on, in our view.

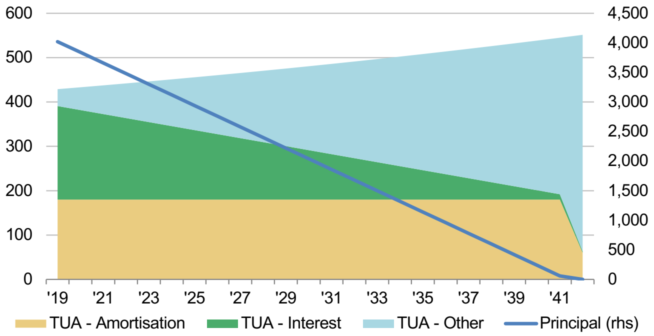
The outlook ahead

So what gives? Negotiations are set to extend, which is likely to keep volatility of bond prices high. However, there is scope from both sides to come closer to each other. We suspect that the main changes from the current deal could revolve around the actual tender price moving higher, the inclusion of potential future TUA streams from new airports so as to avoid the problem of dilution by competing airports and finally an amortising structure. On the other hand, we think that the cap on the tender is unlikely to move much above US$1.8 billion (or 30% of outstanding). First, there is still some uncertainty around the amounts actually available to pay the bonds, given that the construction fund will need to be used to pay contractors as well, a cost which cannot be fully estimated at this point. Also, as outlined earlier, while a few billions is manageable for the government, it's still a significant amount, particularly given all other competing spending initiatives. Second, any buyback above 50% would see the three shorter-maturity bonds' outstanding amounts drop below US$500 million and hence drop out of indices, which may not be what bondholders want.

Pricing an improved offer with an amortising structure: A possible solution to the problem around principal repayments would be to have an amortising structure. We looked at this in our earlier piece yet now update the analysis with the most recent passenger numbers (up 6.6% on the year, instead of our flat earlier assumption), adjust the TUA downwards for VAT and admin payments and assume that 30% of bonds are paid up front as per the current offer.

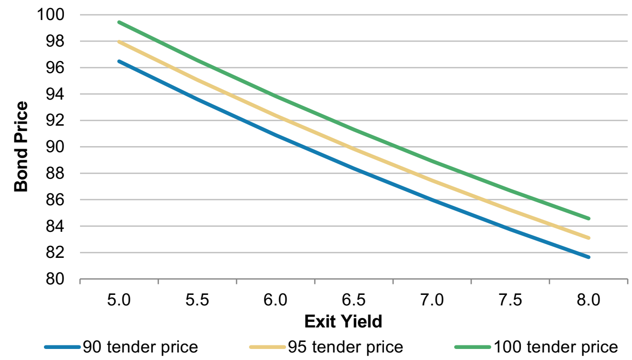
Thinking about the four bonds as one package for now, this leaves US$4.2 billion to be repaid. The net TUA available for the most recent four quarters as published in the debt-service ratio report as of August 21, 2018 was US$473 million. Assuming an unchanged aggregate coupon of 5.02% on the remaining US$4.2 billion of bonds would see interest payments of US$211 million in 2019 and in turn leave another US$262 million for other uses. While bondholders could argue that this entire amount could be used to pay down the bonds, we see this as unlikely. It would leave no cash behind for the Fibra E holders and no cash to be passed back to airport operations. Setting a high amortising payment would also set the debt-service ratio very low and thus bring risks in case passenger numbers fall. Assuming an annual US$180 million amortising schedule (or 3% of initial amount) thus seems about as high as possible (Exhibit 2). This would see the structure repaid over 25 years. At an 'exit yield' of 7.5% and assuming a final tender price of 100 it puts the valuation at 86.7, at 6.5% it's 91.3 and at 5.5% it would be 96.5 (Exhibit 3). So, there is upside from current levels in case an agreement can be found.

Exhibit 2: Renegotiation scenario: Potential TUA payment usage under an amortising scenario (US$ million)



Source: AICM, MEXCAT, Bloomberg, Morgan Stanley Research; Assumes no increase in passenger numbers from latest available numbers.

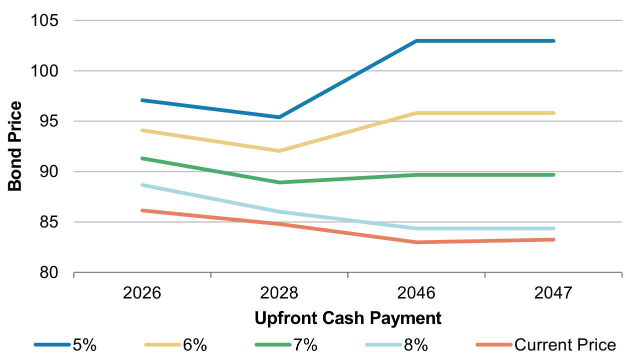
Exhibit 3: Renegotiation scenario: Bond prices under different tender prices and exit yield scenarios



Source: AICM, MEXCAT, Bloomberg, Morgan Stanley Research; Above numbers uses a single bond for simplicity with an average coupon of 5.02%.

Factoring in the different bond maturities: The above is just an example of an outcome and unlikely to exactly reflect what is eventually agreed. In particular, the bonds may not be collapsed into one package with the current maturity differences respected. This would entail the TUA payments used for amortisations being prioritised for the front two bonds until repaid and thereafter stepping up the repayments to the longer two bonds. At higher yields, this benefits the short-end bonds the most while yields of 6% or below sees the 30y bonds trade higher in cash price (Exhibit 4).

Exhibit 4: Renegotiation scenario: A scenario of 100 tender price of 30% of outstanding with original bond maturities respected, given different yield assumptions



Source: AICM, MEXCAT, Bloomberg, Morgan Stanley Research; While calculations use the same TUA, payments are now prioritised for the shorter-maturity bonds to respect initial maturities.

Exhibit 5: Default scenario: IRR projections under various indemnity amounts and entry points

	Indemnity amount paid in 2019			
Bond Price	0	1,000	2,000	3,000
65	10.2%	13.2%	19.3%	33.9%
70	9.2%	11.5%	16.1%	26.4%
75	8.4%	10.1%	13.4%	20.8%
80	7.5%	8.8%	11.2%	16.2%
85	6.8%	7.7%	9.3%	12.6%
90	6.2%	6.7%	7.6%	9.5%

Source: AICM, MEXCAT, Bloomberg, Morgan Stanley Research

Pricing in a default scenario: Proceeds under a default can vary significantly. In an optimistic scenario it could even turn out to be better than the current offer by the government, something that creditors may well point to in negotiations. Specifically, it would see an indemnity payment from the government of potentially as high as US$3 billion ("based on the unamortised investments to-date") paid upfront followed by the remaining outstanding amounts and interest paid down over time using the entire TUA. Since payments would be made rateably across the four bonds, this would actually benefit the 30y bonds at the expense of the 10y bonds since all bonds would now mature at the same time. Assuming this happens, we calculate the IRR for various scenarios depending on the amount paid upfront (the indemnity) and the price at which bonds are bought. For instance, if there is indeed US$3 billion paid upfront and bonds are trading at 85, the IRR would be 12.6%. Even at a price of 90 an IRR of 9.5% could be deemed attractive (Exhibit 5). Breaking it out by bond, it's the 30y bond that benefits the most. Establishing a single recovery value is difficult since it would require determining a single IRR to use on the future cash flows, i.e., there is no asset whose value can be realised on today. That said, we struggle to see how the market would assign an IRR below 15%, which in a best case scenario of a US$3 billion payment upfront results in a price of 82 or as low as 50 in case no upfront payment is made.

The main risk in the default scenario, and why a high IRR is required, is that it relies on both the indemnity payment and the entire future TUA stream being available to bondholders. This is not a certainty, in our view. If the bonds are in default, there will be less incentive for the government to comply with the contracts. Downsides could come from simply not being paid to smaller tweaks such as reducing the TUA (an event of default but this would presumably not matter if already in default).

Where prices go from here depends on a few factors:

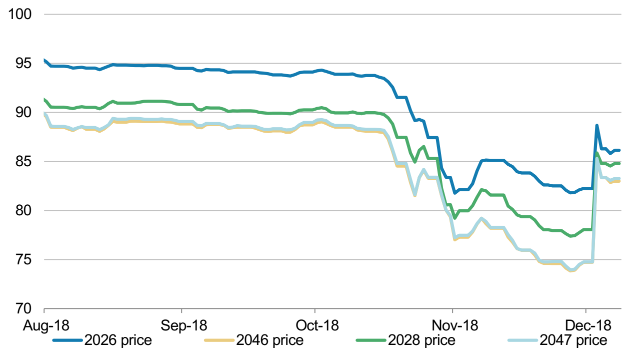
First, the chances of a deal eventually materialising between bondholders and the government: Our bias is that there is a fairly high likelihood of the two sides agreeing since it is in the best interest of both sides and there is room for the government to improve on the current offer from a financial standpoint. In case no deal can be agreed and we come to a standstill there is decent downside, given the lack of immediate avenues for bondholders other than entering litigation in Mexican courts and trying to realise the value of the TUA collateral.

Second, the terms of the tender offer, since this will determine where 30% (or more) of the bonds will be taken out: Our bias is that it will end up being towards the higher end of the 90-100 range currently set, perhaps even par.

Third, the terms of the consent solicitation, since this will determine where the remaining 70% of the bonds will trade, evidenced by the spread over sovereign. The inclusion of potential future TUAs from other airport would go only partly towards offsetting the negative from losing the earlier anticipated passenger growth from the cancelled airport (NAICM). However, reduced leverage ratios should also help. Coupons may even be increased in an optimistic scenario yet we think it's more likely that an amortisation schedule is agreed upon. Overall, we think that if a positive settlement is agreed upon in line with what's outlined above, the spread over sovereign would be slightly tighter than today's levels, with the long end around 110bp over the sovereign and the 10y sector at 80bp.

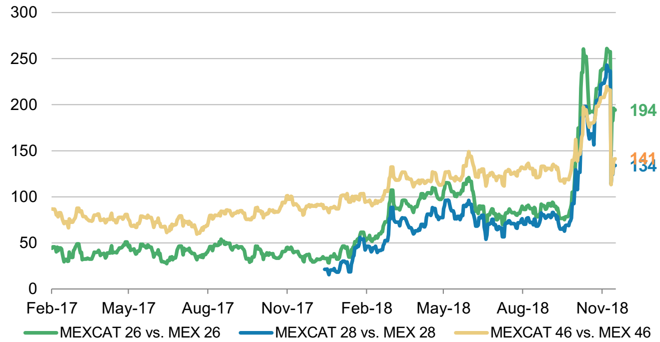
Fourth, pricing of broader Mexico credit risk and UST yields: Overall, our assumption is that the sovereign risk premium remains at a higher spread than history would suggest. After all, even if the airport is resolved, the energy sector and PEMEX represent important downside risks to Mexico's fiscal metrics. Finally, UST yields have repriced higher since the bond issuances. However, our interest rate strategy forecasts do see yields lower from here (UST 10y yields heading to 2.75%), which should help.

Exhibit 6: An improved offer that is agreed to should see 10y bonds move to 93-95 and the 30y bonds to 91-93



Source: Bloomberg, Morgan Stanley Research

Exhibit 7: MEXCAT spread over sovereign



Source: Bloomberg, Morgan Stanley Research

Rating implications: Both S&P and Fitch have noted that the current tender and consent solicitation are not considered distressed since the failure to complete the tender offer would not lead to a materially higher risk of payment default for the bonds. Moody's does not explicitly mention this but does note that the tender is voluntary. Additionally, all rating agencies mention that credit metrics will improve as a result of the tender, given that the same current cash flow will be available to pay fewer bonds, i.e., debt-service ratios will improve. That said, upgrades are unlikely, with all agencies also mentioning the uncertainty relating to the future operations of the airport, including little scope for passenger growth. For now, all three agencies have maintained their negative outlooks and risks remain to the downside, in our view. Moody's (BBB-) is the closest to losing IG, with both S&P and Fitch at BBB+.

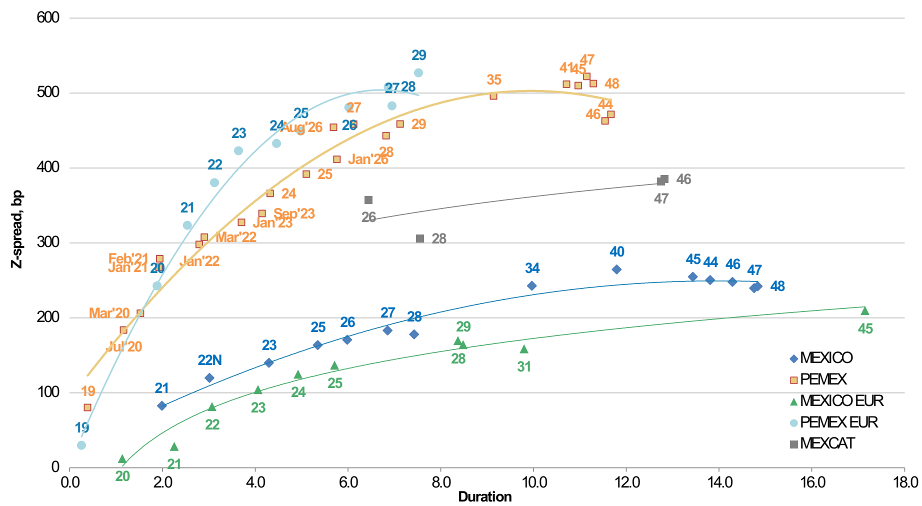
Strategy implications

A base case... Our base case is for an eventual outcome that sees a deal being negotiated between the two sides that involves little or no principal haircut and an improvement in the amended terms. This should see the MEXCAT spread over sovereign tighten slightly further to around 80bp in the 10y sector and 110bp in the 30y sector. At the same time, we don't expect the sovereign spread to tighten much. UST yields fall slightly further. This leaves the 10y yields at around 5.50% and the 30y yields at 6.50%. Going back to the tables above, it leaves the price of the 10y bonds at 93-95 and the 30y bonds at 91-93 with around 7 point downside in case the final tender price comes in at 90 or yields stay slightly higher.

...and a scenario framework: Using the framework above, there are three main probabilities to determine. First, whether there is a negotiated outcome or not. Second, if there is a negotiated outcome, will terms be improved leading to the 93 average price, or with higher yields and worse terms leading a price of around 86. Third, if there is no negotiated outcome and bonds ends up in default, whether bondholders can get access to the collateral in which case bonds should trade around 82, or whether in a negative scenario it proves hard to get to the collateral and prices fall significantly to around 50.

Assigning a subjective two-thirds probability to the positive outcomes in all three scenarios above, the weighted average price comes to 84, close to current prices. This leaves the risk/reward balanced if not slightly positive, given that we expect the two parties to come to a settlement. However, volatility is likely to persist in the coming weeks, particularly as it appears hard to reach a settlement ahead of the budget. Negative events outside of the airport negotiations cannot be excluded either. Adjusting the first probability of whether a negotiated outcome will be reached at all downwards to 50% leaves prices at 81, which is where we would look to add. We still see the long-end bonds as more attractive and stick to our trade of switching out of MEXCAT 26 into MEXCAT 46, particularly in case the cash differential was to widen again.

Exhibit 8: Mexico sovereign credit complex



Source: Bloomberg, Morgan Stanley Research

Exhibit 9: Valuation methodology and risks

Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Dislike Mexico Hard Currency Bonds	29-Oct-18	NA	NA	NA	We expect risk premium to remain high to account for the uncertainty around future policy-making. Positioning has also become heavier.	Investor-friendly budget, and pragmatic policy actions around the quasis Pemex and Mexcat.
Switch out of MEXCAT 2026 into MEXCAT 2046 (notional basis)	2-Nov-18	4.8	0	8	Expect bond prices to converge in a downside scenario while 5 points is still in line with the one year average. Higher carry in long-end	Different treatment in a potential restructuring

Source: Morgan Stanley Research

Exhibit 10: History of recommendations for MEXCAT 2026

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP / ISIN / BLOOMBERG	Gross P&L BP	Gross P&L US$K
MEXCAT 4.250 10/31/2026	31-Oct-26	Buy Mexcat 26 vs. Pemex Jan'26	25-Jun-18	-18bp	11-Jul-18	-68bp	-65bp	10bp	US$10m	USP6629MAA01	50bp	294k
PEMEX 4.500 01/23/2026	31-Oct-26	Buy Mexcat 26 vs. Pemex Jan'26	25-Jun-18	-18bp	11-Jul-18	-68bp	-65bp	10bp	US$10m	US71654QBW15	50bp	294k

Source: Morgan Stanley Research

Exhibit 11: History of recommendations for Mexico hard currency bonds

Trade	Entry Date	Exit Date
Dislike Mexico Hard Currency Bonds	09-Apr-18	24-Sep-18

Source: Morgan Stanley Research

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Selling protection or Buying Risk: The analyst expects that the price of protection against the event occurring will decrease over the relevant time period.

Buying protection or Selling Risk: The analyst expects the price of protection against the event occurring will increase over the relevant time period.

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Global Stock Ratings Distribution

(as of November 30, 2018)

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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MISC
Overweight/Buy	**1156**	**37%**	**295**	**40%**	**26%**	**541**	**38%**
Equal-weight/Hold	**1405**	**44%**	**342**	**47%**	**24%**	**641**	**45%**
Not-Rated/Hold	**46**	**1%**	**7**	**1%**	**15%**	**7**	**0%**
Underweight/Sell	**555**	**18%**	**85**	**12%**	**15%**	**226**	**16%**
TOTAL	**3,162**		**729**			**1415**	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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