

Evolution of subnational debt as of 3Q24

Sector Analysis



Credit
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Public Finance and Sovereign Debt
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HR Ratings comments on the evolution of subnational debt as of 3Q 2024 and its expectations for 2025.

The debt of states, municipalities and their public institutions amounted to P\$683,056 million (m) at the end of the third quarter of 2024 (3Q24), down 3.1% in real terms compared to the same quarter of 2023. This is in line with a gradual debt reduction process that began in 2015, with the entry into force of the Financial Discipline Act for states and municipalities (LDF). Furthermore, debt level reduction has become more prevalent due to a change noted in public policy decisions of many subnational organizations.

Although the most recent monetary policy statements are part of a downward cycle, interest rates remain high compared to those recorded over the last decade and this has reduced the demand for financing. In addition, revenue sharing funds, which are freely available to states and municipalities, have strengthened since the end of the pandemic, driven by economic growth reported in 2022 and 2023. This had a positive impact on Federal Tax Collection (RFP), which supplies some revenue sharing funds, since it increased 3.4% on average over the same period.

Even though the above-mentioned debt reduction is generally seen as favorable, one of the most notable opportunity costs is the execution of infrastructure projects, which are intrinsically related to economic growth. The main objectives of some of these projects are to improve connectivity between urban centers, facilitate the supply of basic services and increase public well-being. The investment expenditure of states and municipalities, which includes disbursements in both public works and the acquisition of equipment & assets, decreased at an average annual rate of 2.5% from 2014 to 2023. The low level of subnational public investment, along with infrastructure needs of main market participants, could lead to the use of short and long-term financing.



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Most of the information used in this report comes from the quarterly statistics of the Debt Public Registry of the Ministry of Finance and Public Credit (SHCP), while the reconstruction and projections of Mexico's municipal population, prepared by the National Population Council (CONAPO), were used to calculate per capita data. According to SHCP, 89.4% of active financing reported as of 3Q24 (P\$683,056m) is for obligations contracted by state governments, 6.3% by decentralized public institutions and 4.3% by municipal governments, indicating the composition of subnational debt has changed over the last decade. Although the combined debt of public institutions has maintained a similar proportion in comparison to the end of 2015 (7.2%), state government concentration increased (vs. 83.8% reported as of 4Q15) while municipal government concentration contracted (vs. 9.0% as of 4Q15). As a result, debt reduction has been more prevalent in municipalities than in states.

Debt level related to revenue sharing was down slightly from 55.1% as of 3Q23 to 54.1% as of 3Q24. This year-over-year change is more moderate than in 3Q23 (vs. 63.7% as of 3Q22), which is explained by the significant growth rate of federal funds in 2023. It should be noted that revenue sharing continues to be the main source of debt payment in the subnational sector with the average state allocation being 53.0%. Additionally, no significant changes were reported with respect to sources of financing. Commercial banks continued to lead the sector, accounting for 50.9% of total government debt (vs. 53% as of 3Q23), followed by development banks, whose obligations comprised 39.9% of debt (vs. 38% as of 3Q23), as well as bond issues and other sources of financing, which accounted for 7.8% and 1.3%, respectively.

Over the coming years, opportunities for states and municipalities to obtain financing are expected to arise from certain economic factors. First, if economic growth rates are less favorable than those estimated by HR Ratings (1.1% for 2025 and 1.9% for subsequent years), tax collection could be affected which would, in turn, affect revenue sharing received by states and municipalities. In line with the above, SHCP includes revenue sharing of P\$1.34 trillion in the 2025 Federal Expenditure Budget (PEF), an increase of 1.8%, which is well below the average increase of 5.0% seen from 2022 to 2023. If the benchmark interest rate is similar or lower than HR Ratings' projection (8.0%), it could prompt debt acquisition or the execution of refinancing transactions. Subnational investment needs, such as public safety, mobility and water infrastructure, could drive sector participants to opt not only for short or long-term debt, but also for factoring and multi-year public works schemes. Finally, HR Ratings will monitor changes brought by new administrations at the federal and state levels, especially regarding their public investment decisions and financing patterns.



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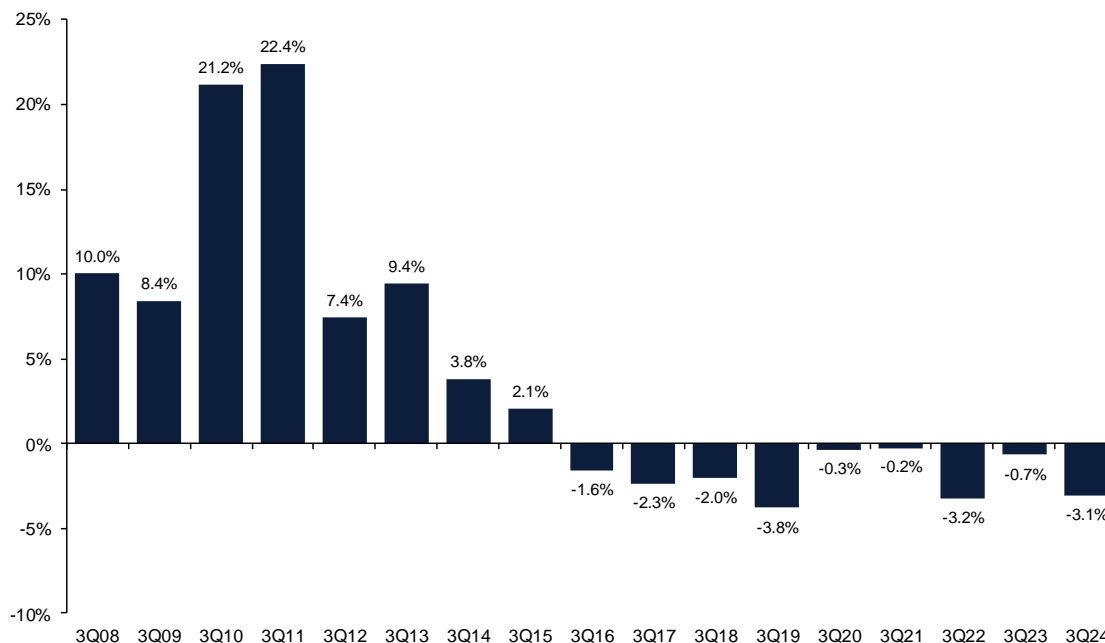
Evolution of financing and obligations of states, municipalities and their public institutions

Subnational indebtedness outlook as of Q3 2024

According to the Debt Public Registry (RPU, its initials in Spanish) of the Ministry of Finance, Mexico's subnational debt amounted to P\$683,057 million (m) at the end of the third quarter of 2024 (3Q24), 3.1% lower than in 3Q23. This subnational debt reported by the SHCP includes current obligations contracted by states, municipalities and public agencies. The figures presented may differ from those used by HR Ratings to calculate debt and debt service metrics since the Direct Debt used does not include the debt of public institutions, highway trusts or obligations backed by zero-coupon bonds.

As shown in Figure 1, subnational debt continued to decline as it has since 2015. This is directly related to the enactment of the Financial Discipline Act (LDF), which establishes state and municipal limits and provisions regarding the use of financing. From 3Q08 to 3Q15, subnational debt had a real CAGR of 10.4% while from 3Q15 to 3Q24, CAGR was at -2.2%. In addition to the impact of LDF, subnational organizations have benefited from a significant increase in revenue sharing, which has reduced their need for debt.

Figure 1. Real annual debt growth of states, municipalities and their public institutions, 3Q08 to 3Q24



Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP).



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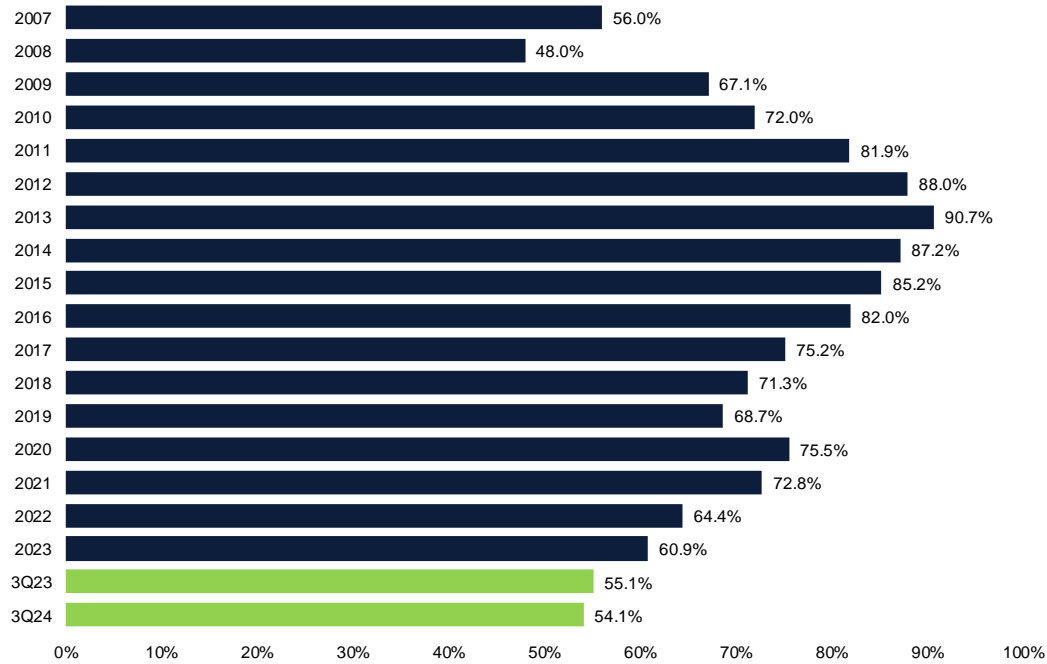
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Revenue sharing activity not only had a direct impact on the fiscal performance of states and municipalities, but also allowed for a decrease in debt level relative to their revenue. According to the Tax Coordination Act (LCF), multiple revenue sharing funds received by subnational organizations are supplied by 20.0% of Federal Tax Collection (RFP), a "bag" comprised of the collection of various taxes and oil revenue. From January to September 2024, RFP amounted to P\$3.47 trillion, 3.1% higher in real terms compared to the same period of the previous year. As a result, subnational debt as a percentage of revenue sharing was down slightly, from 55.1% as of 3Q23 to 54.1% as of 3Q24, as shown in Figure 2.

Figure 2. Subnational total debt balance as a percentage of revenue sharing, 2007 to 3Q24



Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP).

Evolution of state debt

At the end of 3Q24, state government debt was P\$610,472m, accounting for 89.4% of total subnational debt, which is slightly higher than the 87.8% as of 3Q23. State public agency obligations amounted to P\$41,743 (6.1% of the total), while municipal governments and their public institutions reported debt of P\$29,138m and P\$1,704m (4.3% and 0.2% of the total respectively).

As shown in Figure 3, Mexico City (HR AAA), Nuevo León (HR A+), Estado de México, Chihuahua (HR A) and Veracruz (HR A-) are still the states with the highest debt levels in the country in absolute terms. Combined, these states account for 51.9% of total state debt. Tlaxcala was the only state with no active debt after Querétaro took on financing. The Mexican state average was P\$19,077m, which is an actual decrease of 1.3% compared to the average as of 3Q23. It should be noted that the amounts shown in Figure 3, as well as those reported in this section, do not include the debt of state public institutions.



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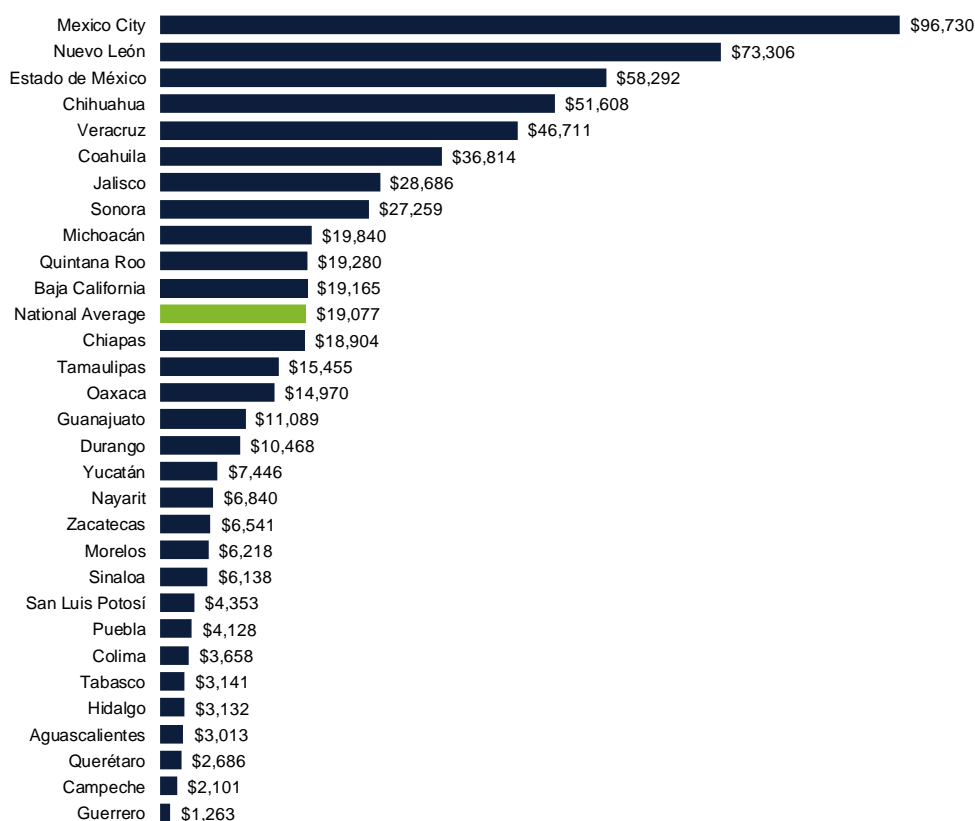


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Figure 3. State debt as of 3Q24 (Balance in millions of pesos)



Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP).
 Note: Tlaxcala was not included since it did not have public debt as of 3Q24.

In line with Figure 4, only eight states increased their debt from 3Q23 to 3Q24: San Luis Potosí (HR A+), Sonora (HR A), Durango (HR BB+), Nuevo León (HR A+), Guanajuato, Guerrero, Chihuahua (HR A) and Querétaro. Although in absolute terms Nuevo León was the state whose debt grew the most (from P\$69,237.0m to P\$73,305.6m), San Luis Potosí had the highest percentage change. In the case of the former, the use of short-term financing accelerated significantly, increasing from P\$1,787m to P\$7,766m after the local congress failed to approve the state budget and resorted to debt renewal. San Luis Potosí also increased its unsecured debt during the same period after contracting obligations with several financial institutions. Querétaro went from having no debt as of 3Q23 to an outstanding balance of P\$2,686m as of 3Q24, after drawing down funds through two long-term loans in October 2023 to implement mobility, energy and infrastructure projects.

Sinaloa (-17.4% vs. 3Q23), Hidalgo (-14.8%), Baja California Sur (-14.0%) and Tabasco (-12.5%) had the most significant debt level reduction. Furthermore, use of short-term financing in Sinaloa was considerably reduced from P\$4,020m in 3Q23 to P\$2,350m in 3Q24. However, this trend could be reversed over the coming months as the Sinaloa Congress approved a loan for up to P\$2,300m on January 10 which would be repaid in 2027.



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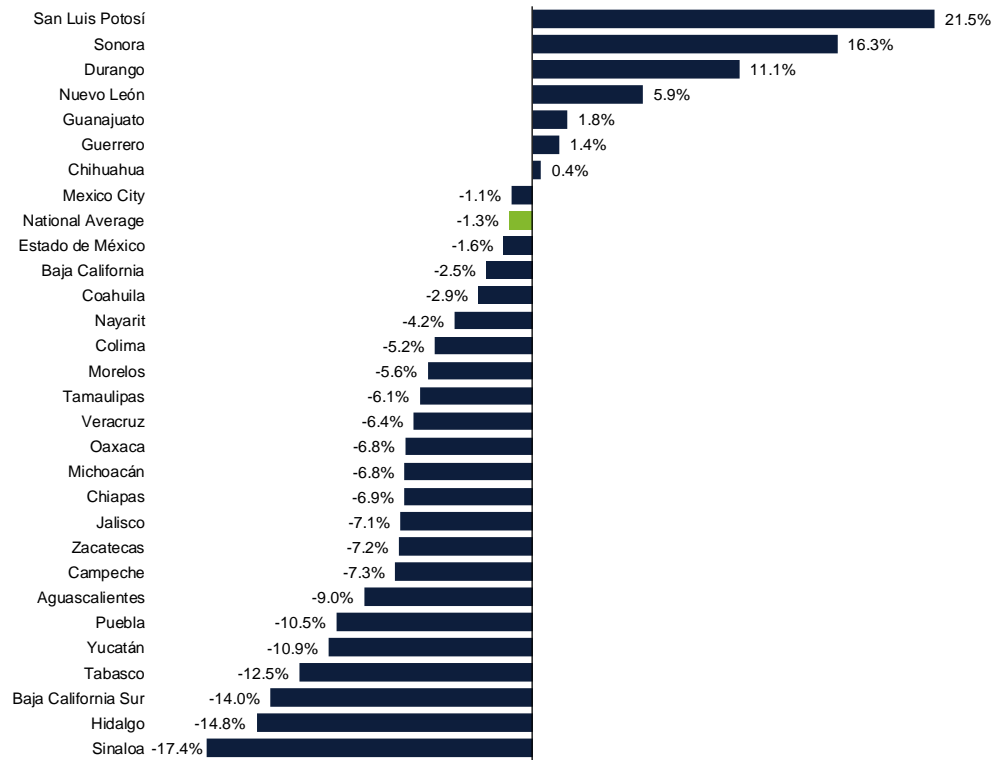


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Figure 4. Real annual state debt growth as of 3Q24



Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP).
 Note: Tlaxcala was not included since it did not have public debt as of 3Q24. Querétaro is also not included as it went from not having any financing to recording P\$2,686m as of 3Q-24, making it impossible to show a percentage.

Figure 5 shows per capita debt of the 31 states with active financing from highest to lowest. The use of per capita values offers a different perspective since the most populous states do not necessarily have the highest debt levels. As shown in Figure 3, Chihuahua (HR A), Nuevo León (HR A+) and Mexico City (HR AAA) are among the states with the highest debt per capita. However, Estado de México, which ranked third in total debt as of 3Q24, dropped to 16th place when considering per capita values. In addition, the states with the lowest per capita debt are Tlaxcala, Puebla and Hidalgo (HR AA+): in the case of Tlaxcala, it has no financing of any kind, while of the other states only Puebla and Hidalgo have less than 1,000 pesos of per capita debt.



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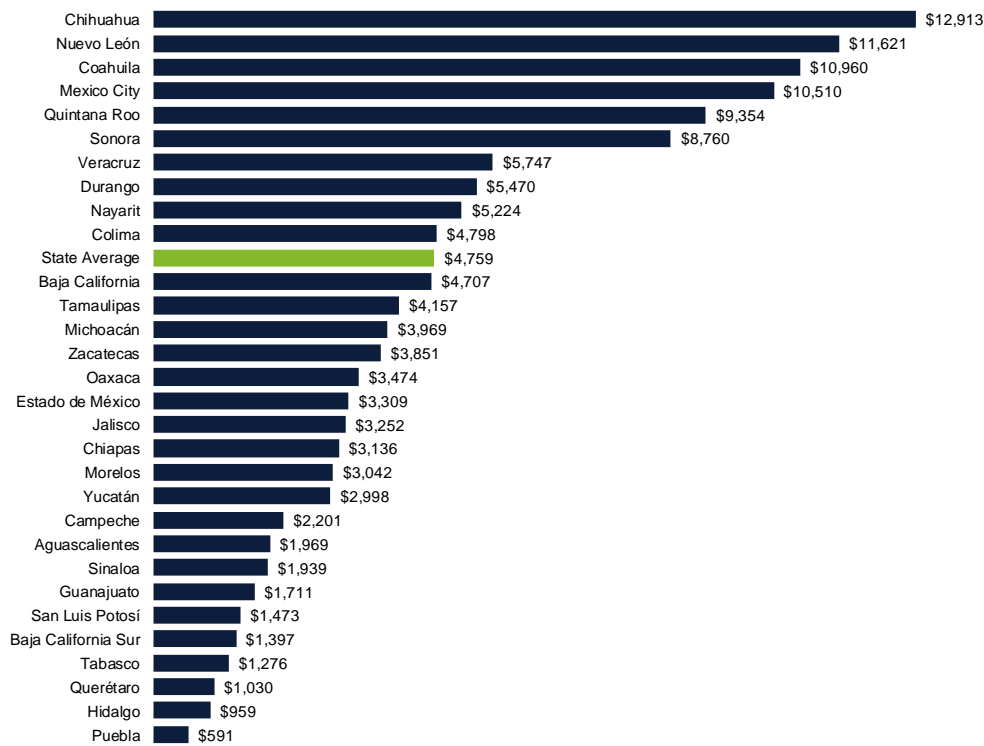


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Figure 5. State per capita debt as of 3Q24 (Balance in pesos per capita)



Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP) and CONAPO.
 Note: Tlaxcala was not included since it did not have public debt as of 3Q24.

Figure 6 shows that commercial banks maintained their position as the main source of financing for states and their decentralized agencies since their share in the sector was, on average, 50.9% of total debt as of 3Q24. Development banks financed 39.9% of the subnational sector's obligations, stock market issues 7.8% and remaining sources 1.3%. During the last two tax years, refinancing and debt restructuring operations were completed in Michoacán (HR BBB+), Tamaulipas (HR A+) and Colima (HR BBB), and it is possible that similar activity will be seen in the short term as interest rates are expected to drop. Restructuring often provides states with access to less accelerated amortization profiles, which frees cash flow and allows for the development of investment projects. As a result, development banks have slightly increased their market share in recent years as they usually offer more favorable conditions for these types of operations.



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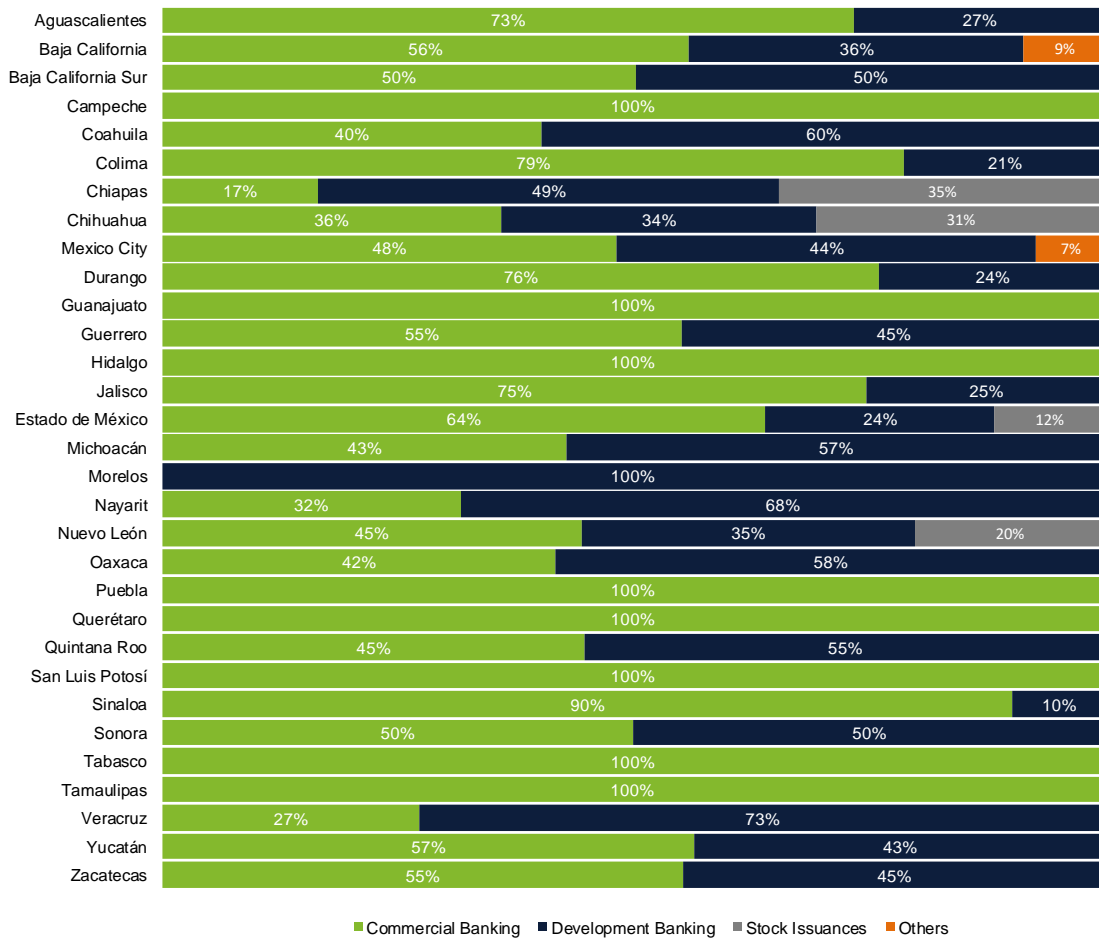


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Figure 6. Source of financing as a percentage of the total state and public institutions debt as of 3Q24



Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP).
 Note: Tlaxcala was omitted since it did not have Public Debt as of 3Q24.

Evolution of municipal debt

Municipalities have significantly reduced their use of financing over the last ten years, in line with the pattern seen in the subnational sector over the same period. However, this change is more prominent than that of states and public agencies since not only has the municipal debt balance decreased, but also its share within the sector. While at the end of 2015, total municipal government debt totaled P\$48,081m, accounting for 9.0% of subnational financing, as of 3Q24 this decreased to P\$29,138m, only 4.3% of total debt. Moreover, the number of municipalities with active loans fell from 693 in 3Q23 to 556 in 3Q24, in accord to LDF, which establishes that all short-term obligations must be settled three months prior to the change of administration. In this regard, mayoral seats were up for election in 30 states in 2024 and the dates when administrations changed range from September 2024 to January 2025.



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Figure 7 shows the percentage of municipal debt distributed among Mexico's states. Municipalities in Jalisco account for 16.0% of total debt, leading the country. Although Guadalajara represents 23.5% of Jalisco's municipal debt (HR AA+), 66 of the remaining 124 municipalities in the state reported the use of financing as of 3Q24. In addition to Jalisco, the municipalities of Estado de México, Nuevo León (HR A+) and Sonora (HR A) account for 13.6%, 13.5% and 13.2% of debt, respectively. Therefore, municipalities in these four states represent 56.3% of municipal debt.

Figure 7. Concentration of municipal debt by state as of 3Q24



Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP).

Figure 8 shows the twenty municipalities with an outstanding balance of debt as of Q3 2024. Hermosillo heads the list (HR BBB+, with a debt of P\$1,635m), followed by Monterrey (HR AA, P\$1,541m), León (P\$1,396m), Guadalajara (P\$1,093m) and Zapopan (P\$909m). Regarding the list provided in the previous sector report, the main change was Tijuana's exit (HR AA+) which as of 3Q24 had the highest debt in absolute terms. León moved up from eighth to third place, as its debt rose from P\$869m to P\$1,396m. Additionally, Cozumel (HR A-) replaced Tonalá due to the latter's accelerated public debt amortization profile. Combined, the obligations of the municipalities shown in Figure 8 account for 47.6% of total municipal debt, so the leverage of the remaining 2,456 municipalities is 52.4%.



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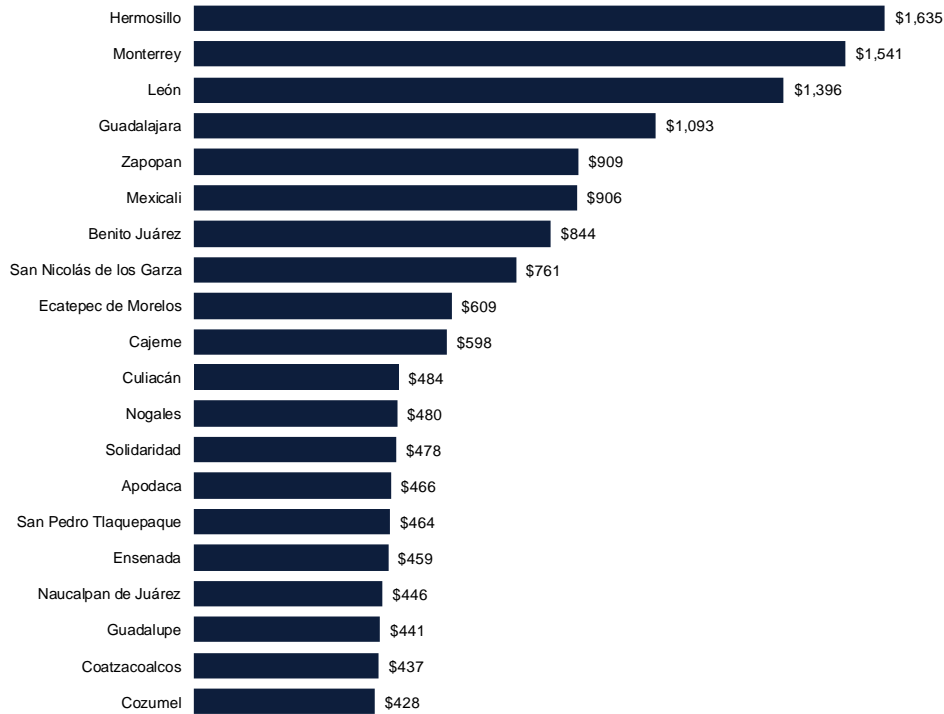


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Figure 8. Municipal debt as of 3Q24 (Balance in millions of pesos)



Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP).
 *Only the first 20 municipalities are shown in order of total debt.

Between the third quarter of 2023 and 2024, the most notable change was that of the municipality of Tijuana (HR AA+), which went from being the most indebted in the country in absolute terms to having no outstanding debt at the end of the period. Between January and February 2024, the municipality made extra payments, paying off its four structured loans thanks to a significant accumulation of liquidity in recent tax years. Aguascalientes (HR AA+) and Toluca reduced their debt by P\$314m and P\$262m, respectively. In terms of increases, the most notable was León, followed by Irapuato, García (Nuevo León, HR A+) and Lerdo. In real terms, 93.6% of municipalities with active financing reported a reduction in their outstanding balance from 3Q23 to 3Q24 while only 6.4% reported an increase.



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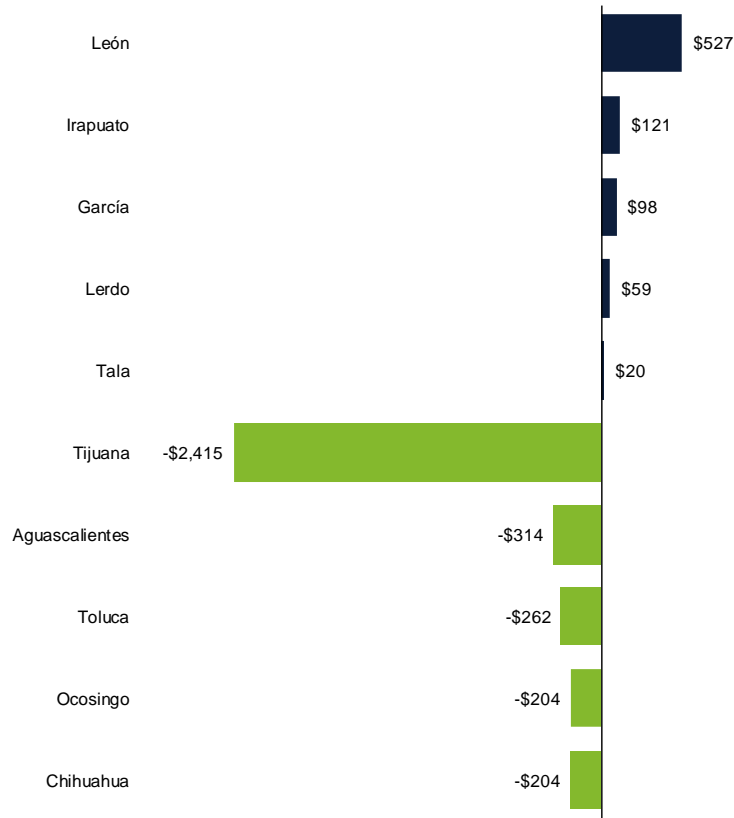


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Figure 9. Municipalities with higher debt growth and reduction, 3Q24 vs. 3Q23 (Balance in millions of pesos of 2024)



Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP).

Figure 10 lists the ten municipalities with the highest per capita debt in the country, considering only those municipalities with a population of more than 15 thousand inhabitants. As of 3Q24, Cozumel (HR A-) and Puerto Peñasco (HR BB) ranked first and second, with per capita debts of 4,536 and 4,338 pesos per inhabitant, respectively. Both municipalities are notable for their intense tourist activity, which results in a constant need for infrastructure renovation, and they also have less than 100,000 inhabitants. They are followed by Guaymas, Tequila and San Nicolás de los Garza, with per capita debt of 1,917, 1,817 and 1,802 pesos per person. The prevalence of municipalities in Sonora in the list -Puerto Peñasco, Guaymas, Nogales (HR BBB), Hermosillo (HR BBB+) and Agua Prieta-, should be noted despite their different demographic, economic and social characteristics.



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Figure 10. Per capita debt of municipalities* as of 3Q24

Municipality	State	Debt balance as of 3Q-24 (thousands of pesos)	Population at mid- year 2024	Debt per capita (pesos)
Cozumel	Quintana Roo	427,682	94,286	4,536
Puerto Peñasco	Sonora	282,450	65,112	4,338
Guaymas	Sonora	308,125	160,709	1,917
Tequila	Jalisco	84,921	46,740	1,817
San Nicolás de los Garza	Nuevo León	761,264	422,404	1,802
Nogales	Sonora	480,234	287,440	1,671
Hermosillo	Sonora	1,634,848	1,013,689	1,613
Agua Prieta	Sonora	156,513	98,528	1,589
Sultepec	Mexico	34,967	23,483	1,489
Ahualulco de Mercado	Jalisco	35,506	24,542	1,447

Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP) and CONAPO.

*Only municipalities with a population of more than 15 thousand inhabitants were included in the list.

Subnational financing outlook

According to the latest update of macroeconomic scenarios, HR Ratings projects that the Mexican economy will grow at an annual rate of 1.1% in 2025, with average growth of 2.3% over the following three years. Although the 2025 growth outlook is not very different from 2024 (1.4%), this exerts downward pressure on prospective tax collections, especially Income Tax (ISR) and Value Added Tax (VAT). As a result, revenue sharing would rise less than the increase reported over the last two tax years, which could exert pressure on the fiscal balances of states and municipalities.

While a drop in financing could be considered desirable, problems at the local level, as well as existing infrastructure conditions, should also be considered. Public investment expenditure in the subnational sector has been dropping since 2009, when it reached an all-time high. Although there was a slight upturn in 2022 and 2023 due to an increase in the funds obtained by states and municipalities through federal contributions, they benefited from the growth of the RFP during the same period. However, as shown in Figure 11, investment expenditure is still below 2018 levels, which could incentivize major players to implement major projects using long-term debt.



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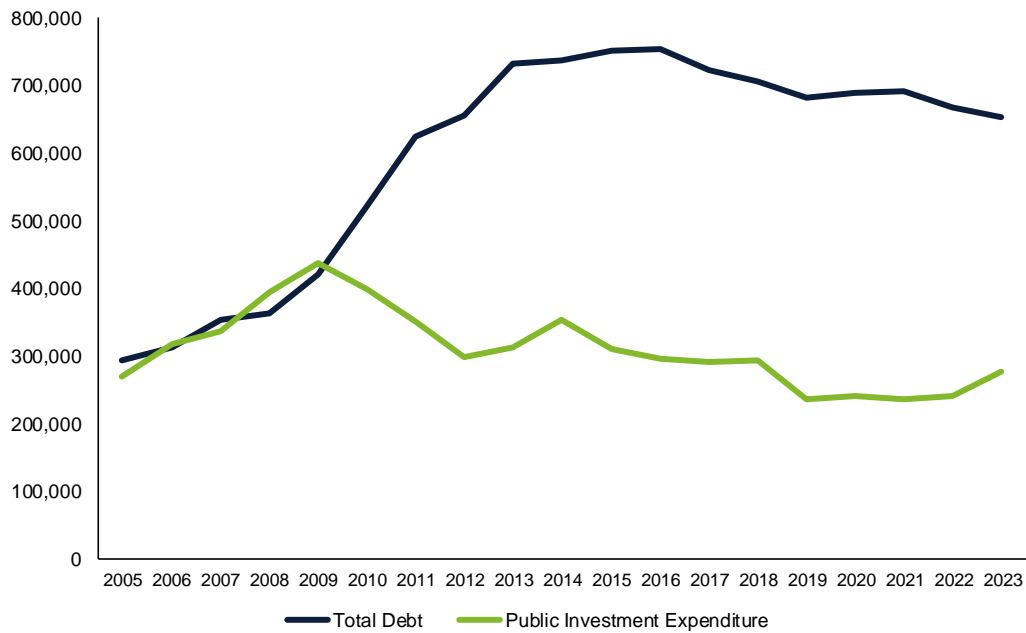


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Figure 11. Evolution of state & municipal debt and productive public investment, 2005 to 2023



Balance in millions of pesos of 2023.

Source: HR Ratings based on information from the Ministry of Finance and Public Credit (SHCP) and INEGI.

Despite the decreasing performance of subnational debt during recent periods, as well as the 1.8% increase in revenue sharing projected by the SHCP in the Federal Expenditure Budget (PEF), opportunities for the use of financing at the state and municipal levels are expected. If annual GDP growth rate is lower than that estimated by HR Ratings and states and municipalities are therefore forced to make budgetary adjustments due to reduced revenue sharing, this could lead to a rebound in the contracting of unsecured loans in subsequent years. Furthermore, due to current macroeconomic conditions, the above risk may not be offset through an activation of the State Inflow Stabilization Fund (FEIEF). In addition to the aforementioned factors, a generalized reduction in interest rates is expected in the short term, so states and municipalities with recurring investment needs could resort to contracting long-term debt or factoring schemes and multi-year public works to execute infrastructure projects. Finally, HR Ratings will monitor any changes in financing patterns for subsequent years as well as financial decisions made by new federal and state administrations.



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