KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA

Venezuela/PDVSA Monthly Report July 2019

Closing July, Venezuelan debt faced a severe decline that sent its prices significantly below pre-Guaidó levels. This is mainly an already expected effect derived from phasing-out Venezuelan debt from JP Morgan indices that was announced on July 9th, and expected to begin on July 29th, finishing on November 29th. Prices decline has turned YTD return negative for all PDVSA and Venezuela issues for the first time in 2019.

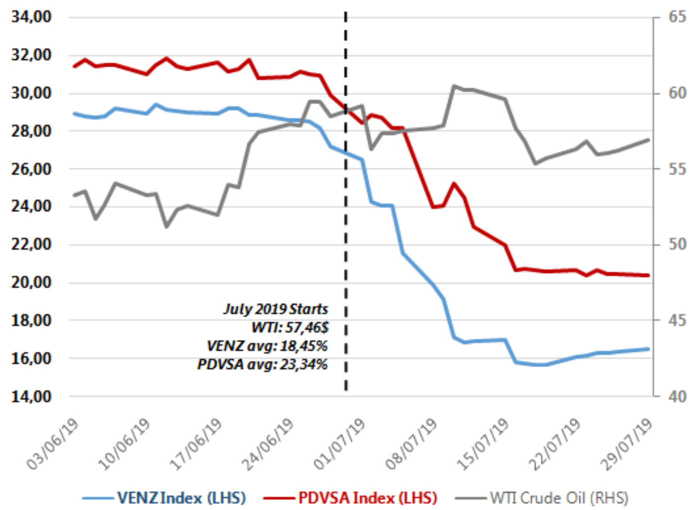

Chart N°1: VENZ/PDVSA bond indexes and oil prices, Jun-Jul 2019.
Source: Bloomberg, Knossos Asset Management.

According to our indices, Venezuelan sovereign debt average prices were around 16 cents at the close of July, with monthly average near to 29 cents. PDVSA bonds' average prices closed around 20 cents, with monthly average of 23 cents. As a consequence of the change in JP Morgan indices, it is estimated that ETF's will be selling USD 1.8 billion of Venezuelan debt. We expect prices to move lower in the following weeks, as forced sells in an already halted market will pressure prices.

On July 31th, Reuters reported that managers are still figuring out how to proceed and it seems to be too early to know if there is any possibility to keep Venezuelan debt in their portfolios. We don´t know what will prevail in the decision process, as selling or holding on to the positions each carry its own complications. Even though prices may seem attractive at these levels if you believe a change of regime will take place, passive funds are not in the business of making these assessments.

Security	28/06/2019	31/07/2019	Total Return	Total Return (2019 YTD)
VENZ 7 3/4 10/13/19	27,75	15,70	-43,42%	-33,79%
VENZ 6 12/09/20	25,70	15,50	-39,69%	-32,74%
VENZ 12 3/4 08/23/22	27,20	15,45	-43,20%	-35,38%
VENZ 9 05/07/23	27,15	15,60	-42,54%	-32,38%
VENZ 8 1/4 10/13/24	26,95	15,65	-41,93%	-32,12%
VENZ 7.65 04/21/25	27,75	15,50	-44,14%	-32,34%
VENZ 11 3/4 10/21/26	26,75	15,70	-41,31%	-36,11%
VENZ 9 1/4 09/15/27	26,65	15,75	-40,90%	-32,23%
VENZ 9 1/4 05/07/28	26,65	15,70	-41,09%	-31,72%
VENZ 11.95 08/05/31	26,75	15,70	-41,31%	-33,39%
VENZ 9 3/8 01/13/34	27,35	15,80	-42,23%	-44,45%
VENZ 7 03/31/38	26,85	15,75	-41,34%	-30,74%
PDVSA 8 1/2 10/27/20	89,20	77,85	-12,72%	-16,86%
PDVSA 9 11/17/21	22,45	14,00	-37,64%	-23,97%
PDVSA 12 3/4 02/17/22	27,00	14,05	-47,96%	-26,61%
PDVSA 6 05/16/24	22,60	14,10	-37,61%	-6,13%
PDVSA 6 11/15/26	22,45	13,95	-37,86%	-7,13%
PDVSA 5 3/8 04/12/27	22,35	13,95	-37,58%	-7,59%
PDVSA 9 3/4 05/17/35	23,35	14,05	-39,83%	-26,57%
PDVSA 5 1/2 04/12/37	22,10	13,95	-36,88%	-7,65%

Table N° 1: Venezuela/PDVSA bond performance, July 2019.
Source: Bloomberg CBBT, Knossos Asset Management. ***Note: Returns were adjusted to account for the accrued interest lost, per EMTA resolutions.**

On the other hand, Fitch upgraded all CITGO senior secured debt to 'B+' from 'B' in the eve of its recent USD 1.9 billion offering, which is said to have reached between 4 and 5 billion in orders. Proceeds will be used to pay off the 10.75% notes due next February.

As CITGO did on March when it raised USD 1.2 billion, investors are being asked to waive terms requiring CITGO to repay the debt in the event of a "change of control", which seem to be pointing to the risks that PDVSA is facing right now. Investors' willingness to grant this kind of waiver proves that the market is confident about the soundness of CITGO operations, and would cooperate to avoid any interruptions that may translate in increased risk of repayment.

Others have suggested an alternative reading to this, pointing that many investors may be seeing a change in control beneficial for their interest and that's the reason why they grant the waiver. In our opinion, the likelihood of such an event has lowered, but no totally disappeared, now that the most recent Executive Order N° 13.884 issued from the US Treasury Department on August 5th has blocked all Venezuelan assets in that country, making it harder for creditors to take on CITGO and its assets.

PDVSA and Venezuela entering the next phase of the legal battles

Late July and early August have been one of the most dynamic periods in terms of the legal puzzle that someday should result in a restructuring process for the Venezuelan debt. On July 29th, a US federal appeals court rejected an appeal by PDVSA to set aside an order allowing Crystallex to seize shares in CITGO. In 2018 Crystallex was awarded with a compensation of USD 1.4 billion for the expropriation of its assets in Venezuela under Chavez administration.

On July 30th, Venezuela's interim government filled a request for extension of time to file petition for panel rehearing on this case. On August 1st the request was accepted by Judge Thomas Ambro of the Third Circuit Court of Appeals, so Venezuela and PDVSA's lawyers will have until September 26th to prepare their arguments.

Even when this seems to be a back step, is worth noting that CITGO residual value is enough to pay PDVSA 2020 bondholders, Russia, and Crystallex, that is now the first in the queue waiting for payment. Obligations with these creditors add around 4.7 billion[1], but CITGO equity value is near USD 8.5 billion. However, if the interim government were to face CITGO shares auction, new questions emerge: will auction require additional licenses? Will the Treasury Department issue such licenses? Will they auction 100% of CITGO shares or only 51%? These are some questions that form part of the missing pieces of the puzzle of the Venezuelan debt at this point.

Issuance of the Executive Order N° 13.884 seems to favor interim government in this sense, allowing it to eventually default PDVSA 2020 bond without taking the risk of losing CITGO. On August 6th, Attorney General Hernandez said that this Executive Order paved the way to talks with bondholders, who are already asking for legal advice to define next steps. The market seems to be pricing in this as the PDVSA2020 bonds fell sharply on the news (now trading around 50 cents).

Previously, on August 2nd, Attorney General Hernandez announced that ICSID dismissed Conoco's USD 1.5 billion claim for compensation and damages over PDVSA, reducing the oil company obligations with Conoco to only USD 33.7 million. This victory is as important as the Crystallex setback and illustrates what we expect to see with higher frequency in the following months: the interim government using intensively legal resources to gain time, while they wait to get the full control of the Venezuelan State to begin the restructuring process in better conditions to negotiate.

[1] PDVSA 2020 outstanding is near USD 1.8 billion. Collateralized Russian loan counts for USD 1.5 billion, and Crystallex compensation would add another USD 1.4 billion.

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