KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA GROUP

Venezuela/PDVSA Monthly Report
April 2016

Overview

Venezuela and PDVSA's bonds had a strong performance in April, closing the month with a +10.02% average return, which was about five times the average in emerging market debt (as measured by the JPMorgan EMBI Global Total Return Index). The sustained recovery in oil prices was the main driver and as WTI crude oil futures climbed to new highs for the year above 46$/bbl, so did VENZ and PDVSA bonds which ended April at month- and year-to-date highs. (See Graph N°1 attached).

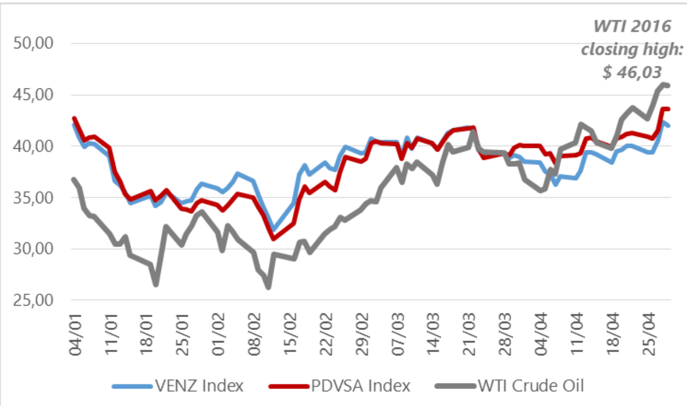


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil. ***Source: Bloomberg BGN, own calculations.***

On the other hand, several bonds paid coupons on the month (VENZ 19,24,25,26 and PDVSA 16, 17 5,25%, 22 6%, 27 and 37) whose proceeds might have been reinvested in the curve, strengthening rumors of short-term debt buybacks by the investment funds managed by the Government . Aditionally, on April 28th, President Nicolás Maduro announced a new USD 1.5Bn capital-expenditure loan for PDVSA, financed by Credit Suisse and a consortium of Japanese banks.

On a less positive note, the nationalized steelmaker Sidetur defaulted on its USD 73,5mm of principal outstanding on the bonds due April 20th, 2016. However, the issuer had first skipped interest payments in April 2013 and there has not been any progress from the company nor the Republic (its current owner) to remedy the default ever since. Therefore, the non-payment was already incorporated into bond prices, which last traded below 10 cents on the dollar, and had little spillover effect on the rest of the bonds.

Rally despite a worsening local situation

Venezuela's situation is getting worse as the year progresses. Amid triple digit inflation and scarcity levels for consumer staples at around 80%, there have been recurring occurrences of mob violence and looting nationwide, which led to the temporary militarization of cities such as Maracaibo, Maracay and San Francisco. Moreover, the long drought is posing an imminent risk of a collapse of the Guri hydroelectric dam - and hence the national electric grid - which led the Executive to decree up to 3 days off per week for public sector workers to save power. Furthermore, in a worrisome sign of distress, several oil service providers (Schlumberger and Halliburton the most salient cases) announced their intention to either reduce operations in Venezuela or cease them altogether, alleging unpaid commercial debts running in the billions. Nonetheless, investors shrugged off the bout of negative headlines and drove credit spreads to year-to-date lows. In this context, it's also important to highlight the start of the Opposition-led recall referendum on President Maduro, which formally initiated this month. This factor could have served as counterweight to a increasingly complicated environment in the country.

Performance in the month

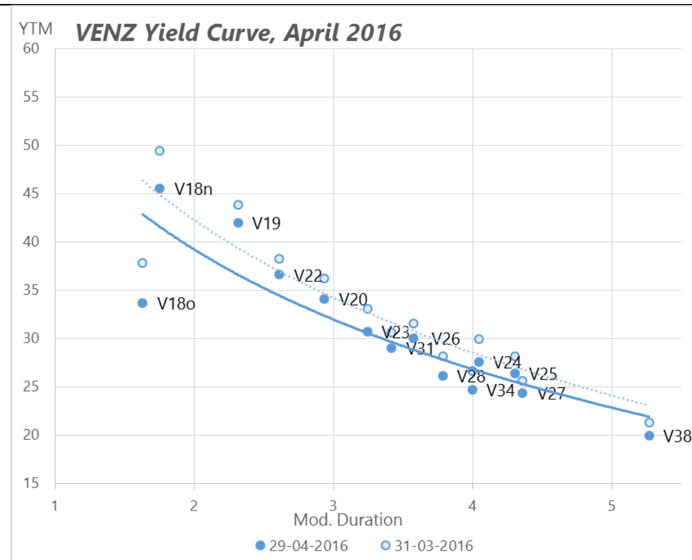
Venezuela and PDVSA bonds close April with an average 8.6% increase in prices and an average total return of +10.02% factoring interest. The performance was broad-based, with high coupon bonds underperforming (Pdvsa 22 was the month's laggard with a +5.3% return), and low dollar value and short-end bonds posting double-digit advances. Most of the upside took place in the last three sessions of the month, where 520MM USD face value of PDVSA bonds changed hands (that represents 27% of the 1.94Bn total PDVSA traded volume in April, according to TRACE). The top 3 performers in the month were PDVSA '16 (+13,1%), PDVSA '27 (+12,1%), and PDVSA '37 (+11,8%).

Security	31/03/2016	29/04/2016	Total Return
VENZ 13 5/8 08/15/18	64,15	70,00	+10,52%
VENZ 7 12/01/18	40,65	44,90	+11,21%
VENZ 7 3/4 10/13/19	38,05	40,60	+7,60%
VENZ 6 12/09/20	34,10	37,00	+9,46%
VENZ 12 3/4 08/23/22	43,80	46,50	+8,27%
VENZ 9 05/07/23	35,50	39,25	+11,45%
VENZ 8 1/4 10/13/24	34,20	37,95	+11,54%
VENZ 7.65 04/21/25	33,85	36,75	+9,50%
VENZ 11 3/4 10/21/26	40,00	42,70	+8,03%
VENZ 9 1/4 09/15/27	40,10	42,75	+8,45%
VENZ 9 1/4 05/07/28	35,55	38,75	+10,09%
VENZ 11.95 08/05/31	40,00	42,65	+8,55%
VENZ 9 3/8 01/13/34	35,85	39,00	+10,21%
VENZ 7 03/31/38	33,70	36,15	+8,89%
PDVSA 5 1/8 10/28/16	78,05	88,15	+13,09%
PDVSA 5 1/4 04/12/17	50,85	54,65	+7,96%
PDVSA 8 1/2 11/02/17	53,00	58,55	+11,02%
PDVSA 9 11/17/21	37,25	39,85	+8,15%
PDVSA 12 3/4 02/17/22	45,35	46,80	+5,28%
PDVSA 6 05/16/24	30,95	34,00	+10,67%
PDVSA 6 11/15/26	30,90	34,05	+10,91%
PDVSA 5 3/8 04/12/27	31,50	35,20	+12,07%
PDVSA 9 3/4 05/17/35	37,95	40,15	+7,10%
PDVSA 5 1/2 04/12/37	31,60	35,20	+11,76%

Table N° 1: Price performance of Venezuela and PDVSA bonds, April 2016

Evolution of the curves

Graphs N° 2 and 3 below plot the changes in VENZ and PDVSA yield curves during the month. In the case of Venezuela, the bull steepening continues: both VENZ '18 bonds compressed more than 350bps, compared with an average -180bps move in the rest of the maturities.



Graph N°2: Venezuela Yield curve changes, April 2016. *Source: Bloomberg CBBT.*

The PDVSA curve experienced massive bull steepening, with 2016 maturities (PDVSA '16 -2200bps, PDVSA '17 8,5% -800bps) outperforming the average -170bps move in the other tenors.

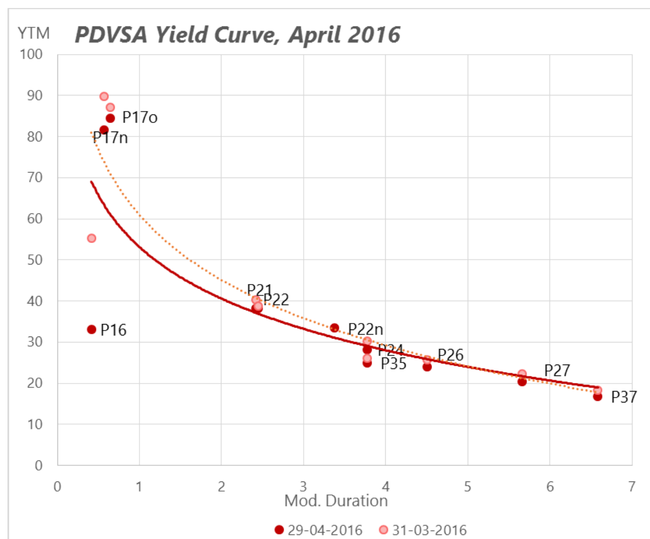


Chart N° 3: PDVSA Yield Curve changes, April 2016. *Source: Bloomberg CBBT.*

Looking ahead

Recent actions in the economic front have not deviated from the *forced austerity* doctrine of last year. The Maduro administration has implemented sharp cuts on imports and real central government spending on 2016, amounting to YoY changes of -40% and -37% respectively, according to Wall Street analysts. These figures amount to the most severe episodes of import and fiscal austerity in the country's history, even surpassing the 2002-03 national oil strike.

Even though recent history has shown convincingly that what is bad for the citizens isn't necessarily bad for the bondholders (and the aforementioned import cuts are a clear example of this), it's crucial to highlight that this isn't a moment to lower the guard. Extreme socioeconomic distress and rapid, disorderly regime change have flirted with each other several times in Latin American history; and there's very little reason to believe that current-day Venezuela is completely safe from this risk. Hence, the current context calls for extraordinary aplomb when it comes to investing on VENZ and PDVSA credit. April's performance is a token of the outsize returns that can be achieved on Venezuelan assets, even on the most adverse circumstances.

Looking into the near future, uncertainty remains regarding the two key events of 2016: PDVSA's bond maturities in October/November, and the actions initiated by the Opposition towards generating a constitutional regime change.

Regarding the first point: the Republic is considering all options to re-profile PDVSA's short term debts. Despite the lack of concrete plans announced by officials on the matter yet, it stands to reason that the Executive will be flexible enough to accommodate creditors' demands, as long as this allows the government to muddle through 2016 without triggering a credit event. The price of PDVSA bonds due 2017 are reflecting the fact that the outcome of these strategies is still uncertain.

Regarding the second point, although the process to carry out a recall referendum is long - and just barely started -, the possibility of a government transition in the medium term is on the table. In this context, one wonders: What would a new administration do in regards to debt service? A new Opposition government would have, in theory, every incentive in the world to repudiate the country's external debt in grounds of unconstitutionality, corruption or malfeasance in general. Nonetheless, we believe that the Democratic Unity Roundtable understands the astronomical economic costs for the nation of taking such a decision, and thus according to our judgment, it would be more inclined to continue the path of amiably negotiating with foreign creditors that Maduro is taking nowadays, perhaps with the added benefits of increased transparency, openness, ideological flexibility and pragmatism.