KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA GROUP

Venezuela/PDVSA Monthly Report
August 2016

Most of Venezuela and PDVSA bonds finished the month of August in positive territory and trading with significant price volatility (See chart N°1). The credit started the month on a negative tone after the surprise sacking of Economic VP Miguel Pérez Abad, who was considered 'pro-market' by analysts, and its replacement for Carlos Farias (Line 'I' of the chart); the weakness resurfaced two weeks later, when CNE chair Tibisay Lucena established a roadmap for the recall referendum prerequisites that all but annulled the possibility of the election taking place before January 2017 (Line 'II'). Despite the negative headlines, Venezuelan debt generated a total return of +4,6% in the month (measured by the JPM EMBI+ Venezuela Index), benefiting from capital inflows to Emerging Markets and a sharp recovery in oil prices, with the WTI benchmark climbing around +7,5%.

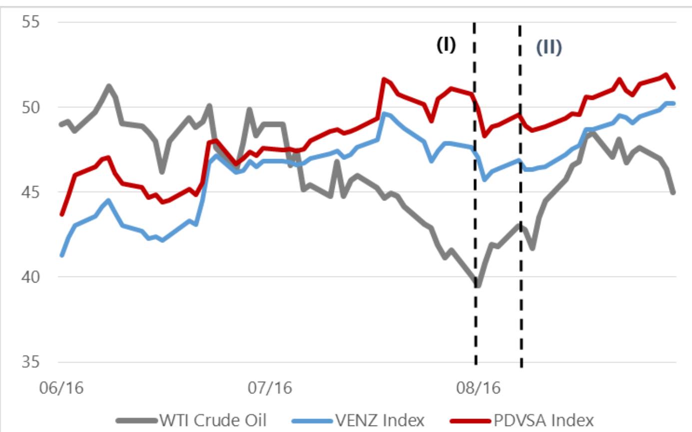


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Q2 2016). *Source: Bloomberg BGN, own calculations.*

Debt service amounted to USD 705mm during August (VENZ 2018/2022/2031, PDVSA 2022). These high-coupon bonds outperformed during the month, possibly as a consequence of flows reinvestment. In addition, the rumors over the reprofiling of PDVSA's short-end bonds increased: leaks suggested that Credit Suisse was assigned the mandate for the operation; PDVSA would offer one or several incentives for participant holders; furthermore, the company would focus on 2017 maturities only (Since the remaining amount in circulation of PDVSA 2016 is relatively low, due to buybacks from local entities). Despite the developments, PDVSA short end bonds were the month's worst performers.

Among the drivers of the positive behavior in Venezuela and PDVSA bonds, it is worth highlighting that emerging market bond funds received inflows in the last two months that averaged over USD 2Bn per week, although the pace decelerated in the last weeks of August (See chart N°2).

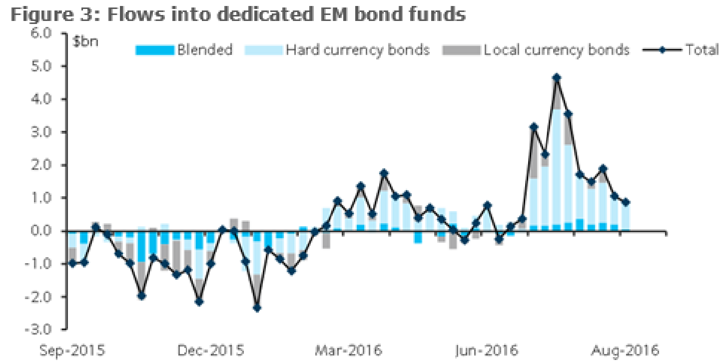


Chart N°2: Flows into dedicated Emerging Market bond funds, in Bn USD (last 12 months). *Source: EPFR Global, Barclays Research*

Performance in the month

Security	29/07/2016	31/08/2016	Total Return
VENZ 13 5/8 08/15/18	67.00	63.75	+6.61%
VENZ 7 12/01/18	54.10	57.05	+6.53%
VENZ 7 3/4 10/13/19	48.25	50.00	+4.86%
VENZ 6 12/09/20	43.80	45.55	+5.15%
VENZ 12 3/4 08/23/22	53.25	55.70	+6.15%
VENZ 9 05/07/23	44.20	45.75	+5.09%
VENZ 8 1/4 10/13/24	43.55	45.25	+5.33%
VENZ 7.65 04/21/25	42.70	44.25	+5.00%
VENZ 11 3/4 10/21/26	48.55	50.65	+6.08%
VENZ 9 1/4 09/15/27	48.45	50.05	+4.66%
VENZ 9 1/4 05/07/28	44.65	46.05	+4.78%
VENZ 11.95 08/05/31	48.65	51.35	+6.91%
VENZ 9 3/8 01/13/34	45.20	46.50	+4.75%
VENZ 7 03/31/38	41.25	41.50	+2.02%
PDVSA 5 1/8 10/28/16	96.15	93.60	-2.11%
PDVSA 5 1/4 04/12/17	69.90	68.55	-1.18%
PDVSA 8 1/2 11/02/17	78.25	73.55	-4.88%
PDVSA 9 11/17/21	49.25	48.70	+0.52%
PDVSA 12 3/4 02/17/22	54.55	58.20	+7.99%
PDVSA 6 05/16/24	37.25	37.30	+1.55%
PDVSA 6 11/15/26	36.80	36.60	+0.90%
PDVSA 5 3/8 04/12/27	36.45	36.10	+0.43%
PDVSA 9 3/4 05/17/35	44.90	46.15	+4.56%
PDVSA 5 1/2 04/12/37	36.50	35.90	-0.25%

Table N° 1: Performance of Venezuela and PDVSA bonds, August 2016

Venezuela and PDVSA bonds ended up with an average +1,88% increase in prices and an average +3,4% total return (including interest); the benchmark JPM EMBI+ Venezuela Index, more weighted towards VENZ, returned +4,6% in August. In contrast to the last month, PDVSA credit (+0,75%) underperformed VENZ (+5,28%). High-coupon bonds were the best performers, and the short end of PDVSA underperformed the rest of the curve (See chart N° 3). August's best performances were seen in PDVSA 2022 (+7,99%) and VENZ 2031 (+6,91%), two of the bonds that paid interest in August. The worst performer was PDVSA 8,50% 2017 (-4,88%).

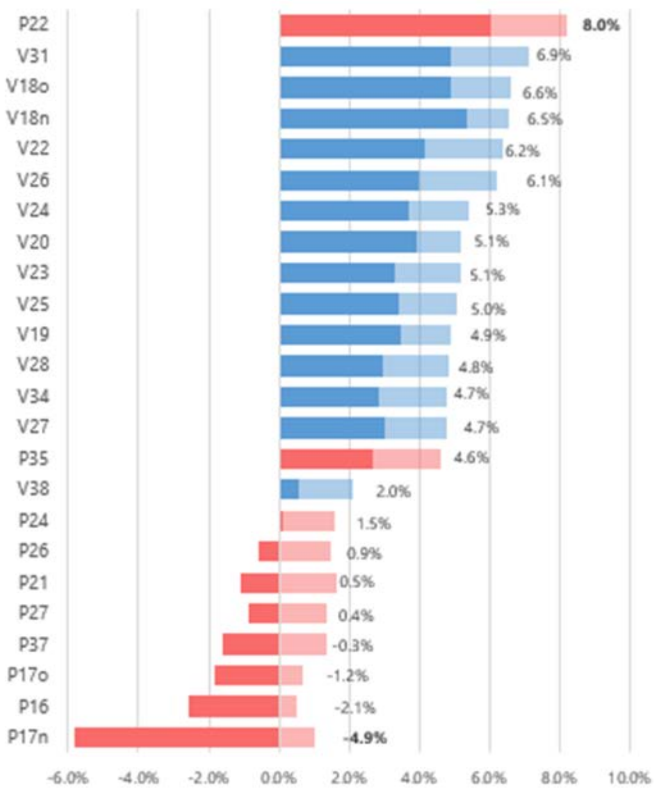
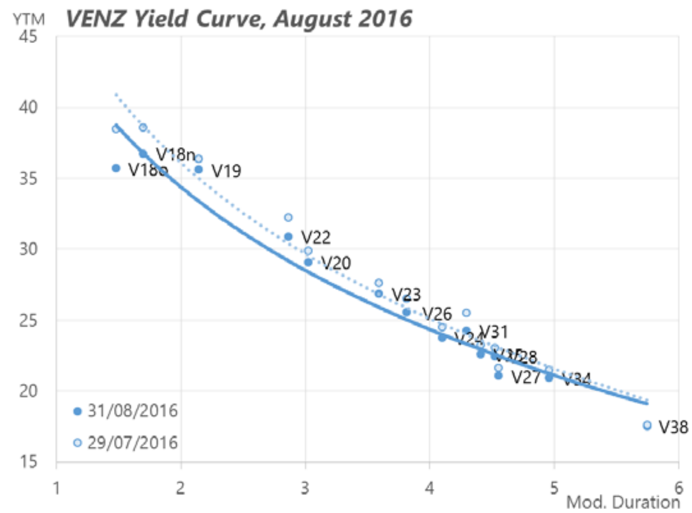


Chart N°3: VENZ/PDVSA bonds by Total Return, Aug 2016.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section).
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Graphs N° 4 and 5 below show the evolution of Venezuela sovereign and PDVSA yield curves during the month. In the case of Venezuela, there was an average 98bps fall in yields, with the bigger yield compression on VENZ 13,625% 2018 (-270bps), significantly better than the 8bps fall in yields seen on VENZ 2038s.



Graph N°4: Venezuela Yield curve changes, August 2016. *Source: Bloomberg CBBT.*

The behavior on the PDVSA yield curve, in contrast, was characterized by a steep rise in the yields of short-end bonds (up to +2600bps in the case of PDVSA 2016), together with a fall in medium- and long-end yields (up to -211bps in PDVSA 2022). On average, yields went up by +620bps.

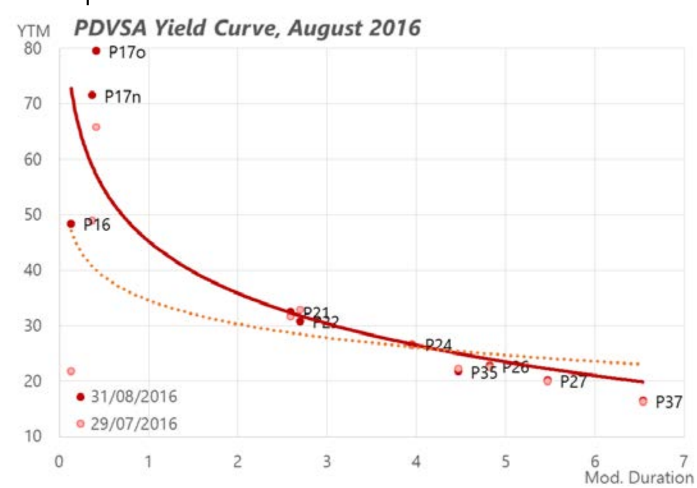


Chart N°5: PDVSA Yield Curve changes, August 2016. *Source: Bloomberg* CBBT.

Political change and re-profiling in September

The highlight of the month in the political spectrum was the announcement of the recall referendum roadmap by the CNE, according to which the election would most likely not occur before the critical date: January 10th 2017. In response, the Democratic Unity Roundtable organized the "Takeover of Caracas", a massive rally that the served to present their upcoming agenda: to force the government to allow the election to take place in 2016, using sustained pressure and street protests in the following weeks. The government's reaction has been all about increasing hostilities: most cities in the country are militarized *de facto*, several opposition politicians have been captured by the intelligence agency – arguing the existence of destabilization plans -, and the rhetoric wielded by PSUV politicians is openly confrontational.

According to our view, the opposition has reiterated its dominance over popular support with the Takeover of Caracas. If the MUD opposition bloc manages to keep this convening power for the following rallies, chances of carrying out the 2016 recall referendum, and thus, the likelihood of regime change, would increase. This might be a positive development for the credit, given that this implies a change in the credit profile of the Republic as well. Since it would be the departure of a government keeping an unsustainable macroeconomic policy mix, and the beginning of a new administration that would combine willingness to pay with sustainable macro policies, a change in the economic regime is an extremely attractive proposition for long-term investors.

Despite the possibility of a positive surprise in the political front, we consider the reprofiling of the PDVSA 2017 as the key event for Venezuelan debt in September. The schedule of upcoming payments for the state oil company means the hard deadline for the operation to take place is just a few weeks ahead. At the same time, it is widely known that PDVSA has the utmost willingness to execute the swap, as a necessary condition to avoid a credit event next year. Against the success of the plan, it's necessary to highlight the volatility in the oil market, given that the bond prices recovered their usual correlation with crude prices during the month. It is prudent to assume that this relationship will hold in the near future and hence, a fall in oil prices could lead to a sharp correction in PDVSA bond prices and as a consequence, an increase in yields that would increase the cost of the swap to a prohibitive level.

In this environment, investors are eagerly waiting for the official proposal by PDVSA, especially in regards to the incentives to motivate private holders to participate in the swap. Market rumors point at several possible 'sweeteners' that the state oil company could put on the table: the new issue might be collateralized with CITGO equity (we estimate *a grosso modo* a net equity value between 2 and 3 Bn USD that would be available for this purpose); a segregated interest-collection account that could guarantee investors more certainty in the bond's cash flows; last, there's the possibility of an upfront cash payment – additional to an increased nominal size in the new bond to deliver -, as to generate a present value for the proposal that exceeds the market value of the outstanding bonds. If any of these measures materializes, investors could be compensated for the 25 to 30 points of upside that they'd be surrendering for their participation in the swap; this would significantly increase the probabilities of success of the reprofiling plan.