Venezuela/PDVSA Monthly Report
August 2018

Venezuela and PDVSA bond prices fell sharply in August, amidst sustained deterioration in the domestic economy and generalized weakness in Emerging Markets. Bonds fell by around 10% on average in both curves, and selling pressure accelerated into the final week of August, in line with prices on several EM bonds and currencies breaking down. Market liquidity has all but vanished after both issuers have been in default for several months, and the political and economic situation in Venezuela suggests an increasingly smaller likelihood of a swift resolution of the external debt crisis. This has driven to a wave of capitulations amidst worsening liquidity, leading bonds to trade down around all-time lows (*See Chart N°1*).

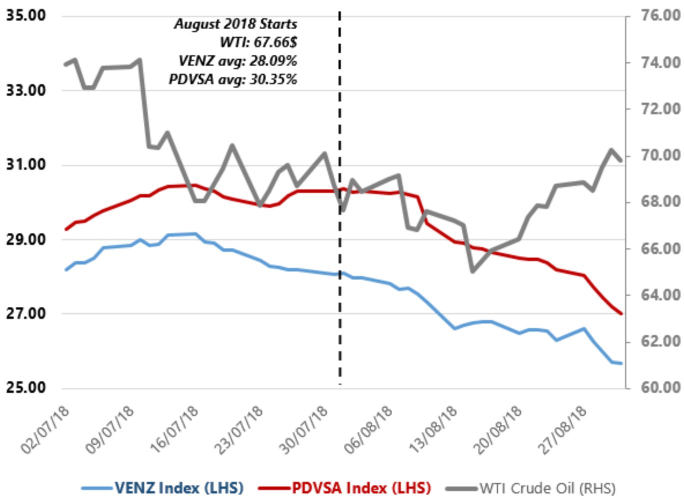

Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Jul-Aug 2018). *Source: Bloomberg BGN, own calculations.*

August began with a failed assassination attempt with explosive drones, of which Maduro came out unscathed and immediately proceeded to accuse and imprison opposition MP Juan Requesens and a former army member (José Monasterio Venegas), blaming them for organizing the attack. Subsequently, public opinion focused on the package of economic measures announced by Maduro to complement the monetary reconversion (effective from Monday 20). The government established a new official exchange rate, using the Petro as a unit of account (1 PTR = 60 USD = 3600 VES), leading them to set the new DICOM official exchange rate at approximately VES 60 per dollar. Maduro also announced an increase of 5900% in the minimum wage, to 1,800 VES (180 MM VEF) as well as increases in VAT and in the frequency of collection of income tax, all this under the stated goals of reducing the fiscal deficit (of almost 20% of GDP and so far covered with money-printing, as Maduro himself admitted), and inflation/exchange-rate stabilization

Of note, the government made no announcements regarding external debt and completely ignored the maturity of the VENZ 13.625% 2018 (due on August 15), adding to a pile of defaulted principal and interest payments, of more than USD 6.3 Bn at months'-end. Thus, Maduro made clear that solving the debt default is not a priority, considering the environment of domestic hyperinflation, US sanctions impeding an orderly debt restructuring, and a full shutdown from capital markets.

The other key event of the month was the evolving dispute between the Republic and the Canadian mining company Crystallex, and the possibility of a forced sale of Citgo Holding. On August 9, Judge Leonard Stark of the Delaware court approved the company's request to seize the shares of PDV Holding Inc. (a US subsidiary of PDVSA that owns Citgo), concluding that PDVSA and its foreign subsidiaries are, in effect, an alter ego of the Republic. This ruling is being appealed by PDVSA, but it must post a bond for the value of the arbitration award to Crystallex (approximately USD 1.3 Bn between the amount of the judgment and accrued interest) in short notice, or risk a forced liquidation of the company. Following on the events, S&P Global ratings raised Citgo's rating from B- to B, well above the 'SD' (Selective Default) assigned to PDVSA, largely due to their assessment of a significant probability that Citgo would be sold to a company with a better credit profile than the Venezuelan state oil producer.

These events have prompted a response from holders of the PDVSA 2020 and Rosneft, who reiterated their first-lien priority interest over 50.1% and 49.9% of Citgo Holding's equity, respectively, obtained by the two loans granted to PDVSA in 2016. Regarding these debt issuances, Crystallex is alleging in a parallel case -opened in November 2016- that there was a "fraudulent transfer" of Citgo's equity to its parent company, to the detriment of its arbitration award that had already been approved by ICSID by that moment. Further worsening the conflict, another group of Venezuela and PDVSA bondholders, advised by Millstein & Co., is exploring legal options to attach Citgo and other foreign assets of the state oil company, in order to recover part of the value of their defaulted bonds. In total, the group owns over USD 8Bn in unsecured VENZ and PDVSA securities.

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Monthly Performance

Security	31/07/2018	31/08/2018	Total Return	Total Return (2018 YTD)
VENZ 13 5/8 08/15/18	29.75	26.50	-10.92%	-51.61%
VENZ 7 12/01/18	27.25	26.00	-4.59%	-34.80%
VENZ 7 3/4 10/13/19	27.45	25.40	-7.47%	+3.02%
VENZ 6 12/09/20	26.75	24.70	-7.66%	+6.41%
VENZ 12 3/4 08/23/22	28.45	26.20	-7.91%	-3.95%
VENZ 9 05/07/23	27.15	24.70	-9.02%	+8.88%
VENZ 8 1/4 10/13/24	27.35	25.00	-8.59%	+10.42%
VENZ 7.65 04/21/25	27.15	24.55	-9.58%	+9.66%
VENZ 11 3/4 10/21/26	28.80	26.25	-8.85%	+5.35%
VENZ 9 1/4 09/15/27	28.55	26.25	-8.06%	+4.66%
VENZ 9 1/4 05/07/28	27.30	24.55	-10.07%	+9.71%
VENZ 11.95 08/05/31	28.75	26.20	-8.87%	+1.30%
VENZ 9 3/8 01/13/34	29.15	27.10	-7.03%	+5.52%
VENZ 7 03/31/38	27.25	24.75	-9.17%	+9.80%
PDVSA 8 1/2 10/27/20	89.80	84.80	-5.57%	+2.23%
PDVSA 9 11/17/21	24.65	21.10	-14.40%	-30.43%
PDVSA 12 3/4 02/17/22	26.50	22.95	-13.40%	-36.10%
PDVSA 6 05/16/24	22.25	19.10	-14.16%	-20.27%
PDVSA 6 11/15/26	22.15	19.15	-13.54%	-19.03%
PDVSA 5 3/8 04/12/27	23.55	20.75	-11.89%	-18.50%
PDVSA 9 3/4 05/17/35	24.50	21.35	-12.86%	-26.15%
PDVSA 5 1/2 04/12/37	23.40	20.75	-11.32%	-17.79%

Table N° 1: Performance of Venezuela and PDVSA bonds, August 2018.
***NOTE: Returns were adjusted to account for the accrued interest lost, per recent EMTA resolutions.**

Venezuela and PDVSA bonds posted an average total return of -9.77%. Bonds issued by the state oil company fell by -12.13% on average, surpassing the average decrease of -8.43% in the Republic's debt. With these results, August amounts to the worst monthly return since November 2017, and now most PDVSA bonds (and short-term VENZ securities) sport double-digit negative returns in 2018.

All PDVSA bonds – save for the senior secured notes due in 2020 – fell by over 10%, and close the month trading at a 4 point discount (or a 20% discount, at current market prices) to long-term Sovereigns. On the other hand, short-term VENZ bonds sharply underperformed the rest of the curve, and are now trading at similar price levels to the rest of the curve. This suggests that the market assigns zero value to the option premium of receiving the capital payment in the VENZ 2018 bonds. In other words, current prices completely rule out the possibility that the holders of these securities will collect their capital before the rest of the unsecured debt investors.

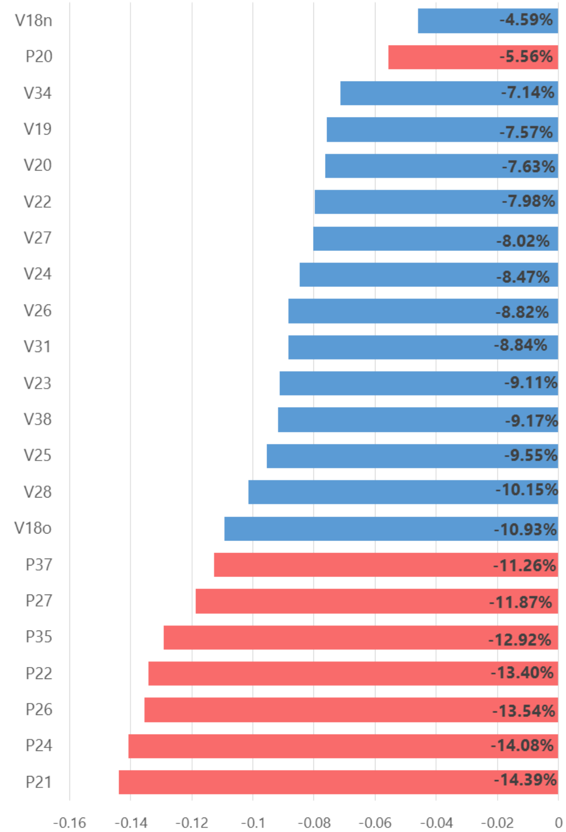
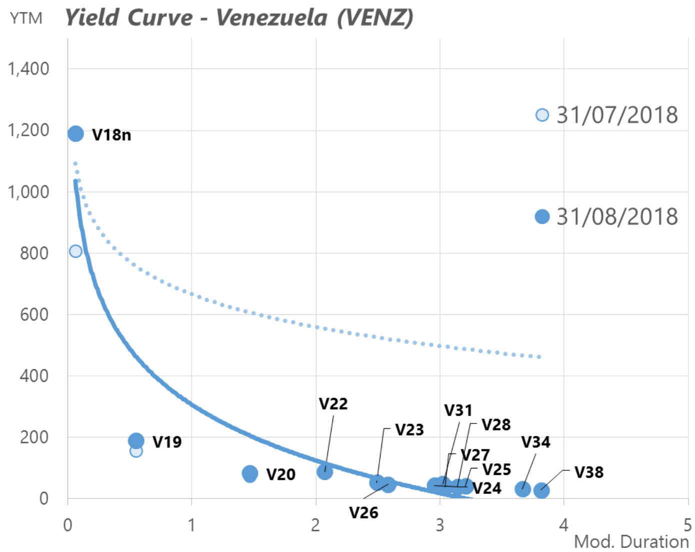


Chart N°2: VENZ/PDVSA bonds by Total Return, August 2018.
Source: Bloomberg, Knossos Asset Management.

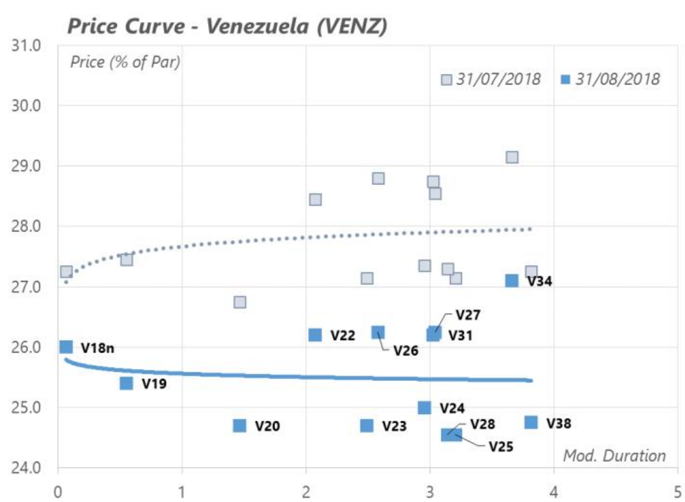
Evolution of the curves

Graphs 3 and 4 show the evolution of the yield curves of Venezuela and PDVSA bonds in August 2018. VENZ 7% 2018s (due in December) began the typical exponential rise in yields as the expiration date approaches on a bond trading at a steep discount to face value. This pattern has become a distinctive feature of the VENZ credit curve, and again underlines that these securities cannot be valued based on their Yield to Maturity in the current environment.



Graph N°3: Venezuela Yield curve evolution, August 2018.
Source: Bloomberg CBBT.

To further complement the analysis of the term structure of Venezuelan credit, *Graph N°3.A* shows the month-to-month evolution in VENZ bond prices by term (VENZ 2018 was excluded from the sample after its default on the maturity date). The Sovereign bond price curve had a parallel downward shift; interestingly, the VENZ 2034 is trading at the highest price in the curve (27.10% at the end of August), possibly due to the lower CAC threshold that encouraged a higher demand for this security by dedicated investors in recent months.



Graph N°3: Venezuela Price Curve evolution, August 2018.
Source: Bloomberg CBBT.

The PDVSA yield curve experienced a parallel upward shift of 8 percentage points, led by PDVSA 21 (+2970bps to 143.2%). Again, the yield of the PDVSA 2020 remains systematically below the rest of the unsecured curve, but its yield went up sharply nonetheless, rising by 890bps to 29.85%. As with VENZ, figure 4.A presents the price curve of PDVSA, which shows the significantly higher price of the PDVSA 2020 (84.8% at the end of August) versus the prices of unsecured bonds (20.75% on average at the end of the month).

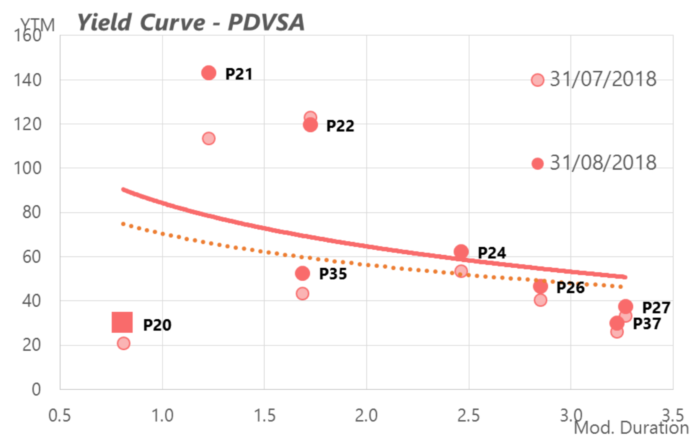


Chart N°4: PDVSA Yield Curve changes, August 2018.
***Source: Bloomberg* CBBT.**

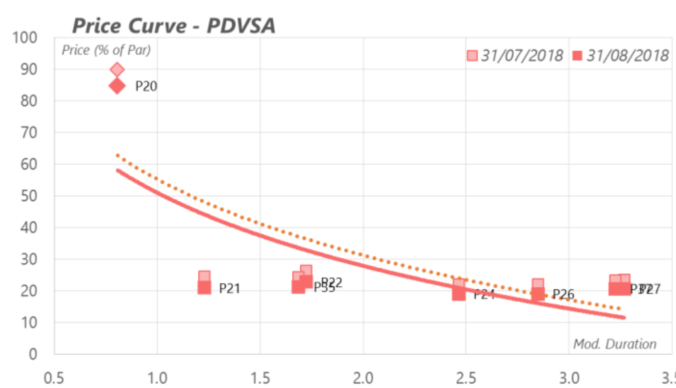


Chart N°4: PDVSA Yield Curve changes, August 2018.
***Source: Bloomberg* CBBT.**

CITGO Holding: Irrevocable loss?

The much-anticipated economic reforms were unveiled. Far from attacking the origins of the crisis, they will cause a further deterioration in the national economy. The policy plan put forward by the Maduro government, in our view, continues to be framed under the (wrong) assumptions that monetary expansion, increases in nominal wages, and the reinforcement of regulations and price controls can have positive real effects. On the contrary, we consider that these measures destroyed any likelihood of a lasting macroeconomic stability in the country and triggered the twin default/Hyperinflation crisis; for this reason, we consider that the speed in price increases and the contraction in real activity will worsen in coming months. Additionally, we believe that the worst mistakes were made in foreign-exchange policy: besides keeping a multi-tiered exchange rate and the (already tried and failed) auction-based mechanism, the government is imposing restrictions to accessing online banking portals from abroad, in a quest to monopolize hard currency earnings from remittances. We consider that none of these measures will be effective in terms of undermining the parallel dollar market, nor halting the exchange-rate depreciation in a sustainable manner.

Recent measures by PDVSA to reactivate oil output, in our view, are insufficient to offset the risk of further falls in the short term. Despite the fact that the state oil company made an agreement with ConocoPhillips for the payment of USD 2Bn over the expropriation suit (and thus, retaking operational control of the Isla refinery in Curacao), the payment hasn't materialized and the 90-day deadline for an initial, USD 500 mm disbursement is still going; therefore, the risk of further legal actions (including seizures) is still latent. Additionally, PDVSA unveiled a plan to restart several abandoned oil wells with 14 local companies. We are skeptical with regards to the likelihood of success of this improvised attempt to revive oil output. Barring a couple of exceptions, the companies selected for the project are local contractors with little to no recognition in the industry, and reactivating abandoned wells requires multi-billion capital investments that PDVSA is currently unable to finance from its own budget.

The statement by the Delaware court that PDVSA is an alter ego of the Republic sets a key precedent for investors and raises incentives for external debt acceleration. It should be noted that the ruling of the Delaware court tries to delimit the scope of its *alter ego* statement by arguing that it only applies to those creditors who have final awards and whose counterpart does not have the liquid resources to settle them. However, due to the fact that most of external debt in bonds and loans is a very similar situation to that of Crystallex v. Venezuela, we consider that it would be trivial to demonstrate in court that the *alter ego* theory would apply in future lawsuits by holders of existing VENZ and PDVSA debt currently in default. This substantially increases incentives for debt acceleration in order to seize external assets and seek a partial recovery of the value of their bond positions, especially for holders of VENZ sovereign debt.

The new legal scenario substantially complicates the conflict among different types of creditors. A conflict which threatens to end in a forced liquidation of Citgo. In strict order of priority of claims, the holders of PDVSA 2020 and Rosneft have priority over Crystallex, which in turn is senior to the holders of unsecured VENZ and PDVSA debt. On the other hand, legal experts suggest that a ruling in favor of Crystallex in this trial could invalidate the collateral currently held by Rosneft and the holders of PDVSA 2020, modifying the payment rank in favor of the Canadian miner. However, we assign a low likelihood to this event, given that the case was already dismissed in a parallel case at the beginning of the year. It is evident that a simultaneous arrangement for these two groups is impossible, and therefore PDVSA 2020 holders and Rosneft have incentives to seek a liquidation of Citgo's assets for their benefit (and to the detriment of the demands put forward by Crystallex) as soon as possible. The state oil company must source USD 1.3Bn in a very limited timeframe to avoid a forced liquidation of PDV Holding. Although the deadline was not published by the Delaware district court, we believe that it should not be longer than October 29 (date of the second capital amortization of PDVSA 2020 for USD 950 MM between principal and interest), given that Citgo Holding's shares placed as collateral in this issue are the only assets with tangible value in the books of PDV Holding, and Judge Stark established at the hearing that both entities are equivalent in practical terms in a liquidation scenario.

While Maduro's government is at risk of losing PDVSA's most valuable asset abroad, persistent downside risk in bonds and an ample of investment alternatives makes us pessimistic about the prospects of Venezuelan debt in the short term. Losing Citgo Holding to its foreign creditors would signal a heavy – and potentially irrecoverable – loss for the Republic, given the strategic role Citgo plays as a key link for the purchase of diluents and other imports for the industry, as well as Venezuelan oil exports to the US. This relevance explains why the Maduro government tapped all available sources of funding and has kept on servicing collateralized debts. Nonetheless, rampant mismanagement and improvisation in debt management ultimately condemned their possibilities of retaining control of the company.

We consider that the immediate impact of losing Citgo would be reflected in a sharp fall in cash-generating oil exports, further deepening the balance of payments crisis. This is joined by the latent possibility of sanctions against the oil sector by the US, and the growing discontent between civilians and the military (evident in the assassination attempt of August 5), as two potential risk factors that could deepen the political crisis in the country and, together with sustained deterioration in the economy, drive bond prices to fresh all-time lows. Furthermore, there was a significant increase in risk premiums in the *High Yield* and *Distressed* segments of Emerging Markets during the last quarter. In this sense, we consider that a wide supply of investment opportunities with high yields and significant upside potential further reduces the incentives to maintain positions in Venezuelan debt in the current context.

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