KNOSSOS ASSET MANAGEMENT

AN AFFILIATED COMPANY OF MIURA

Venezuela/PDVSA Monthly Report
December 2017

The Venezuela/PDVSA bond market finishes 2017 with bonds trading close to their historical lows and a dramatic drop in trading volumes. A fitting end for worst year in the history of Venezuelan debt, total lack of clarity and several procedures associated with credit events set the tone for December. Investors had to deal with another month of debt payment delays, official silence on the restructuring plan or possible measures of macroeconomic adjustment amid worsening hyperinflation. In this context, VENZ medium and long-term debt was the most affected, trading down to 20% of nominal value at the end of the year (*see Chart N ° 1*).

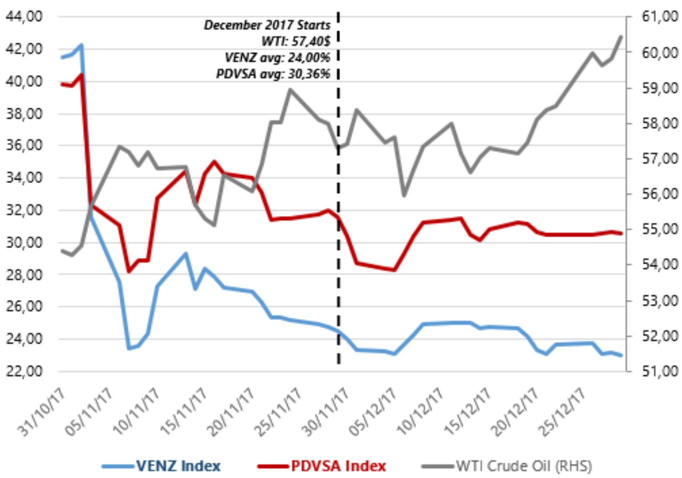


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Nov-Dec 2017). *Source: Bloomberg BGN, own calculations.*

Republic bonds are currently in total default, while some PDVSA coupon payments have reached bondholders. The state oil company executed payments due on PDVSA 17N, 20 and 27, and made official announcements that it would be processing the coupons of the 21/24/26/35 maturities in coming days. However, debt service was extremely irregular, as payments took several days (and transfers were subject to multiple compliance checks along the correspondent chain) before reaching investors' accounts.

The analyst consensus in the face of recent events is that a "selective default" of sovereign debt could be taking place to prioritize PDVSA's debt payments. The hypothesis is based on the view that the state oil company is the main source of the nation's hard currency income, and the most vulnerable target of seizures of assets in the event of a default, so that failing to service their debts directly threatens the survival of the Maduro government. A near-total lack of information on sovereign debt service and the fact known by all market participants that the Republic does not have any correspondent banking lines in US Dollars that can be used for debt service is leading investors to assume a separation of VENZ and PDVSA as two different credits for 2018; the Republic in default, and PDVSA muddling through.

December brings no positive news on the political front. A dialogue process between government and opposition is stagnant as open confrontation between different internal factions (both in the MUD and in the PSUV) hinders any attempt to stabilize the country's situation. In this context, the economy is facing a deepening recession exacerbated by a collapse in oil output (last seen at 1.70mm bbl/d, a year-over-year fall of -20% to the lowest average level since the late 1980s).

Monthly Performance

Security	30/11/2017	29/12/2017	Total Return	Total Return (2017)
VENZ 13 5/8 08/15/18	36,75	43,50	+19,20%	-28,23%
VENZ 7 12/01/18	35,25	38,75	+11,54%	-28,21%
VENZ 7 3/4 10/13/19	25,40	22,85	-7,25%	-42,93%
VENZ 6 12/09/20	20,75	22,75	+10,56%	-39,44%
VENZ 12 3/4 08/23/22	24,15	22,25	-3,07%	-39,21%
VENZ 9 05/07/23	22,60	21,25	-2,58%	-34,91%
VENZ 8 1/4 10/13/24	22,15	20,90	-2,51%	-35,03%
VENZ 7.65 04/21/25	22,40	20,90	-3,97%	-35,04%
VENZ 11 3/4 10/21/26	24,70	22,50	-4,82%	-36,49%
VENZ 9 1/4 09/15/27	24,25	22,30	-4,64%	-36,12%
VENZ 9 1/4 05/07/28	22,90	20,90	-5,16%	-34,25%
VENZ 11.95 08/05/31	22,10	20,80	-1,29%	-37,26%
VENZ 9 3/8 01/13/34	22,15	21,30	-0,19%	-31,56%
VENZ 7 03/31/38	21,00	20,80	+1,58%	-34,08%
PDVSA 8 1/2 11/02/17	-	-	+3,49%	+32,90%
PDVSA 8 1/2 10/27/20	78,40	81,30	+5,26%	+22,08%
PDVSA 9 11/17/21	28,90	28,50	+1,50%	-28,36%
PDVSA 12 3/4 02/17/22	29,05	28,05	+0,79%	-30,18%
PDVSA 6 05/16/24	22,60	22,85	+3,47%	-25,47%
PDVSA 6 11/15/26	22,40	22,50	+3,40%	-25,07%
PDVSA 5 3/8 04/12/27	23,65	23,85	+3,95%	-21,63%
PDVSA 9 3/4 05/17/35	27,30	26,95	+2,92%	-23,03%
PDVSA 5 1/2 04/12/37	23,60	23,65	+2,90%	-21,50%

Table N° 1: Performance of Venezuela and PDVSA bonds, December 2017

Venezuela and PDVSA bonds had an average drop of -1% in prices and a total return of around +1.5% including interest (*See Table N°1 for monthly and annualized returns in 2017 for each bond).* VENZ 18/20 bonds were outliers with two-digit gains. On the other hand, PDVSA debt had a positive return of + 3% on average, while the rest of the

VENZ bonds averaged a -2.6% drop. Broadly speaking, the flows are consistent with the 'selective default' theme; however, recent interest in the VENZ 18 suggests that a sector of the market is betting on the possibility that Venezuela's payments next year may be carried out, despite the current environment. As a result of investor flows, PDVSA's securities have higher average prices than VENZ comparables: for example, the PDVSA 12.75% 22 has a 5.8-point premium (+25% higher at current market prices) with respect to VENZ 12.75% 22 at the end of 2017.

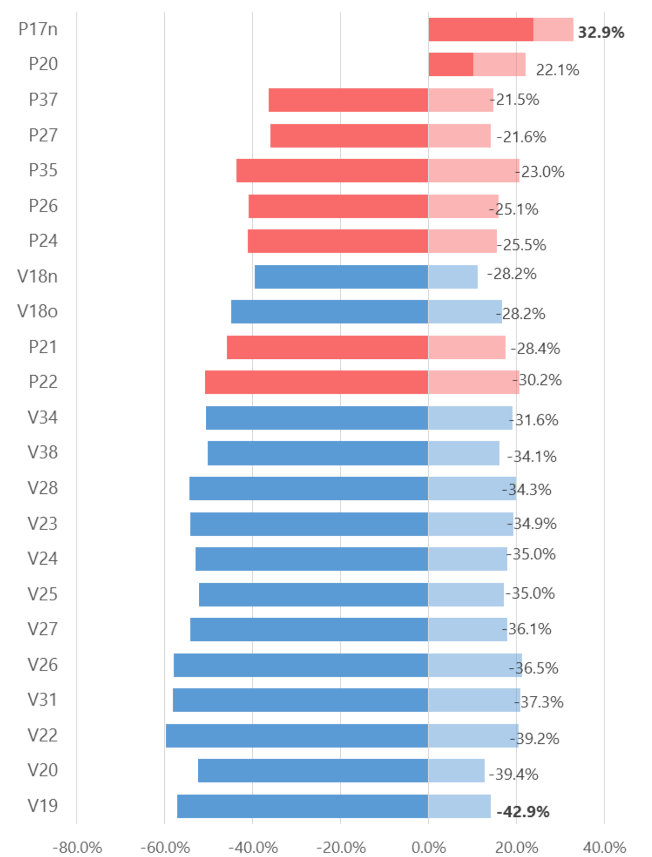


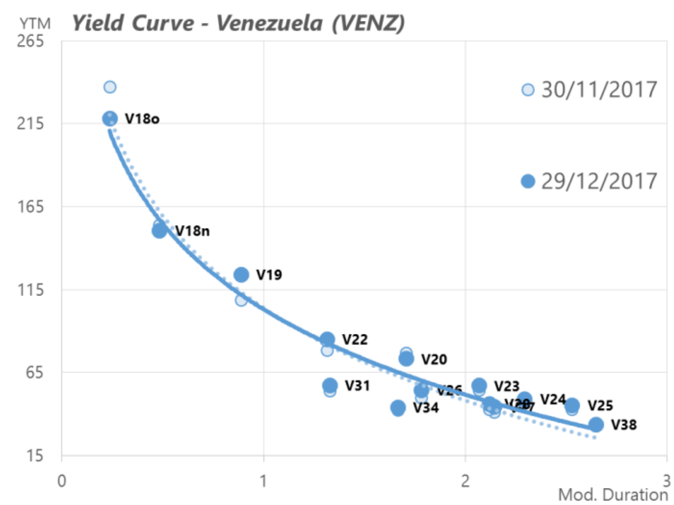
Chart N°2: VENZ/PDVSA bonds by Total Return, December 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment
Source: Bloomberg, Knossos Asset Management.

When comparing 2017 total returns (*see Chart N°2*) we can see that only two securities generated positive -and significant- returns: PDVSA 17 (+33%) and PDVSA 20 (+22%). The rest of the curve posted an average -31% loss, oscillating between the most defensive bonds (PDVSA 37, -21.5%) and the most aggressive short-end plays (VENZ 19, -42.9%).

Evolution of the curves

As we mentioned in the November report, the CDS market was suspended after the declaration of Credit Event and settlement of outstanding CDS contracts, amounting approximately USD 2.2Bn between VENZ and PDVSA. The results of the auction to determine CDS payoffs showed a Recovery Value of 24.5% for VENZ, substantially higher than the 17.625% quoted for PDVSA.

Charts N° 3 and 4 show the evolution of the yield curves of Venezuela and PDVSA bonds in December 2017. In the case of VENZ, yields rose by +144bps on average, with a compression in the VENZ 18 (-1900bps) against the widening trend in the rest of the curve.



Graph N°3: Venezuela Yield curve changes, December 2017.
Source: Bloomberg CBBT.

The PDVSA curve saw minimal changes from the flat slope seen last month, and there's a persistent contrast between the relatively low yields of the PDVSA 20 senior bonds (-23bps to 24.09%) and the rest of the unsecured debt (for example, PDVSA 22 saw an increase of + 345bps to yield 75.80%), reinforcing the hypothesis that the capital structure is the main explanatory driver of expected returns in the state oil company's debt. The more senior *de facto* (either by collateralization or by being first in the line of payments due), the better total returns.

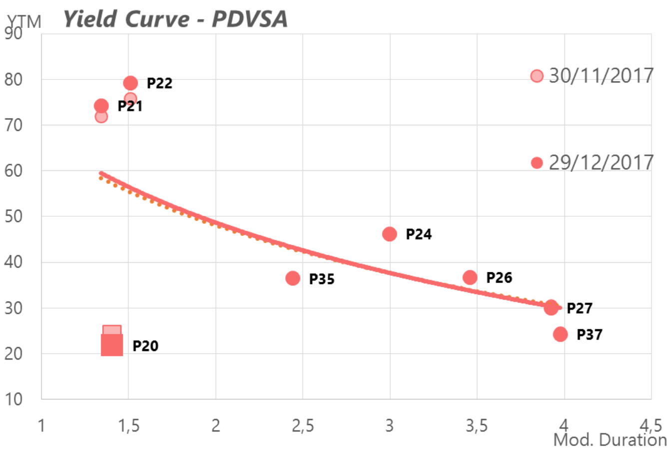


Chart N°4: PDVSA Yield Curve changes, December 2017.
***Source: Bloomberg* CBBT.**

2018: Post-Default Realities

If 2016 was the year of willingness to pay at all costs, 2017 was the year to process payments at all costs, even sacrificing the entire country. The debt dynamics of the Government went out of control this year, leading to an unprecedented twin crisis of hyperinflation and default, affecting an external debt stock that exceeds USD 120Bn between bonds, promissory notes and commercial debt. The outbreak of the crisis took place amid a severe external cash crunch and persistent negative supply shocks caused by the State's interventionist policy, which is highly negative for the business confidence and impairs their capacity to sustainably operate in the domestic market.

Maduro's government begins in 2018 firmly entrenched in power. 2017 was marked by the neutralization of several enemies of the government, including the purge of PDVSA executives and the current persecution against Rafael Ramirez, key player of the Chavez era since his tenure as CEO of the state oil company. The opposition, divided between moderate and radical factions, is full of internal conflicts that have impeded any progress in the promise of regime change that led the National Assembly to the victory in 2015 parliamentary elections. The failure to fulfill their promises explains the decline of opposition turnout in recent elections, although there also was evidence of voting irregularities and direct coercion (eg. Carnet de la Patria) that have led to PSUV electoral victories without any post-results audit. In any case, the opposition does not appear as a relevant actor to shape the events to take place in 2018.

The US government sanctions became the main "game changer" in the year and represent the greatest existential threat that Chavismo has ever faced. Its success lies in political economy considerations: if the sanctions compromise the daily operations of PDVSA and government officials have their personal accounts frozen, their capacity and incentives to maintain the current direction are reduced substantially. Both the sanctions and complementary efforts by the US Treasury Office to shutter access by the Maduro government to financial lifelines have accelerated the sequence of events in recent months, evident as the default in the bonds was ostensibly triggered by the blockade of the Republic and PDVSA's correspondent banks. It is reasonable to assume that the sanctions regime will continue to deepen in 2018; in fact, right in the first week of the year, two officers from the Maduro circle were blacklisted: Francisco Rangel Gómez and Rodolfo Marco Torres. In short, an escalation in financial sanctions against Venezuela could lead to a break in the *Status quo* with two possibilities: a rogue state *a la* North Korea, isolated from the rest of the world and supported by its ideological allies, or a political crisis that triggers a government transition.

Themes of 2018

"Bullish case". The impact of US sanctions is substantially reduced (either by a successful issue of the Petro cryptocurrency, as a result of dialogue with the opposition, or in the context of a government transition). Oil production stops falling and stabilizes; in parallel, world oil prices continue their upward trend. Venezuela/PDVSA bonds are trading at historic-lows versus WTI crude futures and prices could "re-couple" if the country's outlook surprises to the upside.

"Pessimistic" case. In the *Status quo* scenario, Maduro would win a hypothetical presidential election in the first half of 2018 and remain in power without structural reform, which implies worsening macroeconomic distress alongside a greater collapse of domestic oil production. Bonds would continue to fall as the government would continue with suspended debt service and no official responses. In addition, the regime of US economic sanctions would deepen, and extreme solutions such as an explicit oil embargo can't be ruled out in this scenario.

Divergence between VENZ / PDVSA credits. We at the firm consider that the divergence is not relevant. Even if there are strong arguments supporting both sides of the debate, we do not consider that either hypothesis justifies a speculative credit position in the current backdrop of high uncertainty. In addition, there are no minimum conditions of liquidity and operating capacity to invest in 'relative value' strategies profitably.

The capital structure of PDVSA will once again be key. The year began on a positive note for holders of PDVSA 2020 bonds, since a claim for 'fraudulent transfer' made by Crystallex against the Republic and PDVSA in US courts was dismissed. There are still important incentives to maintain PDVSA's debt service; however, the risk of acceleration clauses triggered by holders of unsecured debt remains latent while the lack of clarity and viability of payments persists.