KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA

Venezuela/PDVSA Monthly Report February 2018

Venezuelan bonds had a mixed performance in February, a month in which investors leaned towards buying PDVSA and selling VENZ bonds. The outperformance in the state oil company's debt was attributed by market watchers to EMTA's resolution at the beginning of the month to start trading the credit "flat" (no accrued interest), the same treatment established for Sovereign bonds during January. The aftermath of the resolution saw renewed buying interest for PDVSA, mostly in high-coupon bonds. In contrast, Venezuela bonds fell by the same measure (*See Chart N°1).*

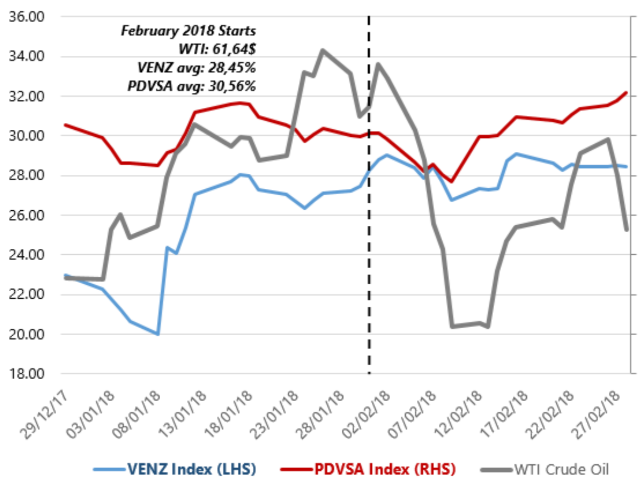


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Jan-Feb 2018). ***Source: Bloomberg BGN, own calculations.***

Even though there has been four months since president Maduro suspended debt service and the financial community has all but embraced the default in practice, press reports during the month suggested that PDVSA had transferred funds to Euroclear to pay a coupon due on PDVSA 6% 22, the infamous bond bought at a discount by Goldman Sachs in May 2017. This and other debt payments amounting close to USD 1.6Bn – according to a statement by Venezuelan foreign minister Jorge Arreaza - are withheld by Euroclear pending an internal compliance investigation. The government's response has been framed in the "financial blockade" narrative, without any further explanations as to the source of funds or justification for the selective treatment in debt service. It is worth highlighting that there are close to USD 2.3Bn of coupon payments in arrears at the date of writing.

In the economic arena, the government keeps promoting the Petro as the cornerstone of its macroeconomic strategy. Government authorities in charge of the issuance claim to have received indications of interest amounting to USD 3Bn; nonetheless, there's no evidence that the indications have materialized, since the NEM *blockchain* supporting the Petro issuance reflects zero movements in the currency to date. In addition, both the US Treasury Department and the opposition-controlled Venezuelan National Assembly have stated that the Petro issuance constitutes an illegal source of public indebtedness and that dealing with the currency will be subject to further sanctions; hence, the analyst consensus points at a low likelihood of success of the Petro in terms of fulfilling the goals of bypassing sanctions and sourcing fresh external financing.

In parallel, reports surfaced that Swiss-based commodities trading firm Mercuria is asking the US OFAC for a license to deal with Rosneft in terms of disposing the collateral (49.9% of the equity of Citgo Holding) backing a USD 1.5Bn loan between PDVSA and the Russian state oil company, targeting a syndicated sale to foreign investors. Even though Mercuria is publicizing the operation as "a private solution for a public security problem" – referencing the risk that a key piece in the US energy infrastructure fell in the hands of the Russian government – the swiss firm retains significant commercial interests as a result of its long-term crude oil supply contract with Citgo.

In the political front, the National Electoral Council confirmed that presidential elections will take place on May 20th. To date, president Maduro and Henri Falcón (ex-PSUV, now from Avanzada Progresista; former governor of Lara State) have registered as candidates. Falcón's nomination has been met with criticism since it doesn't count with the support of the MUD coalition, which has abstained from participating in the elections since none of the conditions requested to ensure that elections would be fair has been met by Chavismo. In addition, Falcón surprised the public by announcing that he was interested in recruiting Henrique Capriles Radonski- as campaign manager – and Francisco Rodriguez (Harvard-trained economist and managing director of an US-based brokerage involved in Venezuelan debt). Capriles has yet to confirm its presence in the team, but Rodriguez publicly acknowledged in social media that he officially joined the Falcón campaign. The Falcón candidacy opens the door to new political scenarios, including a possible government transition; this has driven investor demand for Venezuelan bonds into month-end.

Monthly Performance

Returns among Venezuelan bonds sharply diverged between double-digit gains and losses, with PDVSA (+9% on average) gaining at the expense of falling VENZ bonds (-10.7% on average). Price action for the past couple of months suggests that investors have started to buy in earnest once EMTA has ruled that bonds of a certain issuer will trade flat, at the expense of the other issuer's debt. PDVSA 22 outperformed in the month (+22.86%, net of accrued interest lost), and VENZ 31 (-19.5%) posted the weakest performance among both curves.

Security	31/01/2018	28/02/2018	Total Return	Total Return (2018 YTD)
VENZ 13 5/8 08/15/18	40.50	38.85	-19.85%	-25.39%
VENZ 7 12/01/18	31.95	33.95	+2.55%	-15.48%
VENZ 7 3/4 10/13/19	26.45	26.40	-9.29%	+5.13%
VENZ 6 12/09/20	26.30	25.95	-4.74%	+10.18%
VENZ 12 3/4 08/23/22	29.00	29.35	-18.44%	+6.34%
VENZ 9 05/07/23	26.85	27.05	-7.14%	+17.32%
VENZ 8 1/4 10/13/24	26.75	27.00	-8.41%	+17.39%
VENZ 7.65 04/21/25	26.65	26.90	-7.04%	+18.56%
VENZ 11 3/4 10/21/26	28.50	29.15	-9.33%	+14.74%
VENZ 9 1/4 09/15/27	28.40	28.25	-12.98%	+10.85%
VENZ 9 1/4 05/07/28	27.35	26.85	-9.86%	+17.81%
VENZ 11.95 08/05/31	28.65	29.00	-19.53%	+10.74%
VENZ 9 3/8 01/13/34	27.40	28.35	-15.71%	+8.20%
VENZ 7 03/31/38	27.25	27.00	-9.71%	+18.36%
PDVSA 8 1/2 10/27/20	83.10	82.65	-0.52%	+1.70%
PDVSA 9 11/17/21	26.25	28.30	+7.72%	-0.66%
PDVSA 12 3/4 02/17/22	24.10	29.60	+22.86%	+5.47%
PDVSA 6 05/16/24	23.50	25.35	+7.80%	+10.77%
PDVSA 6 11/15/26	23.15	24.95	+7.86%	+10.83%
PDVSA 5 3/8 04/12/27	23.70	25.75	+8.69%	+7.94%
PDVSA 9 3/4 05/17/35	25.80	27.50	+6.64%	+2.05%
PDVSA 5 1/2 04/12/37	23.65	25.45	+7.72%	+7.60%

Table N° 1: Performance of Venezuela and PDVSA bonds, February 2018.
***NOTE: VENZ bond returns were adjusted to account for the accrued interest lost, per the EMTA resolution of January 5th 2018.**

Among outliers, PDVSA 20 bonds had minimal price volatility throughout the month and finish slightly down at -0.5% in February. Even though its high cash price might suggest (at first sight) that the bond has a high *jump-to-default* risk, its superior payment rank makes any simple price comparison with unsecured PDVSA bonds meaningless. In addition, news about Mercuria seeking to securitize the remaining Citgo equity collateral is marginally positive for the PDVSA 20s, as the bond is backed by the majority stake (50.1%) of the company and possible strategic buyers of Citgo would need to negotiate an attractive deal with bondholders in order to get a secure a controlling interest on the company.

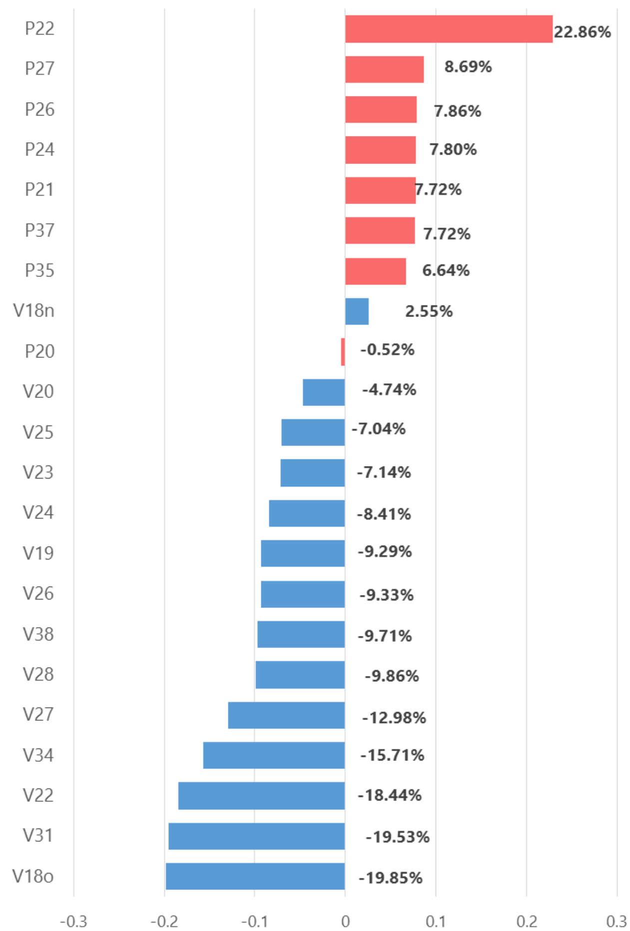
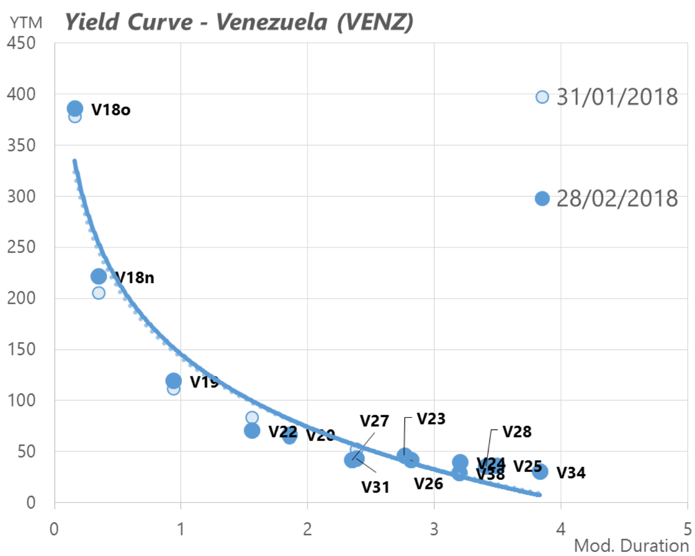


Chart N°2: VENZ/PDVSA bonds by Total Return, February 2018.
Returns were adjusted to account for the accrued interest lost, per recent EMTA resolutions.
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Charts N° 3 and 4 show the evolution of the yield curves of Venezuelan and PDVSA bonds in February 2018. In the case of VENZ, the curve is so extremely inverted that triple-digit yield changes do not translate into significant shifts in the curve. The short end of the curve saw the biggest changes; for example, yields on VENZ 13.625% 18 shot up +760bps to 386%, an astronomic yield that reflects near-zero investor perceptions of any principal payments due being paid.



Graph N°3: Venezuela Yield curve changes, February 2018.
Source: Bloomberg CBBT.

The PDVSA curve significantly compressed in the month, led by the sharp drop in PDVSA 22's yields (-3470bps, to yield 80.18%). The curve is still inverted, but relatively flat in comparison to the Sovereign curve; in addition, the PDVSA 20 continues to trade deep inside the unsecured curve (YTM went up by +185bps to 24.75%).

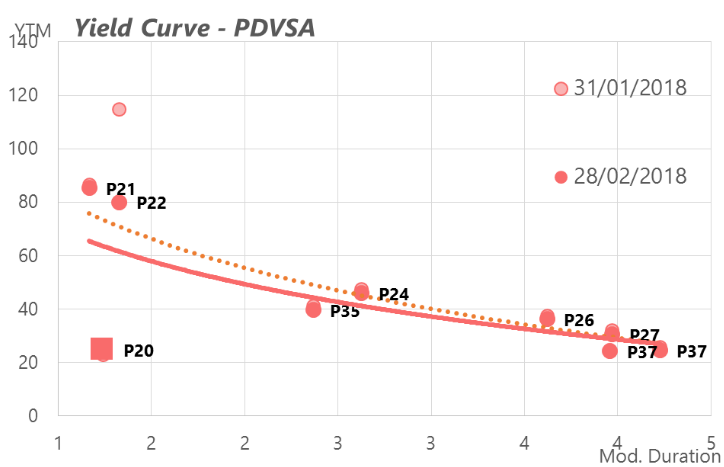


Chart N°4: PDVSA Yield Curve changes, February 2018.
***Source: Bloomberg* CBBT.**

New Currency, New President?

Two significant possibilities of change are coming up in the political-economic map of Venezuela in 2018. The first - presidential elections - will take place next May. Analysts have incessantly speculated about the new scenario posed after the candidacy of Henri Falcón, a candidate widely perceived as a centrist, capable of establishing a conciliatory position before the Maduro government. Critics say his popularity is quite low and that his decision to run independently - and against the consensus opinion of the MUD - means that his chances of success are minimal. Even if Falcón could benefit from the "punishment vote", as a consequence of the worst socio-economic crisis in the country's recent history, this factor has been neutralized by the government through the Carnet de la Patria system, which amounts to more than 12 million of citizens dependent on the government's food program (CLAP) and who are mostly inclined to vote for the PSUV for fear of retaliation. In this context, even if the situation seems to indicate that a democratic transition is imminent, the government's ability to influence the outcome of the elections, in order to generate results contrary to the opinion of the majority (but which technically does not become "Fraud") gives Maduro the advantage of choosing the result that best suits his interests.

We consider that the elections represent a low - but significant - likelihood of a government transition that could be aligned with the interests of bondholders. As we mentioned before, Falcón's candidacy is not a guarantee that he will win the elections; however, if he were to defeat Maduro, we consider it likely for his government to fast-track negotiations to restructure the nation's external debt among its priorities. Falcón's new economic adviser argues that economic stabilization in Venezuela could be executed relatively quickly through dollarization – financed by loans with multilateral organizations such as IMF or CAF -, which should translate into responsible monetary and fiscal policies, as well as boosting foreign investor confidence. With respect to external debt, Rodriguez stands out from other opposition would-be policymakers for its friendly posture towards bondholders, which should translate into a relatively small *haircut* on his restructuring proposal. We estimate a 50% haircut, consistent with Rodriguez's past studies of debt sustainability. Nevertheless, to the extent that immediate measures imply more hard-currency liabilities and do not guarantee debt sustainability in the medium term, we consider that the potential upside of a Falcón win would not be compensated by the significant downside potential we see in case Maduro wins the election; a situation that practically assures a deepening of the political-economic crisis, in our view.

The second possibility of change is a new currency for the nation: the Petro. The issuance of the cryptocurrency has eclipsed all other government communications in the economic front, including the launch of the new *DICOM* - in which two auctions have been held and a new official exchange rate has been set, around 43,000 VEF per EUR, which has replaced the *Dipro* 10 VEF/USD parity. With these actions, the government signals that procuring foreign currency and dodging the sanctions that keep them out of the dollar-based financial system are their top priorities. However, we argue that the Petro lacks a sound economic basis, since the currency does not provide an incentive for the system's maintenance and smooth functioning (it cannot be "mined"), it will not float freely (it will be administered by "government approved exchange houses", according to the authorities) and its intrinsic value is minimal, since it represents not more than the option of receiving future rights for the exploitation of a block of the Orinoco Belt that would require multibillion-dollar investments for its extraction. Hence, we assign a very low likelihood to success to the Petro as a tool to carry out debt service payments or as a source of hard currency funding. The Petro issuance requires breeding confidence among foreign investors that the currency has intrinsic value and that the government will seek to maintain price stability after the market launch. Two promises virtually impossible to believe coming from a government in default, with hyperinflation, double-digit fiscal deficits and oil production in free fall.

Now that PDVSA is trading "flat" of interest just like Venezuela, we consider that the "selective default" hypothesis seems to have lost relevance. At this time, both issuers are trading at similar price levels in the long end of the curve, close to the consensus *Recovery Value* estimates of around 25%. The only difference between credits lies in cases such as the PDVSA 6% 22: bonds in which the authorities are making interest payments selectively, without a logical reason at first sight for their prioritization. However, there are no indications to date that the dollar payments blockade will be corrected under the current administration, so we believe that betting on incidental coupon payments involves taking outsized risks that would likely not be rewarded.

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Disclosure concerning 'Debt Research Reports'