Venezuela/PDVSA Monthly Report
July 2016

Venezuela and PDVSA's bonds ended the month of July with sixth straight months of advances and with the leading year-to-date returns in emerging markets. Bonds advanced +6.5% on average during the month, with the best performance seen in PDVSA, especially in the short end and belly of the curve. There was a noteworthy disconnect between bond prices and oil during this month as WTI futures ended at 3-month lows, settling at 41.14$ (-13,9%); nonetheless, bonds continued to print new highs for the year (See Graph N°1 below).

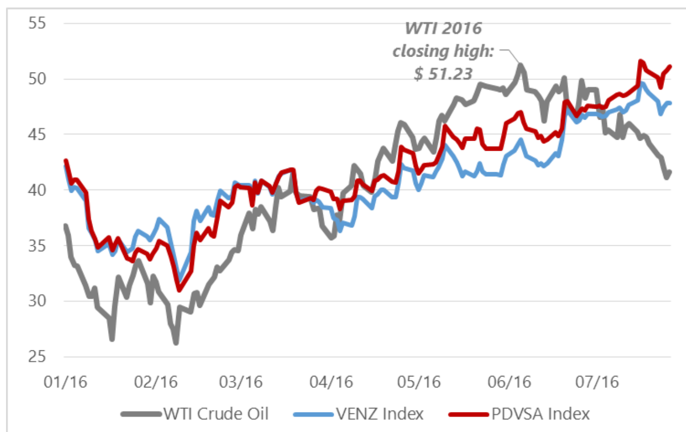


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (2016 year-to-date). *Source: Bloomberg BGN, own calculations.*

The Venezuelan credit market centered it attention all month on the possibility of a '*Reprofiling*', a voluntary exchange of PDVSA 2016/2017 bonds for longer term debt. This idea had been mentioned by government officials several times in the past two years, and returned to the spotlight in July in two episodes. First, by leaks of a debt exchange proposal led by Rotschild & Co. and afterwards from PDVSA CEO Eulogio Del Pino himself, who declared to the press that the company was in an advanced stage and that it would soon release an "attractive" voluntary exchange offer for bondholders. The market reacted instantly to these headlines, lifting the short-end bonds to their highest levels since September 2014.

For the second month in a row, there was a slowdown in the depletion of International Reserves (USD 11.830 at the end of July, -2% MoM), explained by a light debt service schedule (USD 70.3MM of VENZ 2034 coupons) and a USD 482.5 MM inflow coming from a financing operation based on the Central Bank´s capital contribution to the Latin American Reserve Fund (FLAR).

At the same time, inflows to emerging markets continue unabated. The Institute of International Finance (IIF) estimated a USD 24.8 Bn inflow in dedicated funds (USD 10.2 Bn in bond funds alone), and the trend is expected to continue in coming months, under the current context of low interest rates and expansionary monetary policies coming from most Central Banks. Under this backdrop, which encourages investors to '*hunt for yield*', some US investment banks have recommended buying Venezuelan debt, based on current bond valuations, and strong willingness to pay by government authorities.

Performance in the month

Security	30/06/2016	29/07/2016	Total Return
VENZ 13 5/8 08/15/18	65.45	**67.00**	+3.73%
VENZ 7 12/01/18	50.55	**54.10**	+8.00%
VENZ 7 3/4 10/13/19	45.40	**48.25**	+7.33%
VENZ 6 12/09/20	41.15	**43.80**	+7.46%
VENZ 12 3/4 08/23/22	51.30	**53.25**	+5.30%
VENZ 9 05/07/23	42.90	**44.20**	+4.67%
VENZ 8 1/4 10/13/24	42.05	**43.55**	+4.96%
VENZ 7.65 04/21/25	41.00	**42.70**	+5.45%
VENZ 11 3/4 10/21/26	47.70	**48.55**	+3.66%
VENZ 9 1/4 09/15/27	48.80	**48.45**	+0.77%
VENZ 9 1/4 05/07/28	43.75	**44.65**	+3.64%
VENZ 11.95 08/05/31	47.45	**48.65**	+4.10%
VENZ 9 3/8 01/13/34	43.85	**45.20**	+4.41%
VENZ 7 03/31/38	40.40	**41.25**	+3.36%
PDVSA 5 1/8 10/28/16	90.85	**96.15**	+6.30%
PDVSA 5 1/4 04/12/17	62.75	**69.90**	+11.79%
PDVSA 8 1/2 11/02/17	70.25	**78.25**	+12.15%
PDVSA 9 11/17/21	43.50	**49.25**	+14.64%
PDVSA 12 3/4 02/17/22	50.70	**54.55**	+8.79%
PDVSA 6 05/16/24	35.35	**37.25**	+6.63%
PDVSA 6 11/15/26	35.15	**36.80**	+6.20%
PDVSA 5 3/8 04/12/27	35.10	**36.45**	+5.04%
PDVSA 9 3/4 05/17/35	40.50	**44.90**	+12.21%
PDVSA 5 1/2 04/12/37	34.85	**36.50**	+5.58%

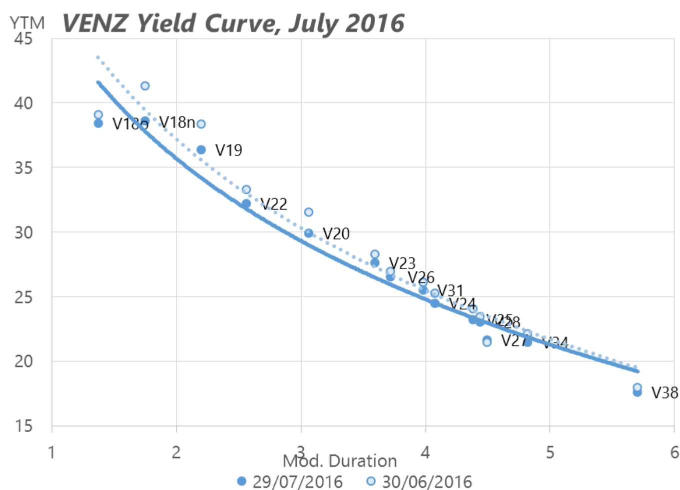
Table N° 1: Performance of Venezuela and PDVSA bonds, July 2016

Venezuela and PDVSA bonds closed the month of July with an average +5.29% increase in prices, and a total return of +6.50% including interest. PDVSA (+8.89%) strongly outperformed VENZ (+4.77%), and in general terms, the

short end and belly outperformed the rest of the curve. The best performances in the month were seen in PDVSA bonds due 2021 (+14.64%) and 2035 (+12.21%), which were trading at a discount to VENZ bonds of similar maturities at the end of the month. The worst performer was VENZ 2027 (+0,77%).

Evolution of the curves

Graphs N° 3 and 4 below show the evolution of Venezuela sovereign and PDVSA yield curves during the month. In the case of Venezuela, there was an average 90bps fall in yields, with the bigger yield compression on VENZ 2018 7% bonds (-277bps) for the second straight month.



Graph N°3: Venezuela Yield curve changes, July 2016. *Source: Bloomberg CBBT.*

The PDVSA yield curve reacted even more positively: yields tumbled by -550bps on average, with drops of over 1000 basis points in the bonds most directly benefited by the expectation of a Reprofiling: PDVSA 2016/2017 bonds. Nevertheless, and even after this month's movements, PDVSA 2017 5,25% "olds" are trading at a yield over 60%, highlighting the fact that there are still doubts among investors over PDVSA's capacity to service their debt maturities due next year.

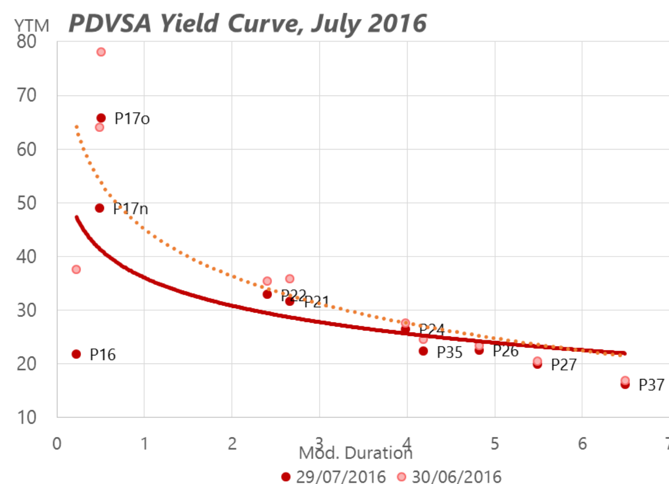


Chart N° 4: PDVSA Yield Curve changes, July 2016. *Source: Bloomberg* CBBT.

The political Game of Reprofiling

The confrontation among Venezuelan public powers aggravated in July, after another month without major advances in the recall referendum process and subsequent retaliation measures by the National Assembly. The confrontation spread to issues of public finances and despite threats of opposition MPs that all new financing signed without parliamentary consent would be considered null and void, the Supreme Court of Justice ruled against them, allowing the Venezuelan Central Bank to execute the FLAR financing operation outlined above. It's logical to assume that this confrontation will worsen, as the negotiations for the reprofiling of PDVSA's short-end debts – both financial and commercial – move along.

Against this background, the Maduro administration has undertaken during all of 2016 a strategy of "willingness to pay at all costs", under which the idea of a voluntary swap of 2017 debt maturities was considered as a tool of last resort under current market conditions due to its high financial cost. After the Republic and PDVSA exhausted virtually all alternative sources of financing, the reprofiling arises as the big bet of the Maduro government to seek continuing the service of external debt, and thus avoid a credit event that would jeopardize the survival of its mandate.

To understand the political game between the government and the opposition, it's useful to understand the legal implications of a debt reprofiling. PDVSA is independent of

the National Assembly, and may carry out financing operations without explicit parliamentary approval. In this sense, the message of opposition MPs that any new debt from the Maduro administration would be disavowed by the Legislative power loses relevance in the short term, because it wouldn't be an obstacle for executing the debt swap operation. Nevertheless, investors should be aware that a hypothetical new opposition-led government would be incentivized to repudiate new debt incurred by the present administration, claiming that it was issued illegally as set out in Article 150 of the country's National Constitution. This risk factor together with the financial cost of operation are the two main roadblocks that PDVSA would face throughout the reprofiling negotiations.

Based on bond prices at the end of July, a simple extrapolation suggests that PDVSA would have to hand over around 150% of face value of new bonds due in 2020, or up to 200% of face value of bonds due 2024, in order to perform a neutral debt exchange in terms of net present value. Additionally, the company would have to offer an added incentive (such as a guarantee, cash up front, a segregated interest collection account, etc.) to compensate investors willing to surrender the pull-to-par potential of PDVSA 2017 bonds. If PDVSA manages to get a sizeable percentage of bondholders on board for the reprofiling, the company would have the capacity to service the remaining portion of the 2017 maturities to the remaining holders. This would be the most positive scenario for short-end bondholders, especially for owners of the PDVSA 2017 5,25% "olds".

Playing against the success of the debt exchange plan is the renewed bear market in crude oil which, together with the sharp fall in PDVSA oil output, is detrimental to the investors positioned in the company's long-end bonds, as well as to would-be acceptors of the debt reprofiling. In a hypothetical scenario of a successful exchange and assuming no major structural reform takes place alongside, the market would be flooded by several billions' worth of long-end bonds and no incremental demand. Furthermore, there is imminent debt issuance in the form of promissory notes under a plan to swap commercial for financial debts with oil service providers (the outstanding balance of these notes currently sits at USD 831mm, according to the financial statements of the company published during the month) and the USD 3Bn of PDVSA 6% 2022 bonds that sit in the Central Bank's balance sheet at the time of writing. Everything indicates that we should reduce exposure in the long end of PDVSA before the exchange operation takes place; and considering that bonds have temporarily decoupled from oil prices and continue to trade near their highest levels of the year, the current levels are providing an exit opportunity that could last a short time.