KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA

Venezuela/PDVSA Monthly Report
July 2018

The Venezuelan credit market broke its 3-month losing streak, led by a late rally on PDVSA 2020s. During a month of high volatility in oil prices, Venezuela and PDVSA bonds rose steadily in the first half of July, driven by high demand from institutional investors. Towards the end of the month, VENZ's debt fell to its June lows, while PDVSA's bonds maintained their progress on average (*See Chart Nº1)*.

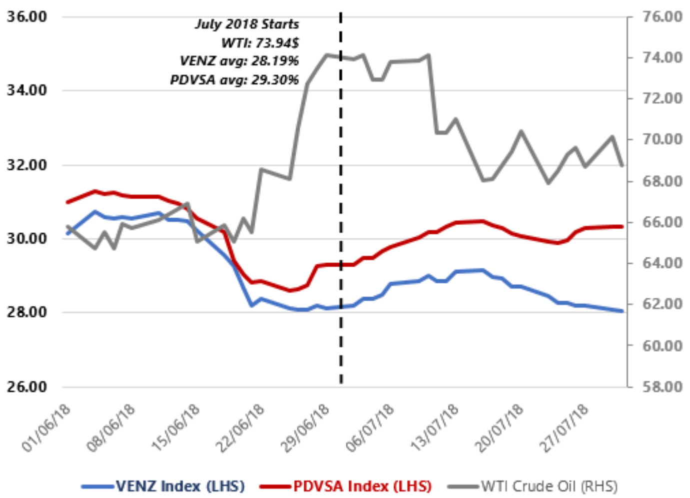


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Jun-Jul 2018). ***Source: Bloomberg BGN, own calculations.***

Rumors circulated early in the month about a possible exchange-rate liberalization plan, which boosted investor appetite, especially for low-dollar value PDVSA bonds. These rumors materialized after the end of July, as the Constituent Assembly signed a repeal of the law on illegal exchange practices. The government has not offered details about a new exchange regime; currently, two official mechanisms - DICOM and authorized exchange houses - coexist, both with overvalued exchange rates with respect to the parallel market. Additionally, the government revised its monetary reconversion plan (it will now withdraw five zeros from the bolivar 'Fuerte' on the new bolívar 'Soberano'), and postponed its start-up for August 20. Maduro promised that he would announce a system for anchoring the Sovereign Bolivar to Petro, reviving the failed project of the state cryptocurrency backed by the Orinoco Belt oil reserves.

A key market-moving event was the issuance of General License No. 5 by the US OFAC, on July 19. This license authorizes US entities to partake in restructuring, refinancing and/or foreclosure deals linked to the PDVSA 2020 bond, which is collateralized by 50.1% of Citgo's assets and could be subject to a process of collateral execution, in the event that the state oil company fails to service the USD 950 MM maturity (between capital and interest) due on October 28. The Treasury Department was emphatic in the communiqué accompanying the new measure, noting that it "*prevents PDVSA from using sanctions as a pretext to default on debt without consequences*" and that "*it maintains the pressure of the sanctions where it corresponds. - in the Maduro regime*."

In the political front, the most noteworthy development was an almost total withdrawal of the opposition coalition, lingering without a defined position after the re-election of Maduro in the controversial elections held in May. It transpired that Henrique Capriles is considering joining the ***Concertación para el Cambio***, a bloc led by Henri Falcón that will advocate reestablishing dialogue with the government. In parallel, the opposition parties PJ, VP, Vente and a faction of AD seek to reestablish an opposition alliance that would be linked to the civil movements encompassed by the ***Frente Amplio***. In any case, the opposition remains divided and does not represent a significant obstacle for the Maduro government.

A growing threat to stability in Miraflores lies in the increasingly large divisions between the *'original'* Chavistas (Diosdado Cabello, Francisco Ameliach, Adán Chávez, Jesús Faría, among other PSUV cadres) and the new elite, led by Maduro, Cilia Flores and the Rodríguez brothers, and represented by the nascent political party ***Somos Venezuela***). The analyst consensus points out that the economic paralysis in past years could be partially explained by the constant differences between both sides, and that the measures announced by Maduro for August represent a concession to the PSUV faction, since they respond to recent calls from the "traditional" wing of Chavismo for a reform of the exchange regime. However, political instability in the country persists - manifested in events such as the alleged assassination attempt, perpetrated this Saturday – and all signs suggest it's set to worsen in the coming months

Monthly Performance

Measured by the JPMorgan EMBI+ Venezuela Index, VENZ/PDVSA bonds posted an average positive return of + 0.7% in July 2018 and accumulates a positive year-to-date total return of +8.73%. Losses on VENZ bonds (-0.61% on average), were compensated by a broad-based rally in

PDVSA debt (+2.99% average increase in the month). Carrying over last month's flows, the short end of the Sovereign curve underperformed, with falls of up to -7.2% (VENZ 7% 18). Conversely, PDVSA 20s rose sharply in July (+ 5.08% in the month) and are currently trading at 90% of par value, an all-time high. The marked contrast between the bonds of the Republic and the state oil company due in 2018 suggests that the market is discounting a "selective default" on VENZ debt, while PDVSA holders are betting that the October payment will be made – and if it isn't, a hypothetical liquidation of Citgo's shares collateralizing the bond would compensate the value of their investment to a greater extent. Finally, there is a persistent price differential (of 4 points on average) between the bonds of the Republic and PDVSA of similar coupon and / or term, In the middle and long end of the curves.

Security	29/06/2018	31/07/2018	Total Return	Total Return (2018 YTD)
VENZ 13 5/8 08/15/18	30.15	29.75	-1.23%	-44.13%
VENZ 7 12/01/18	29.40	27.25	-7.22%	-31.58%
VENZ 7 3/4 10/13/19	27.45	27.45	-0.06%	+12.12%
VENZ 6 12/09/20	26.85	26.75	-0.37%	+15.38%
VENZ 12 3/4 08/23/22	28.40	28.45	+0.28%	+6.25%
VENZ 9 05/07/23	27.40	27.15	-0.85%	+20.53%
VENZ 8 1/4 10/13/24	27.40	27.35	-0.23%	+21.50%
VENZ 7.65 04/21/25	27.45	27.15	-1.02%	+22.08%
VENZ 11 3/4 10/21/26	28.60	28.80	+0.66%	+16.64%
VENZ 9 1/4 09/15/27	28.70	28.55	-0.51%	+14.94%
VENZ 9 1/4 05/07/28	27.50	27.30	-0.68%	+22.96%
VENZ 11.95 08/05/31	28.30	28.75	+1.62%	+13.51%
VENZ 9 3/8 01/13/34	29.15	29.15	+0.15%	+15.29%
VENZ 7 03/31/38	27.00	27.25	+0.93%	+21.82%
PDVSA 8 1/2 10/27/20	85.45	89.80	+5.08%	+8.37%
PDVSA 9 11/17/21	24.40	24.65	+1.17%	-17.97%
PDVSA 12 3/4 02/17/22	25.65	26.50	+3.48%	-23.44%
PDVSA 6 05/16/24	21.40	22.25	+3.99%	-6.57%
PDVSA 6 11/15/26	21.45	22.15	+3.14%	-5.72%
PDVSA 5 3/8 04/12/27	22.90	23.55	+2.77%	-6.79%
PDVSA 9 3/4 05/17/35	24.15	24.50	+1.47%	-14.42%
PDVSA 5 1/2 04/12/37	22.75	23.40	+2.82%	-6.64%

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

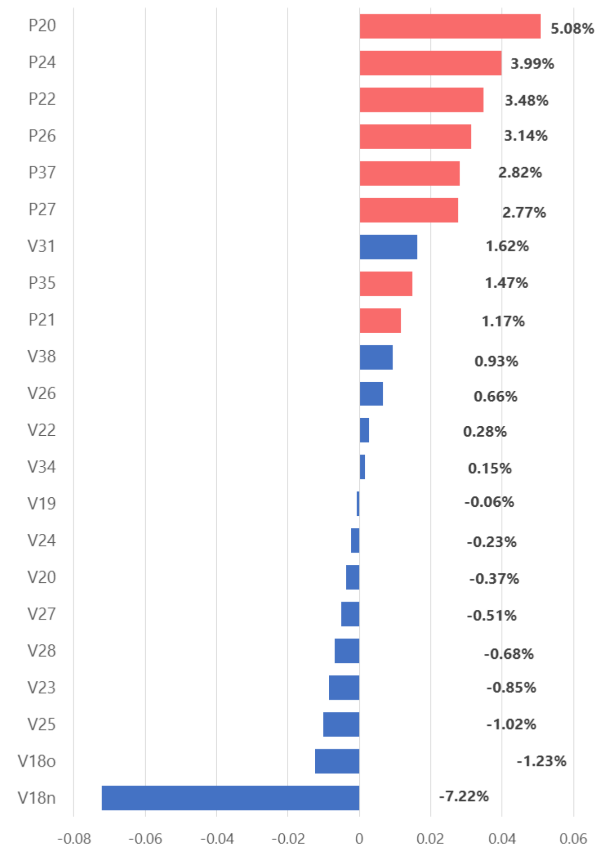
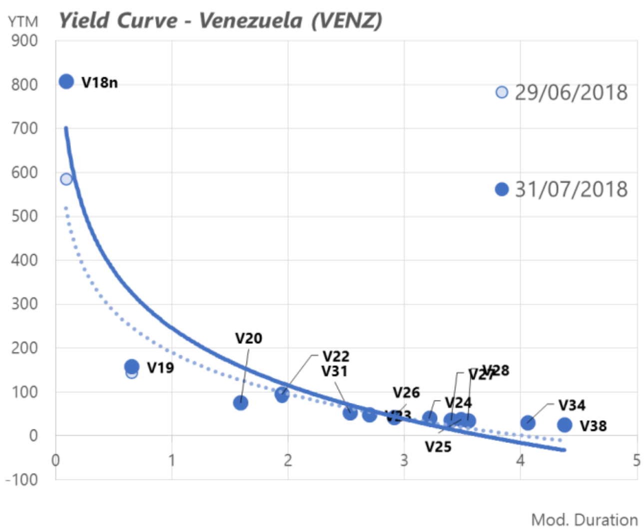


Chart N°2: VENZ/PDVSA bonds by Total Return, July 2018.
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Graphs 3 and 4 show the evolution of the yield curves of Venezuela and PDVSA bonds in July 2018. VENZ 2018 bonds due on August 15 were removed from the curve, currently trading at an annualized yield of 6,500% that distorts the sample (and reflects the fact that the market assigns a probability close to zero of the principal payment made on time). The Sovereign continues strongly inverted in the short term (VENZ 7% 18 bonds that mature in December rose +22000bps to yield 807%); in the middle and long end, the curve shifted +295bps upwards on average and all yields increased, except for VENZ 34 (YTM -320bps to 29.42%).

Economic reform: fact or fiction?



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

The PDVSA curve posted a slight shift upwards on average, explained by widening in the medium and long ends (of up to +600bps on PDVSA 21s, which are currently yielding 113%) and tightening in the front end (-325bps to yield 20.99% on PDVSA 20s).

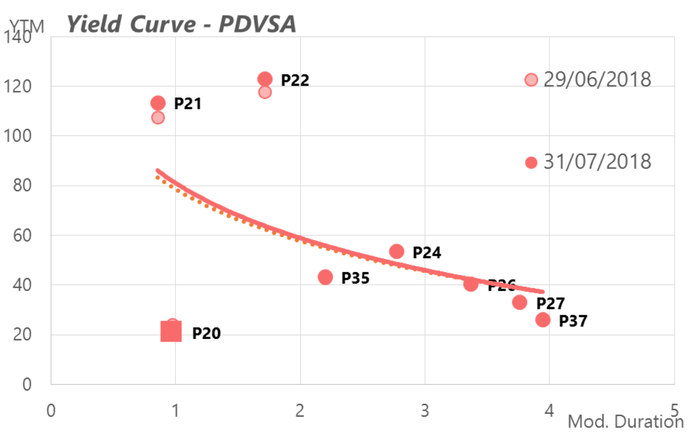


Chart N°4: PDVSA Yield Curve changes, July 2018.
***Source: Bloomberg* CBBT.**

For the first time in more than five years, the Maduro government is signaling a will to pursue economic reform; however, several doubts about the viability of the announced measures linger. We share the market's view that the authorities in Miraflores decided to repeal the previous exchange rate regime as a way to appease their closest detractors - including not only their base of support at PSUV, but also to the governments of Russia and China, whose interests are directly affected by the collapse of the domestic economy. In this sense, everything indicates that a rational policy maker with incentives to stay in power would be committed to a sustainable and realistic stabilization plan. However, we consider a worrisome sign that the ANC (instead of the Central Bank or the Supreme Court) is in charge of reforming the foreign exchange regime; in our view, this suggests that the government seeks private actors to recognize to the ANC as a legitimate public power, an eminently political objective. The no-retroactivity provision on the decree (enabling the executive to prosecute cases of 'foreign-exchange crimes' prior to the repeal of the law) supports this view.

In this sense, we consider there is a high probability that the exchange reform will end up as another failed attempt to stifle the parallel dollar market. The lack of details in the exchange reform is a reflection of the internal disputes of Chavismo, between a faction that advocates a market-based exchange system and seeks the unification of exchange rates (broadly supported by multinational oil companies, which have called for an official mechanism for selling hard currency at a competitive exchange rate to invest in local JVs for several years on end), against another faction that prefers to maintain an overvalued official quote, allowing them to continue capturing rents (through currency arbitrage) at the expense of further aggravating state finances, already enduring a balance of payments crisis. We believe that it is difficult to predict *a priori* the outcome of this dispute, since the supporters of maintaining exchange rate distortions have had the final word in all recent foreign-exchange experiments, but the government's persistent foreign exchange deficit is jeopardizing the viability of the status quo, and stresses the need to reform the current system as a measure of survival of last resort.

On the other hand, the reform proposals do not contemplate the external isolation of the Maduro government, chiefly due to multiple money-laundering investigations linked to Venezuela. The Venezuelan public sector remains blocked by the US Dollar-based financial system. This implies that public banks cannot send nor receive payments in dollars, and also any private entity involved in the new system risks losing their correspondent lines, considering that US-based banks are cutting all exposure to the risk of negotiating - directly or indirectly - with the Maduro government. This aversion has gained strength in recent months, as a result of the operation "*Money Flight*" - led by the US, with collaboration from the European Union - that seeks to dismantle a multinational network of money laundering, and showed signs of complicity on the part of several financial institutions in the US and Switzerland, which enabled the laundering of billions of dollars stolen from PDVSA. As a result, we believe that practically all financial institutions with a global reach, especially in the US and Europe, will now avoid the free flow of hard-currency transactions linked to the Venezuelan government.

A few days before the VENZ 18 maturity, the market is pricing in that the Republic will default on the bond; meanwhile, the holders fine-tune their legal strategy. On August 15, a principal amount of a little over USD 1000 Bn is due on the two issues of VENZ 13.625% 18, a bond issued on identical conditions under two ISIN codes between 1998 and 2001 and lacking Collective Action Clauses. Although the Republic has defaulted on the last coupon payment of this issue, the group of current holders has positioned on the bond with the purpose of collecting full principal payment. In the scenario in which Venezuela defaulted in VENZ 18, the incentives of this group of holders to accelerate increases, since they would stop accruing interest (at least at the current coupon rate) after the maturity date. It should be noted that, unlike the rest of the Republic and PDVSA issues, there are no public ownership records for most of the VENZ 18 issue. This implies that there could be a critical mass of holders (with 25% of the amount in circulation) discreetly positioned on the security and waiting for the statement of non-payment by the fiscal agent to proceed with the corresponding legal actions.

The recent *rally* on PDVSA 20s suggests that the 'call option' on Citgo Holding has repriced higher after the release of the OFAC's new General License; now, a major capacity-to-pay test will come on August 15. The 5-point leg higher in the bonds took place after legal risks dissipated and the hypothetical scenario of collateral execution (subject to PDVSA defaulting on the issue) took renewed strength. This implies that, currently, any US-based entity could purchase the company in an open auction, and we consider highly likely that the foreign investment regulatory authority (CFIUS) will disagree with the sale of Citgo to an offshore company, especially if any links with the Venezuelan government were discovered. In any case, we consider that the sale price of the majority stake on Citgo Holding could approach or equal the current market value of the bonds, given the possibility of a strategic buyer willing to pay at least USD 4-5 billion for the company's equity. A series of US refiners (Valero, Andeavor, Phillips 66, among others) have the resources and the willingness to acquire Citgo's refineries and terminals to exploit synergies in the sector. In another key front, we consider that a 'selective' non-payment on VENZ 18, albeit with significant short-term legal risks, could be a positive sign for PDVSA 20 bondholders, given that it would signal that the Maduro government is fully committed to its strategy of political survival at all costs, which would lead him to make all efforts to secure the capacity to pay the USD 950 MM maturity (principal + interest) due on October 28, and thus postponing the foreclosure of Citgo Holding for another semester.

Credit Research and Strategy
Daniel A. Urdaneta Z.
+56 9 7990 8342
daniel.urdaneta@knossosfunds.com
Knossos Asset Management

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