KNOSSOS ASSET MANAGEMENT

AN AFFILIATED COMPANY OF MIURA

Venezuela/PDVSA Monthly Report
June 2018

Venezuela and PDVSA bonds plunged for a third straight month and finish trading close to all-time lows. An additional month of worsening economic fundamentals, in the context of free-falling oil output alongside the continuation of the political status quo, led most investors to continue liquidating their positions in Venezuelan debt. Of note, most of the fall in bond prices came near the end of the month, contrasting with a sharp rise in crude oil prices in the same period (*See Chart Nº1)*.

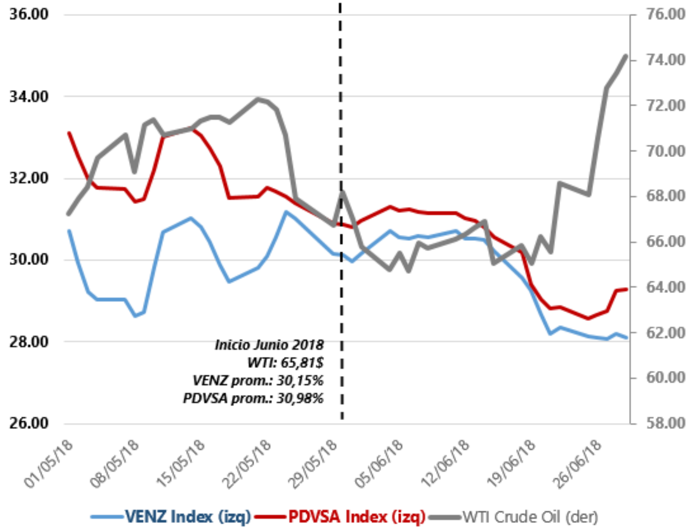

Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (May-Jun 2018). ***Source: Bloomberg BGN, own calculations.***

The total absence of positive willingness-to-pay signs by the Maduro administration has kept fueling market expectations that debt service will continue suspended indefinitely and that there won't be a debt restructuring in the short or medium term. At the end of June, principal and interest amounts in default topped USD 4.26Bn, and all PDVSA and VENZ bonds are in default, save for the PDVSA 20s backed by 50.1% of the equity of Citgo Holding.

As the Venezuelan government keeps accruing days in default, several groups of institutional investors – of different sizes, strategies and time horizons – have been organizing to prepare themselves to enforce their claims through litigation. Three groups were highlighted in the month's newsflow. First, the *Venezuela Creditors Committee*, an organization that includes the most important mutual funds in the world (such as Fidelity, Allianz, BlackRock, among a total of 15 EM-dedicated managers) and owns an aggregate USD 8Bn position value; the Committee hired Millstein & Co. – a law firm specialized in sovereign and corporate restructurings - as advisor. Second, there's a group of holders with a concentrated position in PDVSA 20s, led by British hedge fund manager Ashmore Group (who itself owns at least 15% of the amount outstanding) and advised by White & Case LLP. Lastly, a smaller, unidentified group of hedge funds has established a significant position on VENZ 34s (over the 15% Collective-Action-Clause threshold) and is advised by Robbins, Russell, Englert, Orseck, Untereiner & Sauber LLP. According to the press reports, the group doesn't have a large enough of a stake to accelerate, but it could act as a potential *holdout* investor down the line.

News in PDVSA reflect that the state oil company remains in full-blown crisis mode at the end of June. Except for a single marginally-positive event (the Petropiar crude oil improver, processing 210,000 b/d, was reactivated by Chevron after a month of maintenance), everything else indicates that output and cash-generating exports have fallen further. According to OPEC figures, production plunged to 1.39m b/d (versus 1.53m b/d reported by the nation's Oil ministry). However, the biggest negative effect expected by analysts has not yet been accounted for: the suspension of exports through the Isla refinery in Curaçao (caused by the seizure of the refinery by ConocoPhillips at the beginning of the month) still persists and could imply a drop of up to 200,000 b / d in the next production figure, to be published by OPEC on July 11.

Finally, international pressure against the Maduro government continues to increase. The European Union established an asset freeze and the prohibition of entry into the common area to eleven Venezuelan government officials, including Vice President Delcy Rodríguez. In parallel, both the UN and the OAS presented reports detailing evidence of systematic human rights violations in Venezuela in the period 2014-2017; both reports have been sent to the International Criminal Court. Despite the support of several countries in the hemisphere to proceed with the investigation, the case is currently under "preliminary examination," so that there is still no certainty that a trial will be launched for crimes against humanity against the government of Maduro.

Monthly Performance

Venezuela and PDVSA bonds posted an average -6.5% loss in June 2018, amassing three straight months of declines. On average, VENZ (-6.8%) underperformed PDVSA (-6%). The hardest-hit bonds were in the short end of the

Sovereign curve, with falls of up to -12.7% (VENZ 13.625% 18). On the other hand, the PDVSA 20s went up slightly (+0.5% in June) with the characteristic lower price volatility versus the unsecured debt. In general, we note that PDVSA unsecured bonds are trading at levels closer to the all-time lows recorded in Q4 2017 (after the infamous 'restructuring and refinancing of external debt' announcement by Maduro), while VENZ bonds are trading 3 to 5 points higher than similar maturity/coupon PDVSA securities.

Security	31/05/2018	29/06/2018	Total Return	Total Return (2018 YTD)
VENZ 13 5/8 08/15/18	34.50	30.15	-12.69%	-43.28%
VENZ 7 12/01/18	33.00	29.40	-10.98%	-26.10%
VENZ 7 3/4 10/13/19	29.00	27.45	-5.27%	+12.20%
VENZ 6 12/09/20	28.85	26.85	-6.88%	+15.82%
VENZ 12 3/4 08/23/22	30.20	28.40	-6.06%	+5.89%
VENZ 9 05/07/23	29.15	27.40	-6.00%	+21.62%
VENZ 8 1/4 10/13/24	29.15	27.40	-6.00%	+21.81%
VENZ 7.65 04/21/25	28.75	27.45	-4.53%	+23.42%
VENZ 11 3/4 10/21/26	30.25	28.60	-5.45%	+15.79%
VENZ 9 1/4 09/15/27	29.80	28.70	-3.80%	+15.60%
VENZ 9 1/4 05/07/28	29.15	27.50	-5.72%	+23.85%
VENZ 11.95 08/05/31	30.15	28.30	-6.21%	+11.31%
VENZ 9 3/8 01/13/34	31.20	29.15	-6.68%	+15.08%
VENZ 7 03/31/38	29.60	27.00	-8.84%	+20.63%
PDVSA 8 1/2 10/27/20	85.00	85.45	+0.51%	+3.04%
PDVSA 9 11/17/21	26.60	24.40	-8.30%	-18.97%
PDVSA 12 3/4 02/17/22	27.50	25.65	-6.87%	-26.61%
PDVSA 6 05/16/24	23.05	21.40	-7.12%	-10.30%
PDVSA 6 11/15/26	22.95	21.45	-6.40%	-8.71%
PDVSA 5 3/8 04/12/27	24.35	22.90	-5.88%	-9.45%
PDVSA 9 3/4 05/17/35	26.30	24.15	-8.30%	-15.74%
PDVSA 5 1/2 04/12/37	24.15	22.75	-5.80%	-9.36%

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

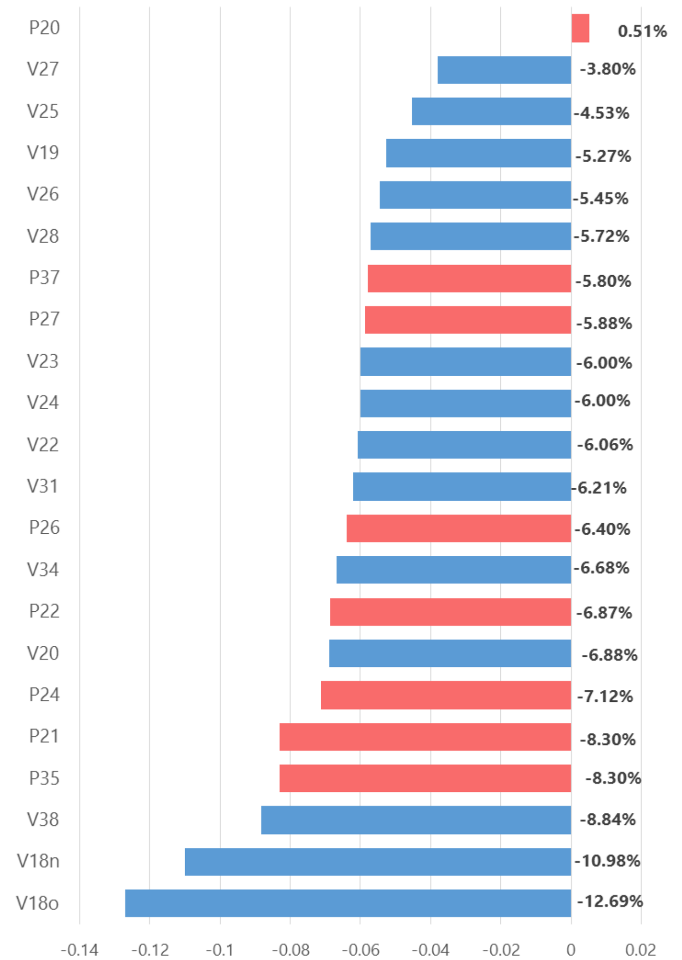

Chart N°2: VENZ/PDVSA bonds by Total Return, June 2018.
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Graphs 3 and 4 show the evolution of the yield curves of Venezuela and PDVSA bonds in June 2018. The Sovereign curve continues to invert further, as VENZ 18 approaches its maturity date trading at 30 cents on the dollar (an annualized yield of almost 2000%); even though the pricing suggests that the market assigns a near-zero probability that the bond principal will be paid back at maturity, it should be noted that this security has no Collective Action Clauses, implying a superior bargaining power vis-à-vis the rest of the curve in a principal default scenario in August. Excluding the VENZ 18, the curve shifted up by + 450bps and all individual yields rose (from +195bps on VENZ 25s, up to +1790bps on VENZ 19s).

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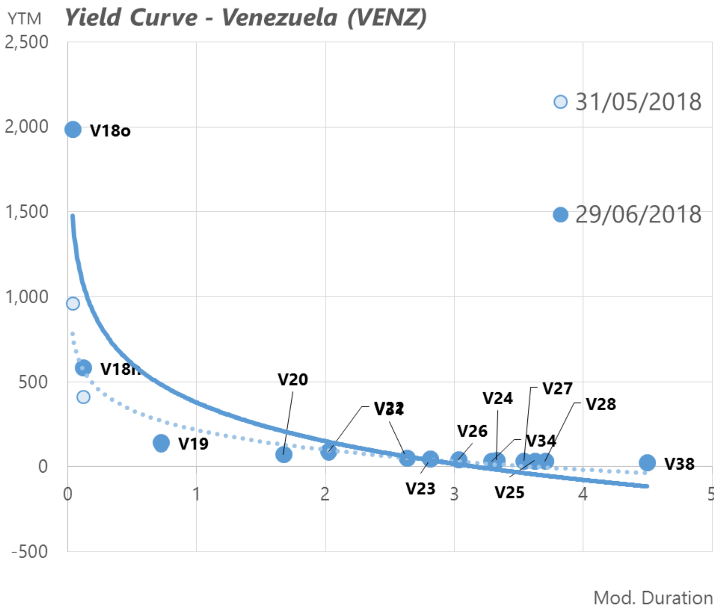

Graph N°3: Venezuela Yield curve changes, June 2018.
Source: Bloomberg CBBT.

The PDVSA curve had a parallel shift upward in June, with yields rising + 575bps on average and intermediate tenors underperforming (PDVSA 21s went up +1400bps to yield 107%; PDVSA 22 +1530bps to yield 118%). PDVSA 20s posted the smallest rise in yields (+120bps to yield 24.23% at the end of June), as the pull-to-par effect more than offset the slightly higher closing price. The next maturity on the 20s is due on October 28th, for approximately USD 950m between principal and interest.

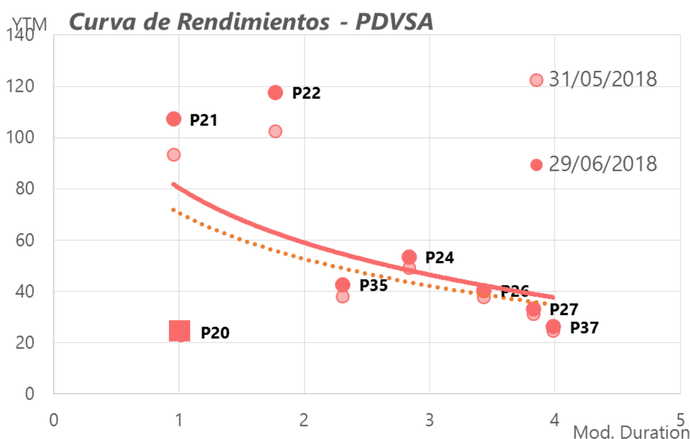

Chart N°4: PDVSA Yield Curve changes, June 2018.
***Source: Bloomberg* CBBT.**

Paralysis meets Hyperinflation

Venezuela finishes the first half of 2018 amidst an unprecedented political and economic crisis. In what is perhaps the most striking development of the year, the Maduro government seems to be stronger than ever as a result of strong repression against dissidents in the army, the neutralization of all opposition parties and civil, and the recent victory in the presidential elections of May 20, which sent a clear sign of the government's domination of Venezuelan society at all levels. However, this domination has been achieved in the context of ever-accelerating inflation and a crisis in the oil sector that represents a growing threat against the viability of the *status quo*. Either because of disputes between the groups of power or because of the inability to understand the seriousness of the situation, the government has not taken a single, weighty economic measure throughout the year.

The total incapacity of Maduro's team has been demonstrated by the abandonment of all their attempts to conduct economic policy. The Petro issuance was unfeasible since its creation (as a result of the collapse in the global cryptocurrency market and the US-led sanctions that prohibited its sale in public exchanges). The restoration of the DICOM system has been a total failure in practice: only USD 200,000 was allocated in the last auction of June at an exchange rate of VEF 96,000, with no visible impact on the domestic economy and/or the foreign exchange market. The monetary reconversion (to the Sovereign Bolivar, initially scheduled for June 4) was postponed for two months, amid a generalized collapse in the nation's payments system. Lastly, the country's main exchange houses have recently offered to pay up to VEF 2.2 MM per dollar to receive remittances from abroad, which represents an attempt to establish a legal exchange parity closer to the parallel rate and generate tax revenues in foreign currency in this way. However, the measure has been implemented poorly and parity has lagged behind the market from the start, so this mechanism of remittances has not been relevant in practice.

The operational crisis in PDVSA is leading, in our view, to a permanent negative impact on Venezuela's oil exports. In addition to the obvious fact that PDVSA has been unable to increase its operating profits in line with the rise in oil prices, active oil rigs have fallen by 44% year-to-date – from 50 at the end of 2017 to 28 in May 2018, according to figures released by Baker Hughes. The costs of reactivating these wells are high enough to make economically unviable to start them up again at oil prices below current levels. In addition, capital investments needed to recover the refining infrastructure and to barely return to past decade's output levels are in the order of USD 60 billion, and there are no incentives for the private sector to undertake these investments. In this context, and according to rumors that have circulated in the market during the last months, PDVSA would be looking to maintain its viability through a desperate measure: cede the operational and financial control of most of the company to Russia and China under the figure of investments in joint ventures and "cooperation agreements". These measures may not be sufficient, however, if the chronic problems of corruption and lack of human capital in the company remain unattended, as seems to be the case.

The capacity to pay the upcoming PDVSA 20 maturity is severely compromised and the strategies of previous maturities may not be available at this time. The Republic does not have free sources of financing to meet the commitment; in addition, all savings generated by import cuts and the default on unsecured bonds has been counteracted by the fall in cash-generating oil exports. There is also no possibility of a swap of these maturities (as was the case of the PDVSA 17s in October 2016, which led to the issuance of the 20s). Notably, rumors in recent months that a European commodities trader (Arcadia) would be interested in organizing a refinancing of collateralized debt with Citgo Holding's equity have not resulted in concrete steps, which we attribute to US sanctions that bar Venezuela from issuing new debt securities.

The organization of several creditor groups against the Republic and PDVSA, with mutually exclusive interests, augurs a messy litigation down the road. We consider that there are three adversaries in the contest that would take place in the context of a hypothetical restructuring process: the ***traditional mutual funds***, which invest in unsecured debt and are in favor of a treatment that is equitable for all creditors of the same rank, without distinction between bonds of the Republic or PDVSA; the ***Citgo-bullish funds*****,** betting on the PDVSA 20 and speculating that the state oil company will service the principal payment at all costs, but at the same time with high incentives to execute the collateral pledge; and the ***vulture funds***, which are betting on a concentrated position in an issue without CACs (with preference for VENZ 18 and 27 due to their legal characteristics, but also in securities such as VENZ 34) and to litigate for the full principal value at the time of getting paid, regardless of a relatively long time horizon and the uncertainty associated with its strategy. Time will tell which of these strategies will be successful, but a priori we can identify a fundamental conflict in their perspectives: the first group considers that the debt must be restructured; the second group argues that the government will pay the debt because it is incentivized to do so; and the third group will actively sabotage any attempt to restructure the debt, as well as litigate aggressively, once the Republic falls into default with the capital of VENZ 18 owed in August (before the PDVSA 20 maturity).

The growing external isolation of the Maduro government implies that a resolution on the external debt default is increasingly far out in the future. Mainly due to the sanctions regime led by the US and EU, the Venezuelan government has largely cut off its economic ties with the Western world. Under this hypothesis, the decision to stop paying the bonds and indefinitely postpone a restructuring of their commitments represents the government's best response, and will continue to be so long as Maduro is able to cover the growing fiscal and external gap with a combination of money printing and private loans with Russia and China, which have taken the form of direct investment in the oil industry to avoid a direct conflict with sanctions. Given the lack of positive catalysts for bondholders in terms of a speedy restructuring process, we reiterate our opinion that debt prices - and their Recovery Values - will continue to fall in the coming months.

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