# *Venezuela/PDVSA Monthly Report*
## *June 2017*

Venezuela and PDVSA bond prices fell sharply in June, making new year-to-date lows alongside the bear market in crude oil (*See Chart N° 1 attached)*. The negative sentiment was felt all across the curve, without distinctions with regards to seniority or potential pull-to-par on the shortest tenors. Of concern for market watchers, trading activity was substantially diminished during the month and there were only two sessions in June with over USD 100mm face value worth of trades in PDVSA bonds reported to Finra's TRACE platform. Overall, investors backed away from the market due to the lack of clarity on the country's political and economic situation, in contrast with buying interest brought by regime-change bets in the previous two months.

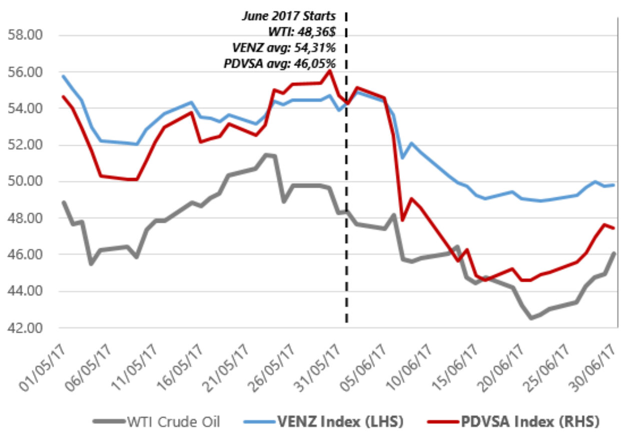



**Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (May-Jun 2017).** ***Source: Bloomberg BGN, own calculations.***

Three negative drivers drove the month's price action. First, the disappointment in the oil market after three straight weekly buildups in US crude inventories, leading WTI futures to trade briefly below 43$/bbl. Second, the Government decided to probe the market with a possible sale of the infamous VENZ 2036, a USD 5Bn bond issued at the end of last year under opaque terms, for which investors didn't show much interest, even at steep discounts to par value. Finally, the controversy regarding the nation's external debt commitments aggravated after reports of an alleged default in a bilateral loan with the Russian government hit the tape; the ISDA's determinations committee, however, ruled out it was not a credit event, and CDS contracts were not triggered. The situation worsened after a sentence in US courts that would enable Crystallex to go after the assets held by the Republic in the US (Including PDVSA Holding) once a final award is granted on the USD 1.2Bn claim brought forward by the Canadian mining company against Venezuela for the expropriation of their operations in 2008.

Bond prices bounced slightly in the last week of June, bolstered by seven straight days of advances in oil prices and dealer short-covering. Right after the end of the month, another headline took the market by surprise; Goldman Sachs Asset Management (GSAM) sold a part of its 2.8Bn position in PDVSA 6% 2022 bonds in the secondary market through Liquidity Finance LP, a boutique brokerage house. The trades were done at prices between 33% and 34%, slightly above GSAM's cost price of 31%, but substantially below the market price of comparable PDVSA securities in circulation.

### *Monthly Performance*

| Security | 31/05/2017 | 30/06/2017 | Total Return | Total Return (2017 YTD) |
|---|---|---|---|---|
| VENZ 13 5/8 08/15/18 | 78.50 | 75.90 | -1.80% | -0.30% |
| VENZ 7 12/01/18 | 67.75 | 64.65 | -3.73% | +5.81% |
| VENZ 7 3/4 10/13/19 | 56.15 | 51.25 | -7.41% | -0.62% |
| VENZ 6 12/09/20 | 50.65 | 45.40 | -8.91% | +0.58% |
| VENZ 12 3/4 08/23/22 | 60.30 | 54.00 | -8.17% | -2.37% |
| VENZ 9 05/07/23 | 50.00 | 44.75 | -8.89% | +2.71% |
| VENZ 8 1/4 10/13/24 | 47.50 | 43.50 | -6.76% | +2.55% |
| VENZ 7.65 04/21/25 | 46.30 | 42.90 | -5.85% | +3.14% |
| VENZ 11 3/4 10/21/26 | 55.95 | 52.00 | -5.19% | +2.44% |
| VENZ 9 1/4 09/15/27 | 53.05 | 50.25 | -3.72% | +5.82% |
| VENZ 9 1/4 05/07/28 | 48.45 | 44.65 | -6.22% | +3.90% |
| VENZ 11.95 08/05/31 | 55.15 | 50.75 | -5.78% | +0.59% |
| VENZ 9 3/8 01/13/34 | 48.25 | 45.25 | -4.27% | +4.50% |
| VENZ 7 03/31/38 | 44.55 | 42.15 | -4.01% | +4.65% |
| PDVSA 8 1/2 11/02/17 | 91.20 | 87.20 | -3.57% | +14.36% |
| PDVSA 8 1/2 10/27/20 | 77.95 | 72.00 | -6.69% | +3.30% |
| PDVSA 9 11/17/21 | 53.40 | 48.70 | -7.35% | +0.25% |
| PDVSA 12 3/4 02/17/22 | 61.25 | 55.85 | -6.67% | +0.87% |
| PDVSA 6 05/16/24 | 39.70 | 37.55 | -4.19% | +3.44% |
| PDVSA 6 11/15/26 | 38.65 | 36.90 | -3.15% | +3.85% |
| PDVSA 5 3/8 04/12/27 | 38.55 | 36.20 | -4.89% | +2.21% |
| PDVSA 9 3/4 05/17/35 | 49.45 | 46.20 | -4.93% | +4.78% |
| PDVSA 5 1/2 04/12/37 | 38.50 | 35.80 | -5.73% | +2.62% |

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

Venezuela and PDVSA bond prices fell by -6.9% in June on average, and amassed a negative -5.6% return including interest. The limited trading activity registered in the month concentrated in a price-compression trade (demand for low-dollar-value bonds versus supply on high-priced bonds). The pull-to-par in the short end of the PDVSA curve buckled under strong selling pressure and increased risk of a credit event in the short term, measured by CDS-implied default probabilities. Medium-term Venezuelan bonds underperformed, in line with the increasingly negative market perception with regards to the Republic's capacity to pay and recovery values.

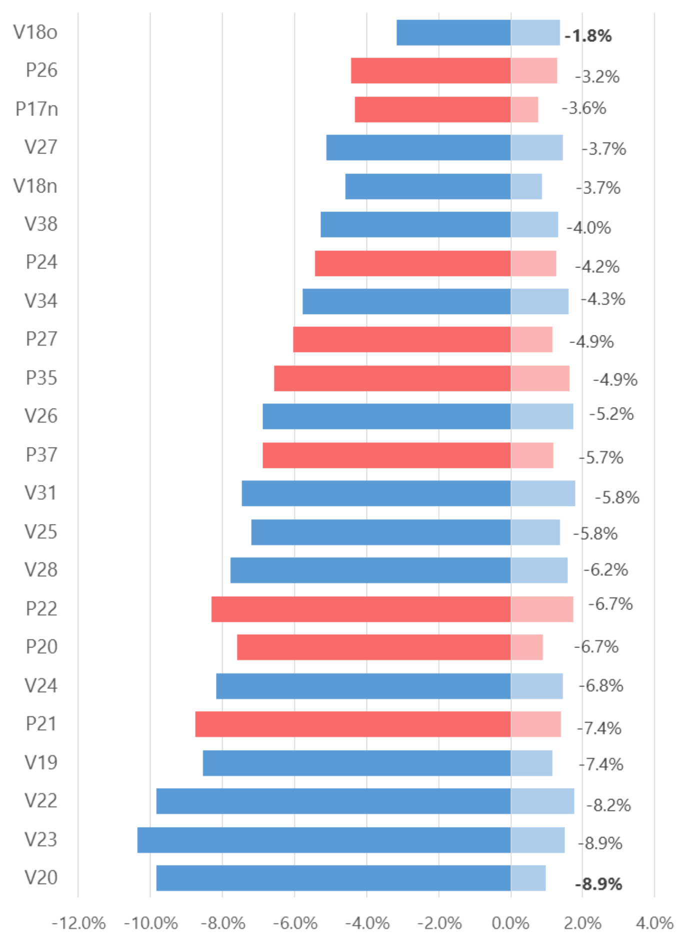
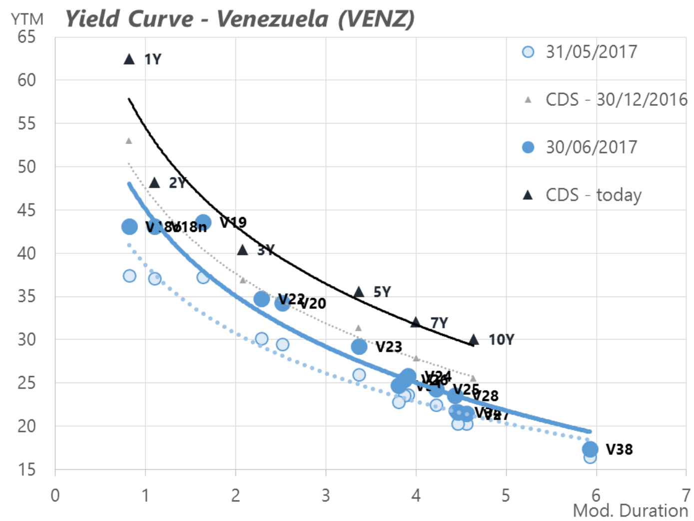



**Chart N°2: VENZ/PDVSA bonds by Total Return, June 2017.**
**NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment**
***Source: Bloomberg, Knossos Asset Management.***

### *Evolution of the curves*

Charts N°3 and N°4 attached show the evolution of Venezuela and PDVSA's yield curves on June 2017, for both cash bonds and CDS. The Sovereign curve further inverted, following through on May's bear-flattening move; yields went up by +315bps on average, with hikes above 600bps in the short end of the curve.




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

The PDVSA yield curve inverted even more aggressively, especially for the Q4 2017 maturities. Yields on PDVSA 2017n bonds went up by +2150bps in June; PDVSA 2020's yields jumped +710bps, to a new all-time high of 31.80%. On average, yields went up by over +500bps throughout the cash bonds curve. We highlight that, based on current CDS prices, the market is pricing in a 63% probability of PDVSA failing to keep up with debt payments in the following 12 months.

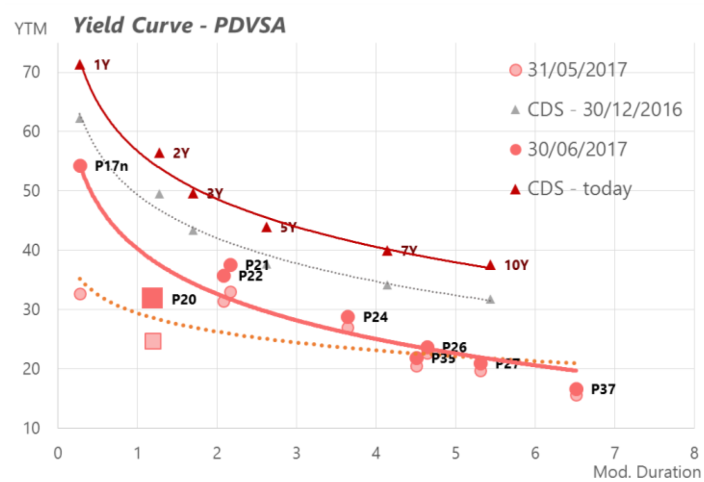



**Chart N°4: PDVSA Yield Curve changes, June 2017.**
***Source: Bloomberg* CBBT.**

### *Lack of visibility and illiquidity hurts the market*

**After three months of protests against Maduro's government, the constitutional crisis keeps on escalating every day.** The death toll surpassed 80 victims at the national level and in response, the international community continues to close ranks against the ruling party. US Secretary of State Rex Tillerson even suggested that the Trump administration was considering industry-wide sanctions against the Venezuelan oil sector, in case Maduro keeps on with his plans to impose a National Constituent Assembly (ANC, by its Spanish acronym) against popular vote. The government's response has consisted on increasing hostility in its rhetoric and escalating repression against peaceful protesters, as well as incarcerating Roberto Picón and Arístides Moreno, key operating managers of the opposition movement.

**Meanwhile, the government's resilience facing the protests is leading investors to question the possibility of regime change in the short term.** Several analysts echoed the opinion - increasingly prevalent among investors - that the ruling party won't back down in establishing the ANC, with little regards for its legality or democratic legitimacy. There's a fear that Maduro plans to dissolve all dissenting public powers and plans to perpetuate itself in power through a structure that would enjoy unlimited power over the country and could get rid of any future democratic election. The lack of precision in the constitution regarding the ANC's terms and conditions suggests that arriving at such a scenario is very likely, as the Supreme Court has proven its capacity to interpret the Venezuelan jurisprudence at the convenience of the Maduro government.

**The timing of debt payments plays in favor of the government's plans; however, the pace of asset depletion and opacity in official statistics suggests that the credit outlook is extremely dire.** Coincidentally, the riskiest political play in the history of Chavismo has coincided with the mildest stretch of the year in the country's external debt service schedule. There's only one payment due in July: USD 70m on the coupon of VENZ 2034s. Nevertheless, the sharp fall in oil prices so far in 2017 has widened the external deficit (As a reference, we estimated an annualized -12Bn gap in the balance of payments @40$/bbl oil, the latest closing price of the Venezuelan basket). This situation has forced the Republic to hasten the sale of its inventory of liquid assets. Measures deemed as of last resort by the market, such as the controversial GSAM bond sale of last month, have already been tapped. In contrast, other options anticipated first by analysts (such as the sale of collateralization of monetary gold reserves) haven't materialized, which has contributed to a relative stability in the International Reserves balance, which has stood slightly above USD 10Bn during most of the year. There's concern about the reasons behind the steadiness, as a possible *covenant* embedded in the bilateral financing agreements subscribed between Venezuela and its strategic allies could bind the nation to hold a minimum Reserves level of USD 10Bn, under penalty of defaulting in the contract. These types of risks underline an additional difficulty in the analysis of Venezuelan debt: there's no clarity or certainty with regards to the real situation in the Republic's external accounts.

**In this context, we consider that the best opportunities within the curve, after the correction in June, reside on the PDVSA 2020.** The bond is trading at all-time-highs in yield and spread after its -6.7% fall last month. It's worth pointing out, though, that its recent weakness is associated with the increased legal risks regarding the execution of the bond's collateral in case of a credit event, mainly due to the latest judicial rulings in favor of Crystallex. The case has significant implications for the valuation of the collateral and requires a constant revision by dedicated investors. In other respect, **there is a positive scenario for the PDVSA 2020s in which the bond would have preferential treatment in a scenario of preemptive external debt restructuring.** Assuming that a new incoming government counts with the support of multilateral lenders to finance a broad macroeconomic stabilization program and understands the strategic relevance of Citgo in PDVSA's operations, it would be inclined to unwind the lien on Citgo Holding's equity shares. This could be achieved through a tender offer for the entire amount outstanding of the bond at an attractive price, or in an extreme case (even more positive for bondholders) through a '*Make-whole call*' provision allowed under the bond's prospectus. These operations would be rational for the issuer after the first amortization (due in October of the current year), from which the book value of the collateral would surpass the amount outstanding due in the bond. The persistent weakness in the PDVSA 2020s, despite the late bounce in crude oil prices, suggests that market expectations aren't particularly optimistic with respect to the possibility of a scenario along these lines.

### *Disclosure concerning 'Debt Research Reports'*