Venezuela/PDVSA Monthly Report
March 2017

Venezuela and PDVSA bonds finished March with the worst monthly returns since October 2016. Among the reasons behind the performance, oil prices fell over 10% at the beginning of the month, alongside some operational mishaps in PDVSA refineries and reports of the upcoming exit of CEO Eulogio Del Pino from the state oil company. The negative sentiment transformed into panic during the last session of the month, when bonds fell as much as 4 points in the midst of a climate of uncertainty regarding PDVSA's capacity and willingness to pay the USD 2.1 Bn maturity due in April 12th (*See Chart N°1 attached*). The market rout worsened after the surprise decision of the Supreme Court of invalidating the National Assembly and stripping opposition MPs from their parliamentary immunity.

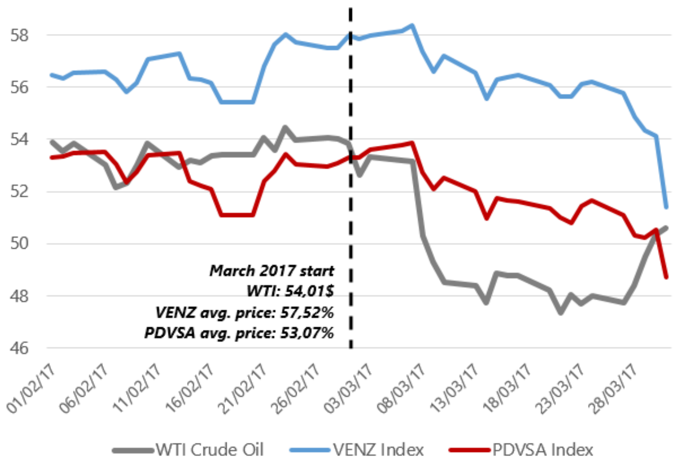


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Feb-Mar 2017). *Source: Bloomberg BGN, own calculations.*

Even though all bonds posted negative returns in March, the biggest losses concentrated in the intermediate tenors (2019-2022), the bonds most affected by the change in investor sentiment and the negative implications of lower oil prices. It is worth mentioning that trading volumes sharply increased in the last days of the month as the selloff accelerated. In fact, according to FINRA's TRACE service, the busiest day in all of 2017 took place on Friday March 31, where an estimated USD 401 mm face value worth of bonds changed hands.

Notwithstanding the recent fall in oil prices, the external backdrop remains supportive for emerging market debt investments. Stimulated by the recent upside surprise in global macroeconomic data, EM fixed income funds totaled around USD 8.5 Bn worth of inflows in March and a cumulative inflow of USD 18.5 Bn in 2017 year-to-date, which suggests that the asset class remains in demand. Additionally, investors are expecting maturities in the EM high yield space for USD 12 BN next quarter. The resulting supply/demand imbalance could lead to a further compression in risk premiums in the sector in the short term.

Monthly Performance

Security	28/02/2017	31/03/2017	Total Return	Total Return (2017 YTD)
VENZ 13 5/8 08/15/18	89.95	**84.60**	-4.61%	+5.47%
VENZ 7 12/01/18	72.80	**69.80**	-3.27%	+10.92%
VENZ 7 3/4 10/13/19	65.70	**56.75**	-12.00%	+5.44%
VENZ 6 12/09/20	55.60	**49.95**	-8.99%	+6.81%
VENZ 12 3/4 08/23/22	68.75	**59.05**	-12.44%	+0.13%
VENZ 9 05/07/23	52.85	**46.80**	-9.48%	+2.06%
VENZ 8 1/4 10/13/24	48.50	**43.75**	-7.85%	-1.39%
VENZ 7.65 04/21/25	47.40	**42.50**	-8.49%	-1.92%
VENZ 11 3/4 10/21/26	59.20	**53.40**	-7.52%	-0.45%
VENZ 9 1/4 09/15/27	52.65	**46.70**	-9.01%	-5.05%
VENZ 9 1/4 05/07/28	48.70	**43.75**	-8.07%	-2.87%
VENZ 11.95 08/05/31	59.10	**53.05**	-8.34%	-0.81%
VENZ 9 3/8 01/13/34	49.75	**43.90**	-9.84%	-2.74%
VENZ 7 03/31/38	45.15	**40.60**	-8.23%	-2.76%
PDVSA 5 1/4 04/12/17	95.95	**95.10**	-0.39%	+7.62%
PDVSA 8 1/2 11/02/17	87.20	**84.20**	-2.49%	+7.96%
PDVSA 8 1/2 10/27/20	81.10	**74.30**	-7.22%	+3.43%
PDVSA 9 11/17/21	57.25	**48.50**	-13.35%	-4.46%
PDVSA 12 3/4 02/17/22	67.50	**56.95**	-13.90%	-2.53%
PDVSA 6 05/16/24	39.95	**36.85**	-6.17%	-2.15%
PDVSA 6 11/15/26	37.75	**35.15**	-5.26%	-4.61%
PDVSA 5 3/8 04/12/27	36.80	**34.50**	-4.71%	-5.58%
PDVSA 9 3/4 05/17/35	49.75	**43.70**	-9.95%	-5.30%
PDVSA 5 1/2 04/12/37	36.50	**34.00**	-5.14%	-5.58%

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

Venezuela and PDVSA bonds fell by -9% on average and delivered an average -7.8% total return including interest in March. PDVSA bonds due in 2017 were the most resilient, while intermediate-term bonds (2019-2022) had double-digit negative returns and practically erased their year-to-date gains. Low-dollar value bonds stood in the middle of the pack, losing around -5% on average in the month (*See Chart N° 3 for the full rankings*).

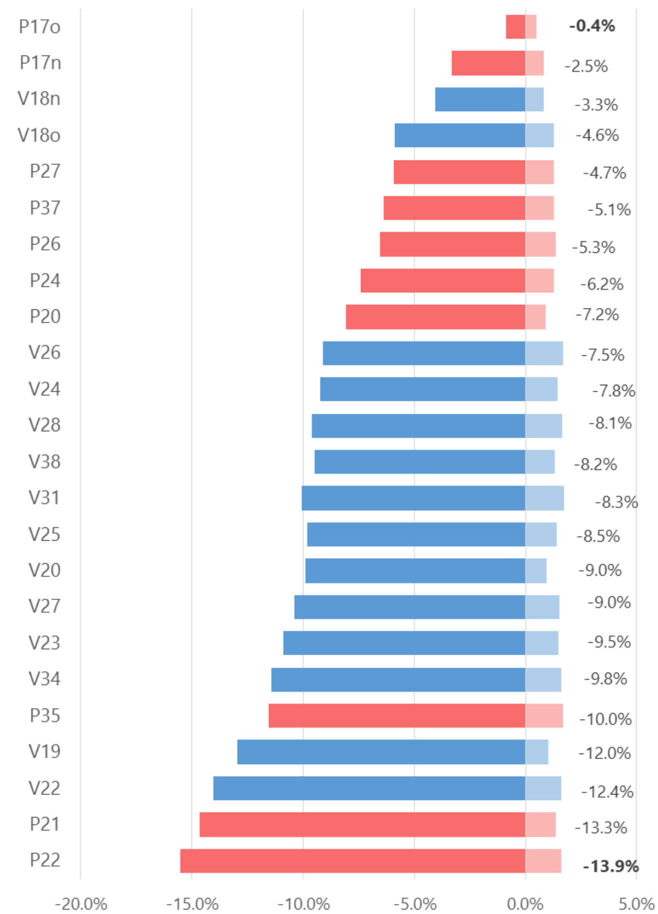
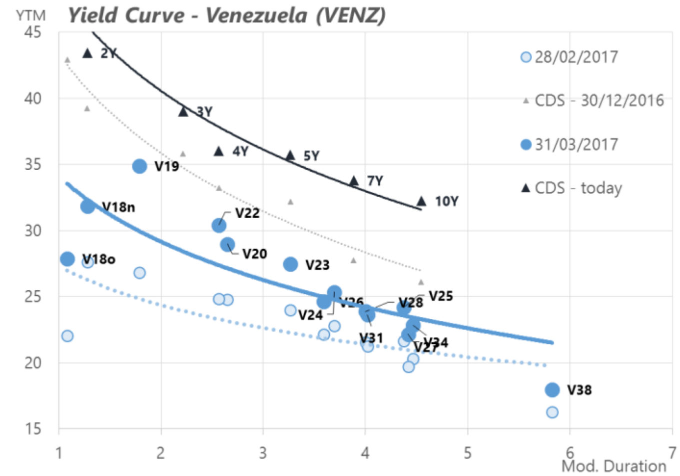


Chart N°3: VENZ/PDVSA bonds by Total Return, March 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

The following charts (*N° 4 and 5*) show the evolution of Venezuela and PDVSA yield curves in February 2017, both for cash bonds and CDS. The Venezuela curve suffered a parallel upward shift (+360bps on average). VENZ 2019 had the sharpest rise in yield (+805bps).



Graph N°4: Venezuela Yield curve changes, March 2017.
Source: Bloomberg CBBT.

The PDVSA curve, on the other hand, inverted massively due to the yield on PDVSA 5,25% 2017 "olds" increasing to an all-time high level of 230% (as the bond continues to trade below par within a few days of its maturity date). Excluding this outlier, PDVSA yields went up by +450bps on average across the curve.

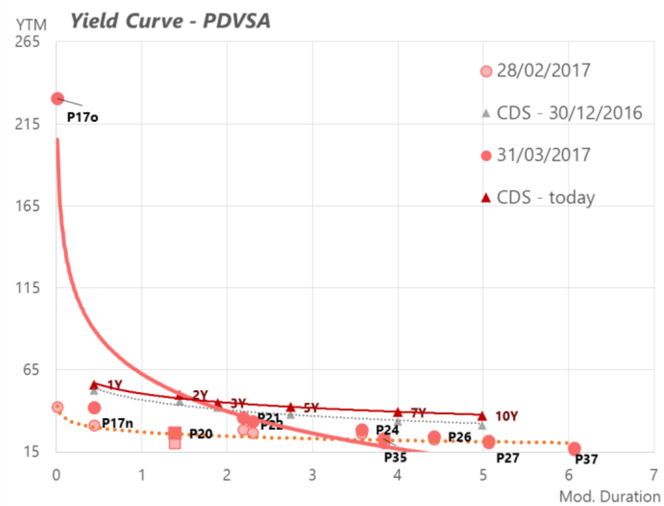


Chart N°5: PDVSA Yield Curve changes, March 2017.
***Source: Bloomberg* CBBT.**

Capacity and willingness to pay, put to the test

Behind the unprecedented Supreme Court ruling lies an increasingly urgent need for external financing. The Judicial power underestimated the international community's reaction against their move and decided to partially reverse its decision (returning the parliamentary immunity to MUD congressmen) but upheld its ruling enabling President Maduro to sign agreements of national interest in the oil & gas sector without explicit parliamentary approval. Press reports during the month suggest PDVSA is seeking a rushed sale of concessions in the Orinoco Belt to its strategic partners with the purpose of raising liquidity needed to meet the April payments without compromising its cash flow for operations and/or food imports for the nation. However, there's uncertainty as to whether the multinationals would be willing to extend financing in the current conditions, given the National Assembly's threat of future repudiation of any public interest operation signed without its authorization.

The analyst consensus (which we share) points to PDVSA having the capacity to service the April 12th maturity. The Maduro administration has followed through with its policy of prioritizing debt payments by further cutting imports, suggesting that its willingness to pay remains intact. On the other hand, there have been rumors about PDVSA trying to source last-minute financing agreements. The latest press reports suggest that Fintech Advisory, a firm specialized in distressed investments, is in talks with BCV to close a USD 500 mm loan. If these rumors are true, we would consider that the quest for financing is a maneuver taken by PDVSA to service the payment without assistance from the Central Bank's Reserves (which stand at USD 10.39 Bn at the end of March). If a fall in Reserves after April 12nd does materialize, it would call into question the true external liquidity position of the Republic, and we would consider this a potential negative catalyst for bond prices.

Due to the aforementioned reasons, we consider that a sudden change in willingness to pay is the biggest risk in the short term and the main reason behind the recent weakness in the credit. We assume that the government is periodically reviewing its priorities regarding uses of external liquidity and it is reasonable to expect that Maduro would seek advisory with ideologically-aligned professionals (such as Alfredo Serrano or the American economist Michael Hudson, mentioned by Maduro himself during a live broadcast in the middle of the month) when it comes to taking a decision regarding its external commitments. Considering the increasing political cost of continuing debt service at the expense of draconian import cuts, the strategy of *'willingness to pay at all costs'* is indeed at risk of a sudden ending. **Nonetheless, we consider that a sudden change in willingness to pay lacks strategic sense in the current juncture.** There are no elections in the near future. Besides, neither financial nor legal preparations have been undertaken for a scenario of preemptive non-payment. In addition, government officials have reiterated their willingness to pay on repeated occasions during the past weeks, reinforcing the market's hypothesis that the Republic and PDVSA will continue to pay until they lose the capacity of doing so.

Assuming that PDVSA services the PDVSA 2017 "olds" without further mishaps, there are three arguments to bet on a rebound in bond prices in the following weeks. In the first place, debt service will be significantly lower for the next six months, with no principal payments and interest payments no higher than USD 700 mm per month until the October/November stretch. This would come in hand with a potential reinvestment flow coming from the USD 2.9 Bn between principal and interest payments due in April. Moreover, oil prices have recovered substantially in the last sessions (WTI futures stand around the 51$ mark at the time of writing), supported by a reaffirmation of the OPEC-led policy of output cuts among aligned producers, coupled with signs of a possible supply crunch in the medium term as a consequence of a third straight year of cuts in capital expenditures by multinational energy producers. Ultimately, there is speculation that Eulogio Del Pino would be replaced in the presidency of PDVSA by Nelson Martínez (the current Oil Minister), an oil industry veteran with over 20 years of experience in the sector that, according to our view, might do a better job than Del Pino in terms of supporting domestic oil output.

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